SARB Financial Stability Review

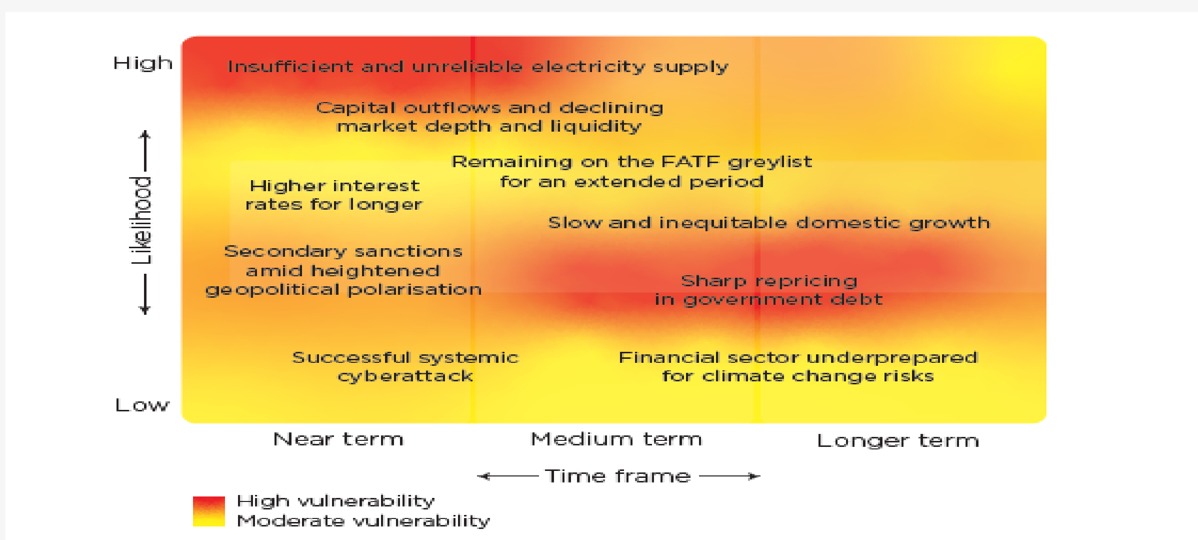
ECONOMICS | SOUTH AFRICA

The SARB highlights sanctions and capital outflows as new risks to the financial system

- The South African Reserve Bank (SARB) published its first edition of the Financial Stability Review (FSR) for 2023 on 29 May. The SARB highlighted nine risks to the financial system, with the risk of US sanctions and the possibility of capital outflows being new additions to the list. If the risk of US sanctions materialises, the SARB warns that this could trigger a financial crisis. Load-shedding also features prominently, with the central bank highlighting, amongst other things, that a worsening in the energy crisis could disturb financial system infrastructure.
- **Global conditions:** According to the SARB, concerns over rapid policy normalisation have materialised, while fears of a global recession continue to linger. Furthermore, systemic risk has increased, mainly due to further global monetary policy tightening, persistently high inflation, concerns over the resilience of the global banking system, volatile financial markets, and weak growth projections for most economies.
- **Domestic conditions:** The SARB states that idiosyncratic factors continued to negatively impact the financial system and overall economic growth prospects. Given its detrimental and widespread ramifications, the electricity crisis is highlighted as the most notable country-specific vulnerability. However, the deteriorating rail and port infrastructure were also flagged as a growing concern.
- **Risks to the domestic financial system:** The main risks to the domestic financial system are outlined in the SARB's Risk and Vulnerability Matrix (RVM). The RVM is meant to be a forward-looking assessment of the key risks to the financial system over the short-, medium-, and long-term. The SARB identified nine risks, seven of which are unchanged from the previous publication. These risks include:

    1. Insufficient and unreliable electricity supply
    2. Sharp repricing in government debt
    3. Higher interest rates for longer
    4. Remaining on the Financial Action Task Force (FATF) greylisting for an extended period
    5. Slow and inequitable domestic growth
    6. Financial sector underprepared for climate change risk
    7. Successful systemic cyberattack
    8. **Capital outflows and declining market depth and liquidity**
    9. **Secondary sanctions amid heightened geopolitical polarisation**

Table 1: Risk and Vulnerability Matrix (RVM)



Source: SARB

Unpacking the new risks to the financial system

Capital outflows and declining market depth and liquidity:

Risks associated with sustained capital outflows, declining market depth and liquidity have been outlined in previous versions of the FSR. This time around, the focus is on how the risk may interact with other vulnerabilities and potentially destabilise the domestic financial system. The SARB states that the recent turmoil in the US banking sector demonstrated how vulnerabilities related to unhedged interest rate risks, concentrated exposures to the sovereign, and an undiversified depositor base may interact to drain liquidity and eventually result in solvency challenges for banks. They add that these risks are not unique to SA, with several emerging markets facing the same challenge. However, domestic factors (e.g., the greylisting by the FATF, electricity supply challenges and political instability) exacerbate these risks. If these concerns were to materialise, the potential consequences include:

- A sustained decrease in the value of South African government bonds held by non-residents, which would cause greater concentration within the domestic financial system.
- Disruption of the government bond market, potentially requiring repeated episodes of support by authorities.
- Less diversified capital markets ecosystem, which reduces the financial system's ability to absorb systemic shocks.
- A decrease in the exchange value of the rand if foreign investor appetite wanes and commodity prices decline.
- A potential interaction with the high exposure of the financial sector to government debt.

Secondary sanctions amid heightened geopolitical polarisation:

A new, but critical, risk identified by the SARB is that of possible direct or indirect sanctions against SA. This risk comes off the back of the US accusations that SA sold arms to Russia in support of the Kremlin's war against Ukraine. The allegations and the SA government's defensive stance have raised concerns about whether the country is genuinely neutral in its position, thus fuelling tensions with the US. The financial stability impact will be significant should this risk materialise. The SARB states that, at worst, it could trigger a systemic event. The potential consequences attached to this risk include:

- A significant disruption to the SA financial system, given that it will not be able to make international payments in USD.
- Loss of correspondent banking relationships and more intensive scrutiny of South African financial institutions by foreign counterparties, even in the absence of formal secondary sanctions.
- A sudden stop to capital inflows and increased outflows.

In addition to the financial stability implications, the trade risks are just as significant given the country's strong links with the US. The US accounts for about 9.7% of the country's total export revenue, while Russia contributes a tiny 0.3%. (*Please see the Nedbank Group Economic Unit's publication on the trade implications*: The cost of the Russia Saga).

Further areas of interest highlighted in the FSR: The financial stability impact of the energy crisis

The publication also includes various short research briefs focusing on current events that could potentially impact the financial system. One such research brief is titled "*The financial stability implications of an insufficient and unreliable electricity supply*". The energy crisis has had a severe impact on the domestic economy, and this was clearly reflected in the contraction in GDP in Q4 2022. However, the FSR shows how detrimental this crisis could be to financial stability if it was to worsen.

According to the SARB, the prevalence of higher stages of load-shedding poses an immediate risk to the efficient functioning of infrastructure such as automated teller machines (ATMs) and cellular networks, which are crucial for the smooth functioning of the financial system. The central bank indicated that an increasing number of insurers could exclude load-shedding related claims from policies as more households and consumers submit such claims. Load-shedding also impacts the structural viability of some municipalities, particularly those in rural areas, given that electricity sales account for the bulk of their revenue. This, in turn, could place further strain on the fiscus and overall service delivery.

The SARB also highlighted the inflationary impact of load-shedding, stating that energy constraints lead to goods shortages, and thereby becomes an active driver of medium-term inflation expectations. As a result, load-shedding slows the disinflationary process, thus contributing to monetary policy and financial conditions remaining restrictive for longer. Lastly, load-shedding negatively impacts investor sentiment and fuels the country's already elevated risk premium.

Other research briefs included:

1. *Establishment of the Corporation for Deposit Insurance*
2. *Implementation of the Resolution Framework*

3. *Risks of secondary sanctions imposed on South Africa*

Policy actions and initiatives undertaken

The SARB undertook the following initiatives and policy actions to enhance and support the financial system over the past six months:

1. The SARB continued to collaborate with Financial Sector Oversight Committee (FSOC) members to address some of the key risks to financial stability (i.e., greylisting by FATF and the possibility of secondary sanctions)

2. The SARB's Financial Stability Committee (FSC) maintained the Countercyclical capital buffer (CCyB) at 0% at its April 2023 meeting.

3. Work continued on the implementation of the resolution and deposit insurance frameworks. The Cooperation for Deposit Insurance (CODI) became a legal entity on 24 March 2023 but will only be fully operational from 1 April 2024. The SARB will become the Resolution Authority for designated institutions on 1 June 2023, when the resolution framework becomes effective.

4. The SARB, through the Financial Sector Contingency Forum (FSCF), continued to plan for the improbable but not impossible scenario of a national electricity grid shutdown. In line with the role and function of the FSCF, current efforts are centred on developing, coordinating, and testing contingency plans to mitigate, to the extent possible, the impact on the financial system and the economy.

5. The FSC continues to assess whether concerns over the sovereign-bank nexus require policy intervention. The PA began introducing measures to manage interest rate risk in the banking book to support bank-based risk assessments relating to assets such as government bonds. Although the FSC did not take any further steps regarding policy action to directly address the sovereign-bank nexus at its meeting in April 2023, developments continue to be monitored closely.

Overall financial system assessment and conclusion

The SARB indicated that systemic risk increased during the review period, mainly due to tight monetary policy, the global bank turmoil, volatile financial markets, and weaker growth prospects. Lingering recession fears and rising geopolitical tensions also contributed to the upside. The FATF decision to grey list the domestic economy as well as the severe energy crisis continued to weigh on the financial sector's resilience. Overall, financial institutions remain resilient and adequately capitalised, with sufficient liquidity buffers to absorb the impact of shocks. The financial system is still resilient despite the global banking sector turmoil and resulting volatility. However, slower unequal growth will likely weigh on the system's resilience beyond the forecast period.

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