POLICY PAPER

Financial Stability Department

South African Reserve Bank

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South African Reserve Bank

Financial Stability Monitoring and Assessment Framework

Key terms

Drawing on the definitions used by the Financial Stability Board (2021), key terms in this document are defined as follows:

Financial sector regulators: As per the Financial Sector Regulation Act 9 of 2017 (FSR Act), (i) the Prudential Authority; (ii) the Financial Sector Conduct Authority; (iii) the National Credit Regulator; and (iv) the Financial Intelligence Centre.

Financial stability: According to section 4 of the FSR Act, financial stability means (i) financial institutions and market infrastructures are capable of providing financial products and financial services and performing their functions and duties in terms of financial sector laws without interruption and despite changes in economic circumstances; and (ii) there is general confidence in the ability of financial institutions and market infrastructures to keep providing the said products and services, and to keep performing their functions and duties. Phrased differently, 'financial stability' refers to a financial system that is resilient to systemic risks and shocks and that can efficiently intermediate funds, even in adverse conditions, thereby bolstering confidence in the financial system and financial institutions. Financial stability is not an end in itself, but a precondition for balanced and sustainable economic growth.

Financial system: The system of institutions and markets through which financial products, financial instruments and financial services are provided and traded, and includes the operation of a market infrastructure and a payment system.

Macroprudential instrument: Any policy instrument, regardless of the institutional authority with whom it vests, that is explicitly applied to (i) mitigate vulnerabilities in the financial system and reduce systemic risk; thereby (ii) improving the resilience of the financial system; in turn ultimately (iii) protecting and enhancing financial stability in South Africa.

Residual/net vulnerability: The remaining vulnerability after considering the identified mitigating factors and actions.

Resilience: The ability of a financial system to deal with shocks without leading to financial instability.

Risk: The possibility of an adverse or undesirable event or outcome materialising. Risks may have materialised already or could still materialise in future. The materialisation of risks can often not be prevented completely, but the impact of a risk materialising may be mitigated to a greater or lesser extent.

Risk and Vulnerability Matrix (RVM): The RVM shows the residual vulnerability of the financial system after considering existing mitigating factors and policy actions.

Shock: An event that may cause disruption to, or the partial failure of, the financial system.

Systemic event: According to the FSR Act, 'an event or circumstance, including one that occurs or arises outside [of] the Republic [of South Africa], that may reasonably be expected to have a substantial adverse effect on the financial system or on economic activity in the Republic, including an event or circumstance that leads to a loss of confidence that operators of, or participants in, payment systems, settlement systems or financial markets, or financial institutions, are able to continue to provide financial products or financial services, or services provided by a market infrastructure'.

Systemic risk: According to the Financial Market Act 19 of 2012, 'the danger of a failure or disruption of the whole or significant part of [South Africa's] financial system'.

Transmission channels or mechanisms: The channels through which vulnerabilities may lead to the actual disruption of the financial system, should a shock occur.

Vulnerability: A property of the financial system that (i) reflects the existence or accumulation of imbalances; (ii) may increase the likelihood of a shock; or (iii) when impacted by a shock, may lead to systemic disruption.

1. Background and purpose of the document

The SARB last published its macroprudential policy and financial stability monitoring framework in 2021 (available here). In April 2024, the SARB's Financial Stability Committee (FSC) endorsed the updated SARB macroprudential policy and financial stability monitoring frameworks. This document sets out the SARB's financial stability monitoring and assessment framework, and should be read in conjunction with the SARB's macroprudential policy framework and decision-making process (available here). Its publication aims to increase transparency on how the SARB pursues its financial stability mandate in line with international best practice.

2. Statutory requirements for monitoring and assessing financial stability

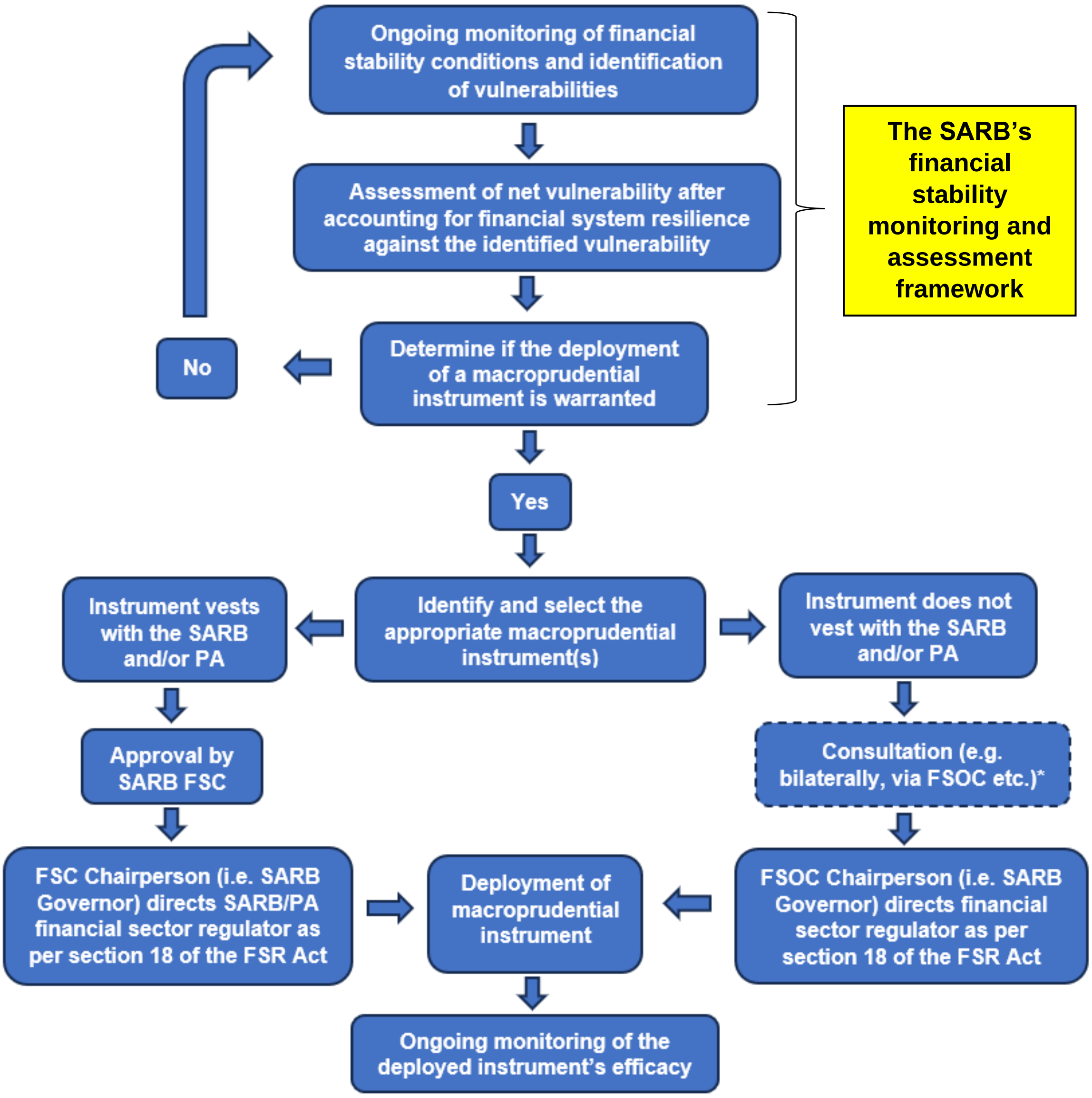
Section 11 of the FSR Act requires the SARB to pursue and fulfil its financial stability mandate in accordance with a policy framework agreed between the Minister of Finance and the SARB Governor. Section 13 of the FSR Act requires the SARB to assess the stability of the South African financial system at least every six months, and to communicate its assessment in the Financial Stability Review (FSR). Among other things, the SARB is required to include the following in the FSR:

a. its assessment of the stability of the financial system during the six-month review period;
b. its identification and assessment of the risks to financial stability in at least the next 12 months;
c. an overview of the steps taken by the SARB and the financial sector regulators to identify and manage identified risks and vulnerabilities in the financial system; and
d. an overview of the recommendations made by the SARB and the Financial Stability Oversight Committee (FSOC) during the period under review, and progress made in implementing those recommendations.

3. Financial stability monitoring and assessment framework

Macroprudential policy aims to limit the build-up of vulnerabilities in the financial system and strengthen financial system resilience, thereby protecting and promoting financial stability (Gadanecz and Jayaram, 2015). However, in order to determine when and if the deployment of a macroprudential instrument is warranted, risks to financial stability have to be monitored and assessed on an ongoing basis. The SARB's financial stability monitoring and assessment framework is highlighted in Figure 1 below.

Figure 1: SARB macroprudential policy framework and decision-making process



* Although the FSR Act makes provision for the SARB Governor to act unilaterally, a consultation process will be followed to the extent practically possible.

4. The SARB's financial stability monitoring and assessment framework

4.1 Financial stability monitoring framework

The early and accurate identification of systemic risks and vulnerabilities is the foundation of effective macroprudential policy. Section 12 of the FSR Act requires the SARB to monitor and keep under review (i) the strengths and weaknesses of the financial system; and (ii) any risks to financial stability, and the nature and extent of those risks. To give effect to this mandate, the SARB operates a holistic financial stability monitoring framework. In order to capture both the cyclical and structural build-up of systemic risk, the SARB monitors domestic financial stability conditions through the following financial stability indicators. These are quantitative indicators by nature and serve as reference points for deeper analysis.

a. **Financial soundness indicators (FSIs):** The IMF initiated the FSI initiative in the 1990s to monitor the soundness of the broader financial sector specifically from a macroprudential perspective. Simplistically, FSIs are indicators of the current financial health of a country's financial institutions and their counterparts (i.e. corporates and households). The FSIs initially included indicators of banks' capital adequacy, asset quality, profitability, liquidity, and market risk sensitivity, and were refined over time to allow for cross-country comparability and to reflect the evolution of countries' financial systems. For more information about the IMF's work on FSIs, including South Africa's submissions, click here.
b. **The SARB financial stability heatmap:** The heatmap is a graphical representation of changes in a wide range of financial stability indicators relative to their historical averages. It highlights cyclical changes, either positive or negative, relative to past trends. The heatmap consists of indicators that should ideally provide reliable and early detection of the build-up of financial imbalances (Aikman et al, 2017). Once such changes are identified, it requires further assessment of whether the changes represent a build-up of cyclical vulnerabilities in the financial system. The SARB heatmap consists of four broad categories or partitions of vulnerabilities identified in the literature, namely the (i) risk appetite and asset valuations; (ii) the financial sector; (iii) the non-financial sector; and (iv) external vulnerabilities. For more information on

the SARB's financial stability heatmap, including the underlying indicators and methodology, click here.

c. **Systemic risk analyses:** While the quantitative FSIs and the heatmap are valuable to highlight trend changes, it requires further qualitative analysis to identify the build-up of a systemic risk or vulnerability. Also, not all risks can be captured in quantitative ratios, firstly because there are always data gaps, and secondly because quantitative indicators are typically designed to pick up cyclical rather than structural risks and vulnerabilities. The SARB employs financial stability specialists with expertise in different sectors to identify financial stability risks.

d. **Stress-testing:** The SARB's common scenario stress test (CSST) is conducted every two to three years and covers banks that are designated as systemically important financial institutions. The tests estimate potential losses and capital shortfalls in the banking sector resulting from severe and plausible scenarios over a three-year horizon. These tests are conducted on both bottom-up and top-down bases and include sensitivity analyses intended to assess the effects of specific risk factors that might adversely affect the solvency position or liquidity profile of a financial institution. In addition to the CSST, the SARB also conducts thematic stress tests, such as stress tests based on climate change scenarios, and stress tests in non-bank sectors, notably the insurance sector. For more information on the SARB's stress-testing framework, click here.

e. **Network and interconnectedness measures:** The South African financial system is highly interconnected, with strong linkages between banks, insurers and money-market funds. A systemic assessment of risk requires an understanding of how developments in one part of the financial system affect other parts. The SARB is developing an integrated model to map interconnectedness in the financial sector.

f. **The SARB's financial conditions index (FCI):** The SARB FCI is a composite index of asset prices and funding costs across the domestic and global economy. The FCI is a useful measure of current financial conditions since it is based on regularly updated financial data and can also provide valuable information about future risks to economic growth (Van der Wath, 2016).

g. **Analyses conducted by SARB line departments:** Various departments within the SARB conduct ongoing analyses of developments and topics of relevance to financial stability (e.g. the Financial Markets, Financial Surveillance, Economic Statistics and National Payment System departments). These analyses are discussed and considered at FSC meetings as and when appropriate.

h. **Industry and regulatory engagements:** The SARB regularly engages with industry bodies, regulators and financial institutions to obtain information about, and a better understanding of, systemic risks and vulnerabilities. In addition to information obtained through statutory committees established in terms of the in the FSR Act (see section 5), the SARB also engages bilaterally with industry bodies, regulators, the National Treasury and financial institutions on specific issues.
i. **Financial stability research outputs:** The SARB conducts research on a broad range of topics related to financial stability to inform macroprudential policy. The SARB collaborates with academia in several ways to deepen an understanding of financial stability related topics. Click here to view the latest Financial Stability Topical Briefings published on the SARB website.

The above collective body of information obtained through the financial stability monitoring framework equips the SARB to formulate a forward-looking assessment of the key risks to financial stability in South Africa, which are captured in its risks and vulnerabilities matrix (RVM) as discussed next.

4.2 Financial stability assessment framework

The SARB’s RVM provides a forward-looking assessment of the key risks to financial stability in South Africa over the short, medium and longer term. The RVM shows the residual vulnerability of the financial system to such developments, after considering existing mitigating factors and policy actions. The SARB’s assessment of key risks to domestic financial stability is published twice a year in the *FSR*, which:

a. summarises the channels through which the risks could manifest in the event of a shock to the South African financial system;
b. identifies the mitigating factors and actions that would alleviate the expected impact of a shock; and

c. describes the likely residual impact on financial stability in South Africa (i.e. the potential net impact the risks would have should they materialise as a shock, after the identified mitigating factors and actions have been accounted for).

The RVM is approved by the FSC prior to publication in the *FSR*. Should there be agreement at the FSC that any of the risks and vulnerabilities on the RVM require the deployment of a macroprudential instrument, the SARB's financial stability monitoring and assessment process concludes and gives way to the next step in the SARB's macroprudential policy framework and decision-making process, namely to identify and select the most appropriate macroprudential instrument(s).

Conclusion

Macroprudential policy and macroprudential instruments support financial stability. This document details the structured approach employed by the SARB to monitor and assess risks to financial stability, to inform the decision of whether or not the deployment of a macroprudential instrument is warranted.

References

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