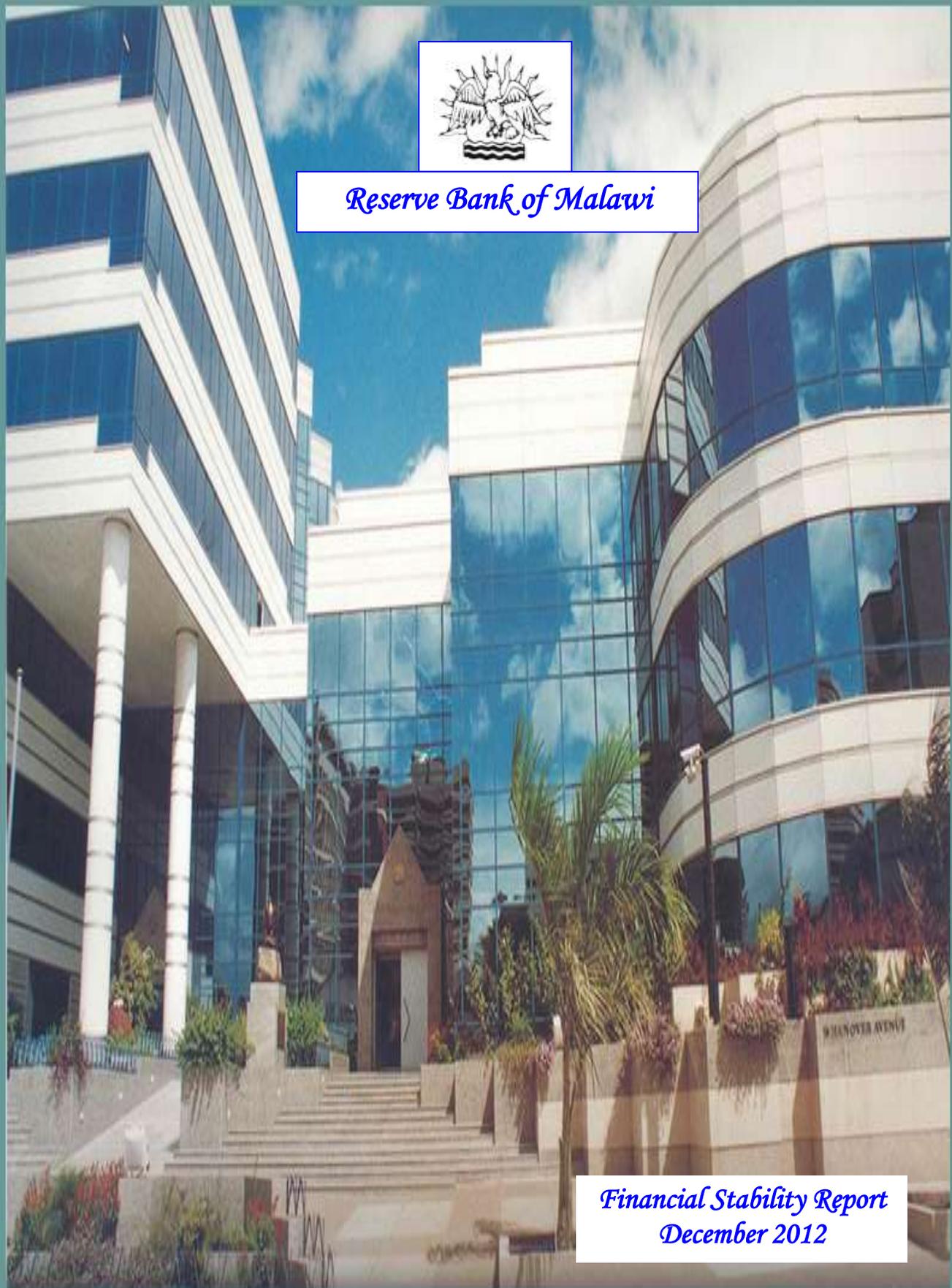




*Reserve Bank of Malawi*



*Financial Stability Report  
December 2012*



RESERVE BANK OF MALAWI

FINANCIAL STABILITY REPORT

DECEMBER 2012

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## Foreword and Summary Of Financial Stability Assessment

The Reserve Bank of Malawi (RBM) considers financial stability as a condition represented by a strong financial system capable of withstanding shocks to the economy; one that is able to allocate savings into investment opportunities, facilitate the settlement of payments efficiently and manage risks in a satisfactory manner. Presented in this report are financial system stability developments covering the period March through October 2012.

Risks to global financial stability remained intense due to continued market turbulence, debt woes and uncertainty in the Euro zone and weak demand in emerging markets. Regional financial systems continued to remain stable owing to weak interconnectedness with developed markets and stable macroeconomic outcomes. The high levels of debt and continued market uncertainty in most developed countries have implications on sustainability of aid flows to Least Developed Countries (LDCs), which may have further adverse implications on fiscal outturns, exchange rate movements and hence financial system stability in these countries. The weak transmission mechanism between financial institutions in the developed countries and Malawi was key in inhibiting contagion effects and risks arising there from.

The period under review saw the Malawi Government undertaking major policy changes with respect to monetary and fiscal policies. This followed the ascendency to Presidency of Mrs. Joyce Banda, following the death of her predecessor in April 2012. The President authorised the implementation of a set of bold measures to address the long-standing internal and external imbalances in the economy. The key measures comprised a devaluation that increased the price of foreign exchange by approximately 50 percent and adoption of a floating exchange rate regime; removal of restrictions on foreign exchange transactions by banks and foreign exchange bureaus; relaxation of surrender requirements on export proceeds; and increases in the retail prices of petroleum products and adoption of an automatic adjustment mechanisms to keep prices in line with import costs.

Subsequent to the liberalisation policies, domestic macroeconomic and financial risks intensified between April and September 2012. The devaluation, and continued depreciation of the kwacha after the adoption of a floating exchange rate and food scarcity contributed to a surge in inflation expectations thereby elevating uncertainty. The economic growth projection was revised downwards to 1.9 percent in 2012 from an earlier projection of 4.3 percent mainly on account of output contraction in the agriculture sector. This interplay of various macroeconomic and financial factors

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threatened the stability of Malawi's financial system through a build up of liquidity and credit risks in the banking system. Since the implementation of the new measures though, the country has seen an improvement in the fuel and foreign exchange availability, a reduction in foreign exchange arrears and the convergence of foreign exchange rates on the official and parallel markets. Furthermore, beyond the six months period ahead the adopted tight monetary and fiscal policies are expected to stabilize the exchange rate and reduce further pressures on inflation.

These developments notwithstanding, the current financial stability assessment confirms that all commercial banks were affected by liquidity challenges and sought recourse to Discount Window Accommodation subsequent to the improved availability of foreign exchange. These developments however had transient effects as the general liquidity outturn had significantly improved by end of October 2012. Credit risks heightened following high interest rates and hence an increase in non performing loans. Nonetheless, Commercial banks' resilience to adverse developments remained strong. According to stress test results, banks remained well capitalised and would be able to withstand short-term economic shocks but, as expected, may break down under prolonged adverse conditions. With respect to the insurance sector, Malawi's life insurance companies on a consolidated basis remained adequately capitalised during the period under review. On account of the high lending rates that prevailed during the review period, institutions in the microfinance industry experienced a high rate of default. Nonetheless they remained resilient. Meanwhile, the payment and settlement system in Malawi's financial system remained robust and able to mitigate operational and financial risks in the review period. Thus the overall assessment of this report is that Malawi's financial markets remained broadly sound, notwithstanding the challenges faced during the review period, and well equipped to withstand shocks and to mediate credit and payments as well as redistribute risk appropriately.

Looking ahead, risks to the stability of the financial system could arise from a number of potential sources. Spillovers from the global economy, including the stagnation of the euro area and world growth, a substantial fall in non-oil commodity prices and a reduction in aid flows from major donors such as the EU whose countries are currently shrinking aid budgets are likely to pose a threat. Domestically, adverse weather conditions pose a significant risk as they would lower agricultural output thereby affecting GDP. Furthermore any slippages in the implementation of policy reforms or indeed any policy reversals such as those affecting the exchange rate could have adverse effects.

Risk appetite is expected to remain subdued owing to high interest rates and deteriorating real incomes. Monetary and financial conditions are expected to remain tight in the ensuing months. While

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dividends are expected from fiscal and monetary policies beyond the first quarter of 2013, the ongoing lean season and depressed economic activity still pose credit and liquidity risks to the financial system in the next six months. The banking systems' financial positions are however expected to remain buoyant although marginal increases in loan loss provision are envisaged following low prospects in income growth and high interest rates.

The RBM will continue to step up its oversight of banks with a view to addressing emergent threats to the stability of the financial system. It is paying particular attention to ensuring that banks that had faced most extreme liquidity problems implement restructuring plans that put them back on a sound financial footing.

C.S.R. CHUKA  
**GOVERNOR**

## Main Message

Despite market improvements arising from sovereigns' policy actions, risks to global financial stability remained intense due to a prolonged deterioration in underlying trends. The euro area crisis remained the major source of concern. Macro-economic risks worsened as global growth projections continued to depict a sluggish trend. Emerging market risks also intensified owing to emerging markets' dependability on the developed economies.

## 1.0 MACROECONOMIC AND FINANCIAL ENVIRONMENT

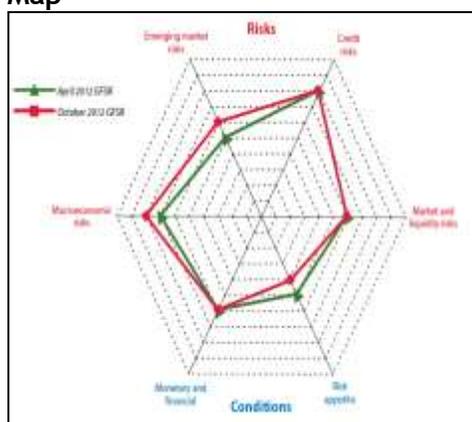
### 1.1 GLOBAL DEVELOPMENTS

Risks to global financial stability intensified over the period April to October 2012. The on-going euro area crisis remained the major reason as it caused a reduction in investors' confidence in the global financial system. Furthermore, the lack of clear medium term policies on how to address imbalances in the United States and Japan exacerbated reduction in investors' confidence in the global financial system.

#### 1.1.1 Global Financial Stability<sup>1</sup>

As indicated in figure 1.1 the deteriorating conditions in the global financial system stability largely emanated from increasing emerging market risks as well as macroeconomic risks which arose from a combination of lower risk appetite, a weak outlook for economic growth, rising unemployment levels and volatile and wide spreads in the euro periphery area.

Figure 1.1 Global Financial Stability Map



Note: Closer to centre signifies less risk, tighter monetary and financial conditions, or reduced risk appetite.

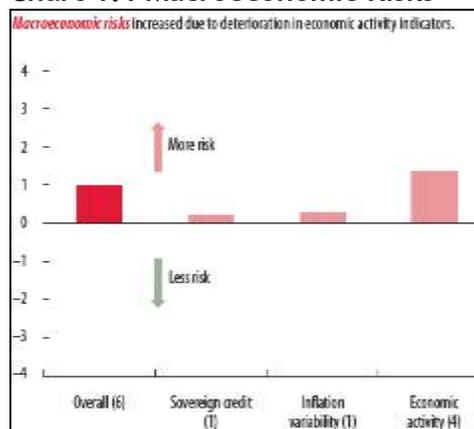
Source: Global Financial Stability Report (GFSR) October 2012

The World Economic Outlook (WEO), October 2012 indicates that global manufacturing contracted sharply and that spill-overs from advanced economies and homegrown difficulties held back activity in emerging markets and developing economies.

Emerging market risks increased due to emerging market's dependability on the global markets, as some markets do not have enough policy space to provide counter cyclical stimulus and safeguard against external shocks.

Credit risks remained static at their previous levels. This is because corporate and household balance sheets in advanced economies improved, resulting into an improvement in credit conditions for the corporate and household sectors. This was however offset by deterioration in the banking system and growing deleveraging and credit pressures in the euro area periphery. Nonetheless, credit risks remained high.

Chart 1.1 Macroeconomic Risks



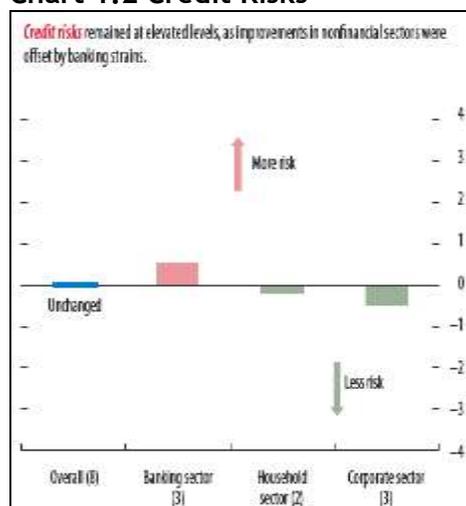
Note: figures in parenthesis stand for weights  
Source: GFSR October 2012

Monetary and financial conditions remained unchanged. In response to the increasing threats to global financial stability, the monetary authorities maintained a supportive policy stance, by keeping overall monetary and financial conditions broadly accommodative. Following the longer-term refinancing operations, through the European Central Bank's (ECB's) three-year LTROs, bank funding strains eased and the pace of deleveraging in the euro area slowed.

Market and liquidity risks remained unchanged despite bearish market positioning. Easing liquidity strains was the main cause of stable market and liquidity risks. Notably, introduction in September 2012 of a program of Outright Monetary Transactions (OMT) to provide liquidity to sovereign debt markets in the euro

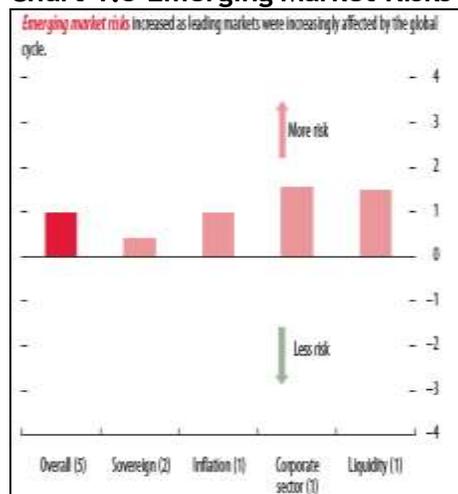
<sup>1</sup> The analysis is based on GFSR (IMF) October 2012

## Chart 1.2 Credit Risks



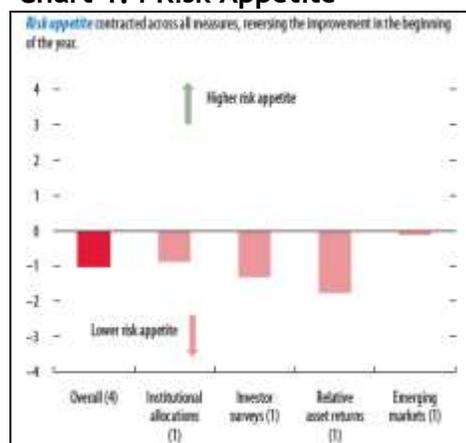
Note: figures in parenthesis stand for weights  
Source: GFSR October 2012

## Chart 1.3 Emerging Market Risks



Note: figures in parenthesis stand for weights  
Source: GFSR October 2012

## Chart 1.4 Risk Appetite



Note: figures in parenthesis stand for weights  
Source: GFSR October 2012

area periphery, helped to reduce tensions and boost market recovery. Thus, the OMT helped to narrow sovereign spreads between periphery and the core Euro area countries.

### 1.1.2 Risks to Global Financial Stability

Low private sector confidence in the global financial system remains a key challenge to global financial stability. In the euro area, despite the significant public resources being deployed to the periphery, private sector confidence remained sluggish. Such a trend is exacerbated by concerns over a possible euro zone breakup. Consequently, the euro area has faced extreme fragmentation between funding markets in the core and the periphery areas<sup>2</sup>.

Rising imbalances in the United States of America and Japan coupled with unclear policies on addressing the imbalances also continue to be a cause for concern. An increase in safe haven inflows to these countries has significantly compressed credit risk premiums and government yields. Thus any rapid increase in yields has severe implications on global financial stability.

European countries are likely to face redenomination risk. Most of the risks in the euro area emanate from balance of payments imbalances across member states. There is a reverse in capital inflows from debtor countries back to creditor countries. Creditor countries are willing to repatriate capital from debtor nations, where interest rates are relatively high to creditors' countries, where interest rates are as low as minus one, with the aim of guarding against a euro breakup and the introduction of national or sub-regional currencies (currency redenomination risk). Creditor countries are anticipating a significant appreciation in their currencies, which can offset the negative interest rates.

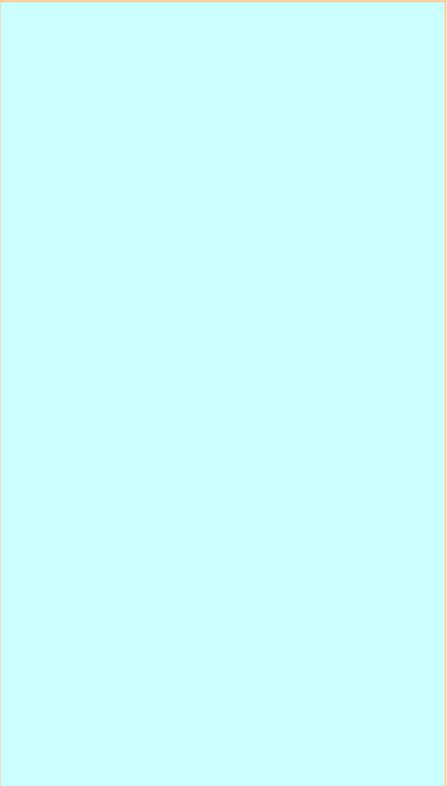
A further escalation of euro area stresses coupled with a slowdown in economic activity poses risks to emerging markets as some emerging market economies have only limited policy space to provide countercyclical stimulus and safeguard against external shocks. These risks have spilled over to broader global economic conditions. In addition, rising political risks elsewhere have postponed medium-term adjustment.

### 1.1.3 Potential Global Financial Stability Policy Responses

It is likely that policymakers in the euro area will concentrate on rebuilding investor confidence as it is of paramount importance for the restoration of global financial stability. The basis of this is likely to be additional policy action that demonstrates political commitment to closer integration as opposed to the prevailing threats of a euro area break up. This

<sup>2</sup> Core Eurozone countries: Germany, France, UK, Netherlands, Belgium. Periphery areas / economies mainly consist of countries lying to the south, east and west of the EU.

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can be achieved through establishing a single supervisory mechanism and containing pressure on spreads. On their part, individual countries are likely to prioritize stabilization of impaired balance sheets and correction of high debt burdens. Policy makers aim to build political support for the necessary pooling of sovereignty that a more complete currency union entails. Emerging markets will be guarding- against further external shocks from the Eurozone that can exacerbate the slow growth and financial vulnerabilities.

Like most developing countries, the full assessment of the direct impact of the ongoing Eurozone financial crisis on Malawi's financial system remains a challenge owing to data unavailability to map transmission channels and the fact that the crisis is still on-going. However, the impact on Malawi's financial markets is likely to be less severe as there is a weak connection between them and financial markets in the euro zone area. Nonetheless, the likely impacts are a general reduction in flows of aid, foreign direct investment, trade and remittances, between Eurozone and LDCs. Notwithstanding this, Malawi will continue to conduct financial system surveillance to ensure the resilience of the local financial system to both internal and external shocks.

## Main Message

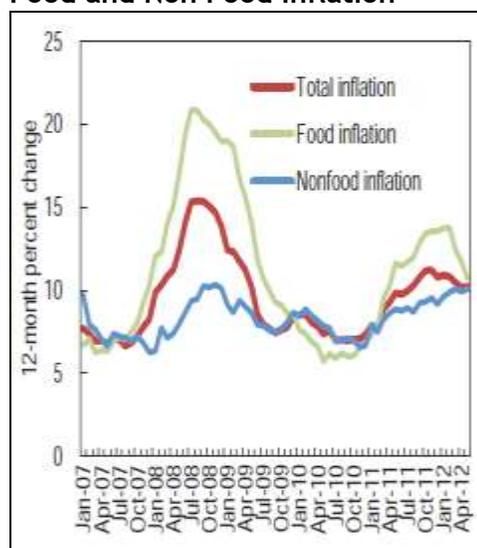
*Financial systems within the Sub-Saharan Africa region remained broadly stable largely owing to limited exposure of the regional financial systems to the rest of the world and macroeconomic stability within the region. However, a few banks experienced some portfolio deterioration as borrowers faced financial distress in the global economic downturn.*

**Table 2.1 Sub Saharan Africa: Other Macroeconomic Indicators**

	2004-08	2009	2010	2011	2012	2013
	(Percent change)					
Inflation, end-of-period	8.8	8.6	7.2	10.1	8.0	6.9
	(Percent of GDP)					
Fiscal balance	1.9	-5.4	-3.7	-1.6	-2.2	-1.4
Of which: Excluding oil exporters	-0.7	-4.6	-4.3	-4.1	-4.5	-3.6
Current account balance	0.7	-3.2	-1.3	-2.0	-3.1	-3.5
Of which: Excluding oil exporters	-5.0	-5.3	-4.5	-4.9	-7.3	-7.0
	(Months of imports)					
Reserves coverage	4.8	5.1	4.2	4.4	4.7	4.9

Source: REO October 2012

**Chart 2.1 Sub Saharan Africa: Food and Non Food Inflation**



Source: REO October 2012

## 1.2 REGIONAL DEVELOPMENTS<sup>3</sup>

### 1.2.1 Regional Financial Stability

Sub Saharan Africa's financial markets continued to remain resilient to external shocks emanating from the Eurozone crisis. Most financial systems within the region have a limited level of integration with the rest of the world, including the euro area. Thus the limited exposure of regional financial markets provided a cushion against adverse impacts from the euro area financial distress.

Internally, macroeconomic risks to the region's financial systems eased, in turn enhancing financial system stability. Firstly, the region registered robust growth despite the global economic slowdown, drought in many Sahel countries and political instability in Mali and Guinea-Bissau. The region is estimated to grow at 5.25 percent in 2012/2013, a similar growth as the one recorded in the previous year. Most low income countries posted significant contributions to the region's growth. However, middle-income countries, which are closely linked to European markets, registered slower economic growth.

Secondly, inflationary pressures in sub Saharan Africa subsided (see Table 2.1 and chart 2.1), largely owing to low inflation in food and fuel prices coupled with effective tight monetary policies and good weather in some countries.

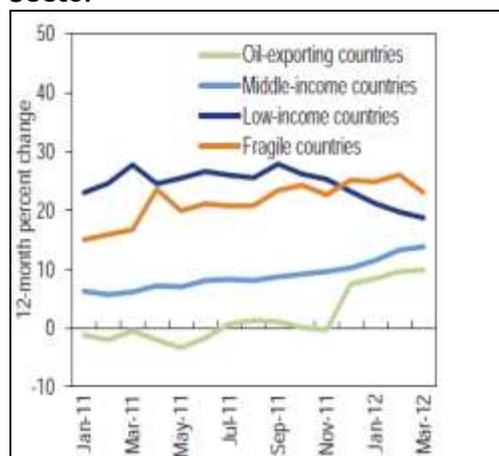
The region experienced significant growth in nominal credit to the private sector (chart 2.2). However, there were significant variations in growth trends of credit to the private sector across countries within the region. Low income countries experienced low rates of growth in nominal credit to the private sector, largely owing to tight monetary policies that prevailed within the economies while middle-income countries, registered high growth rates in private sector credit partly owing to supportive monetary policies.

Despite the resilience of regional financial markets to direct external shocks, regional banks succumbed to some indirect shocks from the global economic slowdown. This was reflected in deteriorating portfolios as borrowers experienced financial distress in the global economic downturn.

Banks' profitability over the past years maintained a downward trend partly due to loan losses on portfolios as reflected in an increase in non-performing loans. Consequently, rates of return on assets and bank equity continued to deteriorate. In addition, banks' capital adequacy ratios worsened, largely due to a rise in non-performing loans (NPLs), before declining again. However, recently, non-performing loans have started to improve.

<sup>3</sup> Analysis is based on that from the REO (IMF) October 2012

**Chart 2.2 Sub Saharan Africa Nominal Credit to The Private Sector**



Source: REO October 2012

### 1.2.2 Key Downside Risks to the Regional Macroeconomic and Financial Environment

At 3.6 percent, the projected low global economic growth is likely to spill over into sub-Saharan Africa and suppress the region's growth, especially in middle income countries, which are highly linked to the European countries. An assessment of the impact of estimated low global economic growth on sub-Saharan Africa's economic growth reveals that the regional growth rate is likely to slow down by about 1 percent a year. Economies like Malawi, which have less diversified exports, are likely to be more affected.

Recent inflationary pressures on world prices of cereals are likely to pose challenges for monetary policy in some countries. Most countries, especially those with poor crop harvests are likely to experience an upward pressure on inflation; this may in turn have adverse impact on inflation in the region.

Some of the regional economies with a diversified nature of exports may also face deterioration in their current account deficits. Trade balances may weaken due to deterioration in the terms of trade and ongoing weakness in import demand among traditional partners. In turn this will widen current account deficits.

### 1.2.3 Regional Policy Options in the Period Ahead

Despite the resilience of financial systems to both external and internal shocks, the IMF advises that sub-Saharan Africa needs to continually assess vulnerabilities and implement policies aimed at maintaining financial system resilience. However, effective implementation of policies depends on individual economies specifics.

Firstly, countries, which have stronger trade links with European countries need to consider diversifying their exports. In addition, they should consider establishing new markets elsewhere. This is likely to reduce the impact of the recent low demand from the European economies

Secondly, where inflation episodes are still high, countries should implement policies aimed at containing such high inflation. There is therefore need to pursue appropriate tighter monetary policies. Where inflation, has subsided, economies need to ensure that they maintain sustainable levels of inflation.

Lastly, countries, which have recovered from the recession and have high rates of growth, need to rebuild their fiscal positions in order to maintain their robust growth. This can be achieved by rebuilding fiscal and external buffers without adversely impacting on social and capital spending.



Malawi has strong trade links with the Euro zone countries. The country has already embarked on various efforts to diversify its exports through the National Export Strategy. The latter involves the prioritisation of the growing of potential non-traditional export earning crops other than the country's main traditional cash crop tobacco. The search for new markets is also part of the export strategy. Furthermore the country which has experienced unusually high inflation during the period April to September 2012 continues to pursue a tight monetary policy stance in order to rein in and contain inflationary pressures.

### **Main Message**

Vulnerabilities in Malawi's financial system persisted. Economic and financial risks intensified, exerting adverse pressure on the stability of the financial system. Economic growth slowed down significantly, inflationary pressures mounted and the exchange rate depreciated significantly. Consequently, credit risks widened. The banking system also faced significant liquidity shortages. In a bid to anchor the banking the system, the monetary authorities introduced an uncollateralized discount window accommodation, leading to an ease in liquidity risk. In the ensuing six months period, macroeconomic risks to financial stability are unlikely to subside owing to an environment characterized by low growth and heightening inflation.

**Table 3.1: Selected Economic Indicators**

	2009	2010	2011	2012 (March)	2012 (Sept)
Real Output Growth (%)	8.9	6.7	4.5	1.9*	1.9**
Inflation	8.4	7.4	7.6	11.4	28.3
Gross Official Reserves (US\$)	163.5	299.0	190.2	137.9	178.5
External Debt %GDP	14.5	15.8	18.6	14.0	27.8
Domestic Debt (%GDP)	24.3	19.2	21.7	16.1	15.5
Exchange Rate (US\$)	141	151	157	166	299

\*Projection as at March 2012, \*\* projection as at September 2012

Source: Reserve Bank of Malawi

## **1.3 DOMESTIC DEVELOPMENTS**

In April 2012, President Joyce Banda implemented a number of bold economic reforms. These included the devaluation of the kwacha by 50 percent on 7<sup>th</sup> May 2013 and the subsequent adoption of a floating exchange rate regime.

The May devaluation and continuing depreciation of exchange rate during the period, which partly reflected lower than expected tobacco sales, coupled with a marked rise in domestically produced food prices contributed to a surge in inflation during the period.

Thus an interplay of various macroeconomic and financial risks threatened the stability of Malawi's financial system. Macroeconomic risks widened during the April - September 2012 period. Liquidity and market risks also intensified owing to liquidity shortages in the banking system and high interest rates in the money market.

### **1.3.1 Macroeconomic Risks**

Macroeconomic risks widened underpinned largely by high inflation, low real GDP growth and continued depreciation of the local currency.

#### **Real GDP Growth**

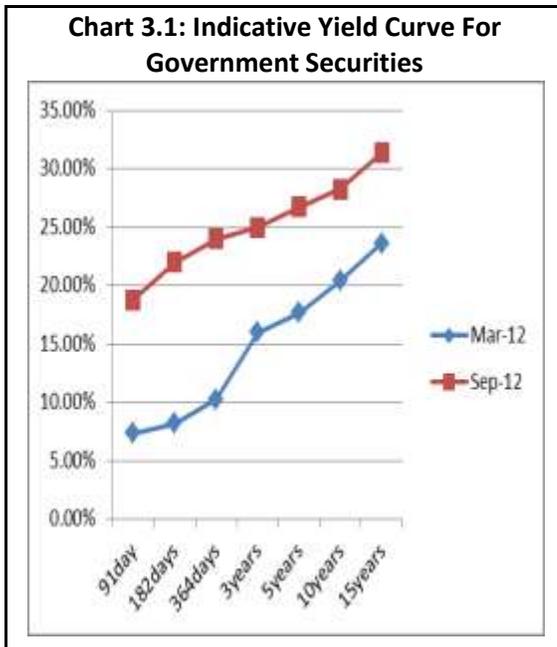
Real GDP growth for 2012 is estimated at 1.9 percent, lower than 4.3 percent projected earlier in the year and lower than 4.3 percent growth in 2011. The declining growth adversely affects prospects for savings by both the corporate and household sectors. Hence, a reduced source of funding for the financial sector and a further weakening of the balance sheets of the deposit taking institutions.

#### **Inflation and Interest Rates**

A considerable amount of fragilities in the financial system were influenced by the high inflation and high interest rates that prevailed in the economy over the review period. Inflation significantly increased to 28.3 percent in September 2012 from 11.4 percent in March 2012, while lending rates increased to 31.42 percent in September 2012 from 18.19 percent in March 2012. Such high inflation and lending rates undermined the creditworthiness of borrowers in the financial system by eroding their purchasing power and resulted in an increase in non-performing loans and losses in the financial institutions.

#### **Gross Official Reserves**

Malawi's gross official foreign reserves stood at U\$178.5 million (equivalent to 0.9 months import cover) in September 2012 compared to reserves of U\$137.9 million in March 2012 (1.1



Source: Reserve Bank of Malawi

months)<sup>4</sup>. The increase in reserves was mainly on account of inflows of donor support following the resumption of the Malawi's Extended Credit Facility (ECF) programme with the International Monetary Fund (IMF).

The RBM discontinued receipt of tobacco proceeds which were directly channeled to Banks. Beyond September 2012 however, the market has no steady source of foreign exchange. Therefore, pressure is expected to pile up on official reserves. Subsequently, efforts to build up a buffer to cushion the country from exogenous shocks will be compromised.

### The Exchange Rate

The kwacha considerably depreciated against major trading currencies. Since the devaluation of the local currency to K250.00 from K168.00 per United States Dollar, effected on 7<sup>th</sup> May 2012 and subsequent floatation of the exchange rate the local currency has remained unstable. The kwacha depreciated to K298.97 against the United States Dollar in September 2012.

### External Debt

External debt as a percentage of GDP in September 2012 increased to 27.75 percent from 14.3 percent in March 2012. This was on account of both the country contracting new debt and a revaluation of debt on account of the depreciating exchange rate. At 27.75 percent the external debt ratio still remained below the threshold for debt sustainability ratio of 40.0 percent, thus developments in external debt did not indicate major cause for concern to financial stability. Nevertheless the pace at which indebtedness increased during the review six months period is a cause for concern. Stabilizing the kwacha is key to averting a similar pace of indebtedness in the ensuing months.

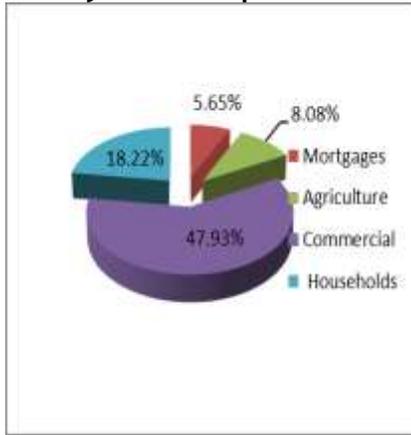
### Domestic Debt

Domestic debt as a percentage of GDP stood at 15.5 percent in September 2012 compared to 16.1 percent in March 2012. The maturity structure of Malawi's public domestic debt remained short, with treasury bills making up 76.2 percent of total domestic debt. Government's short term debt maturity structure does not only amplify repayment pressure but also discourages financial sector deepening.

In addition, yields on the Government securities market increased, following an increase in the Bank rate and inflation. The All Type Treasury bills Yield increased to 21.34 percent in September 2012 from 7.51 percent in March 2012. Consequently, the yield curve for Government securities shifted upwards indicating higher cost of borrowing for the Government, hence increased domestic debt roll over risk.

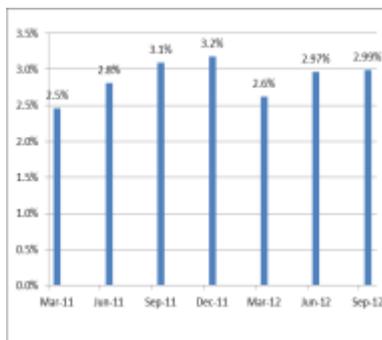
<sup>4</sup> As at March 2012, import requirement was US\$129.0 million vis a vis US\$189.0 million in September 2012

**Chart 3.5: Private Sector Credit by Holder Sept 2012**



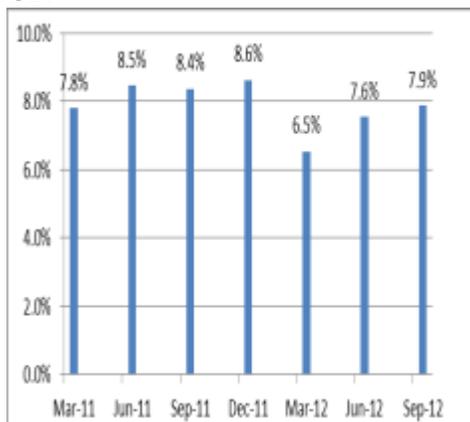
Source: Reserve Bank of Malawi

**Chart 3.6: Household Credit as a Percentage of GDP**



Source: Reserve Bank of Malawi

**Chart 3.7: Corporate Credit as a Percentage of GDP**



Source: Reserve Bank of Malawi

### 1.3.2 Liquidity and Market Risks

The period under review was characterized by banking system liquidity shortages. The most acute decrease was observed in May 2012, when excess reserves moved down to -K0.69 billion from K10.93 billion in March 2012. From June 2012, banking system excess reserves started picking up, although with unsystematic fluctuations and closed the month of September 2012 at K3.33 billion. This intensified banking system liquidity risks and posed systemic challenges in the financial sector.

Consequently, the average discount window accommodation increased to K14.32 billion in September 2012 from K0.45 billion in March 2012.

Not only did the liquidity shortage force banks to hold some of their high interest earning assets in liquid form but it also exerted upward pressure on interbank rates which rose from 5.72 percent in March 2012 to 21.77 percent in September 2012. The liquidity problem caused a loss in income to the banks, on average and also increased the cost of borrowing funds.

### 1.3.3 Credit Risks<sup>5</sup>

Credit risks to the domestic banking system elevated as evidenced by an increase in non-performing loans as a percentage of private sector credit to 7.84 percent in September 2012 from 4.97 percent in March 2012. High lending rates coupled with high inflation undermined the ability of borrowers from the commercial banks to repay their loans. Similarly, the microfinance sector faced significant credit risks. Given the high cost of borrowing from commercial banks, microfinance institutions were forced to increase further their lending rates, which in turn have exacerbated default risk.

#### Private Sector Credit by Holder

The corporate (commercial and industrial) sector remained the largest holder of banking system credit in the review period. As at September 2012, the sector held 47.93 percent of total banking system credit. The other notable holder of banking system credit was the household sector, at 18.22 percent of total banking system credit as at September 2012. Given this, the adverse developments in the corporate and household sectors, mainly due to the unfavourable macroeconomic and financial environment, have dire implications on the portfolio of the Malawi banking system and therefore raises concerns for financial stability.

Total banking sector credit as a percentage of GDP maintained an upward trend from 14.06 percent in March 2012 to 16.43 percent in September 2012. The upward trend was largely

<sup>5</sup> Credit risk as measured by the ratio of non-performing loans as a percentage of total banking system credit to the private sector

influenced by an increase in corporate sector credit and household sector credit as a percentage of GDP. Credit to household as a percentage of GDP increased to 2.99 percent in September 2012 from 2.6 percent in March 2012. Similarly, credit to the corporate sector as percentage of GDP went up to 7.9 percent in September 2012 from 6.5 percent in March 2012.

#### **1.3.4 Monetary Conditions**

Monetary conditions significantly tightened during the review period. Following devaluation of the local currency in May 2012 and the rising inflation, monetary authorities continued to pursue a tighter monetary stance. In May 2012 the Reserve Bank of Malawi increased the policy rate to 16.0 percent from 13.0 percent. Within two months, the monetary authorities tightened further by increasing the bank rate to 21.0 percent. Consequently, bank lending rates rose to 31.42 percent in September 2012 from 20.57 percent in March 2012 and yields of Government securities started increasing. In response to the tight monetary stance, money supply growth receded from an average of 35.5 percent in the six months to March 2012 to an average of 28.5 percent in September 2012.

#### **1.3.5 Potential Risks to Financial Stability Ahead**

In the near term to March 2013, various threats to the domestic financial system are expected to persist, and new ones arise.

Macroeconomic risks are estimated to continue rising in the ensuing three months to December 2012 due to a sluggish economic outlook. The low growth in 2012 continues to suppress prospects for savings. Inflationary pressures are expected to continue to mount with inflation projected to increase to 32.5 percent in December 2012 and further to 35.4 percent in March 2013. The weakening of the local currency against major trading currencies may slightly ease at year end on account of expected development partner inflows. However, pressure may likely resurface in the first quarter of 2013, with another easing likely to begin in the second quarter with the opening of the tobacco auction floors. Inadequate foreign reserves are the reason behind the depreciating local currency and they continue to pose a threat to financial stability.

Despite easing out, liquidity problems are still present in the banking system. A few market players are expected to remain affected in the short run. In addition, high interest rates in the money market will not only add pressure on Government debt roll over risk but will also continue to suppress capital market activity.

Other major risks that pose a threat to stability include any slippages in implementation of the Malawi government/IMF Extended Credit Facility program, such as policy reversals that

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could occur with respect to the exchange rate regime that the country is currently following.

### **1.3.6 Remedial Options**

The prevailing unfavourable macroeconomic environment poses adverse implications to financial system stability. The Malawi authorities have thus embarked on implementing policies that will improve the macroeconomic environment and enhance economic growth. Staying the course of the reforms is critical to a quick return to financial stability.

The Reserve Bank together with the Malawi Government are committed to reversing the upward trend in inflation, which is one of the major threats to financial system stability. The monetary authorities are therefore in the short term, using the Bank's policy rate to contain inflation. Meanwhile fiscal authorities continue to concentrate on such efforts as enhancing domestic revenue and strengthening the public financial management systems. The authorities longer term efforts are focussed on promoting exports, as this will help in building international reserves and stabilising the kwacha.

In order to reduce the levels of non-performing loans, lenders in the financial market need to strengthen their underwriting practices and be able to guard against adverse selection of borrowers.

Despite easing liquidity problems, the banking system is still characterised by some strains of liquidity shortages. While banking institutions may expect intervention from the monetary authorities, individual banking institutions need to enhance their liquidity positions on a day to day basis. This can be achieved by appropriate treasury management. In the meantime, the Reserve Bank is increasing its oversight over distressed banks.

### Main Message

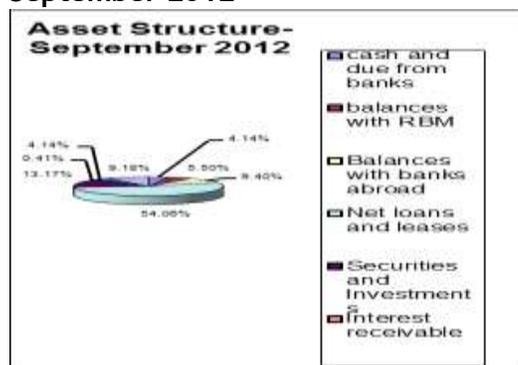
The banking sector remained exposed to significant risks over the review period. Notably, liquidity risk persisted as some banks failed to meet the minimum liquidity ratio. The banking sector also continued to face credit concentration risk, but it remained fairly stable as evidenced by good performance of indicators such as capital adequacy, earnings and quality of assets. Good performance of earnings was on account of banks' heavy dependence on non traditional banking business.

## 2.0 FINANCIAL INSTITUTIONS

### 2.1 The Banking Sector in Malawi

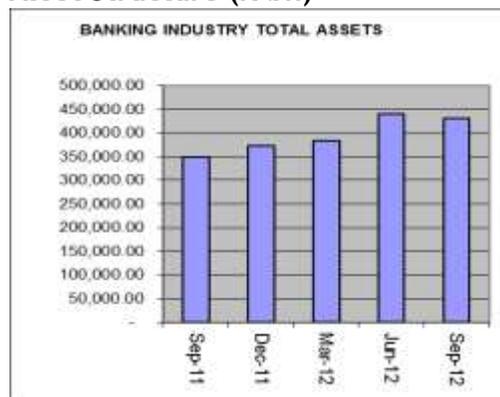
The banking sector in Malawi is dominated by two largest banks (National Bank of Malawi and Standard Bank of Malawi) which hold slightly more than half of the sector's total assets and deposits. As at September 2012, their combined assets and deposits accounted for 52.7 percent and 51.6 percent of the entire sector, respectively. This position is slightly higher than in March 2012, when their dominance stood at 46.0 percent for both assets and deposits. Over the review period, the banking sector faced high liquidity risk and credit concentration risk. The following indicators of banking sector soundness however, show that the banking system remained resilient to vulnerabilities that prevailed in the system over the review period.

Chart 2.1: Asset Structure September 2012



Source: Reserve Bank of Malawi

Chart 2.2 Banking Industry Asset Structure (K'bn)



Source: Reserve Bank of Malawi

#### 2.1.1 Assessment of Financial Soundness Conditions

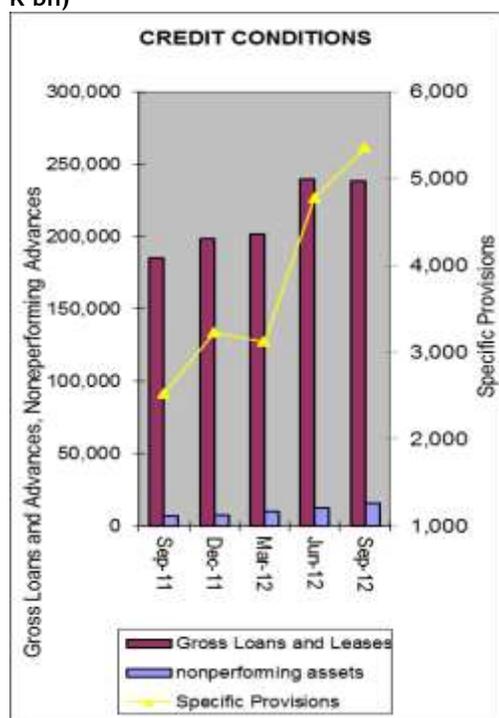
The consolidated balance sheet of the banking industry over the six months to September 2012 grew by 12.3 percent. This was higher than the 9.8 percent growth recorded over the six months to March 2012. The growth in the banking industry's asset size can be explained by the growth in the deposit base especially Foreign Currency Denominated Accounts (FCDAs) following the devaluation of the local currency in May 2012. The consolidated deposit base and capital account grew by 8.5 percent and 8.3 percent, respectively.

The banking sector loan book is estimated to have grown by over 17.9 percent over the last 6 months.

However, the current increased lending in the environment of high lending rates and high inflation has also led to an increase in credit risk for commercial banks (the risk that arises from counter party defaults on agreements). The analysis of the loan book revealed deterioration in terms of quality as evidenced by an increase in non-performing loans (NPL) to gross loans and leases ratio to 6.5 percent as at September 2012 from 4.8 percent in March 2012<sup>6</sup>. This trend is in contrast from September 2011, when the NPL ratio was at 3.7 percent. It is expected that the trend will continue in view of the prevailing macroeconomic environment.

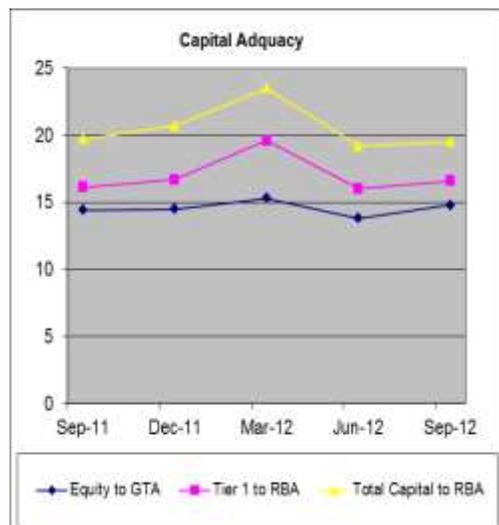
<sup>6</sup> Credit risk as measured by the ratio of non-performing loans as a percentage of gross loans and leases

Chart 2.3 Banking Industry Credit Conditions (K'bn)



Source: Reserve Bank of Malawi

Chart 2.4 Capital Adequacy (%)



Source: Reserve Bank of Malawi

### 2.1.1.1 Capital Adequacy

Banks in Malawi are required to maintain a minimum core capital ratio of 6.0 percent and minimum total capital ratio of 10.0 percent. In the six months to September 2012, the core capital of the banking sector at 16.6 percent decreased by 2.1 percentage points. The decrease can be attributed to 4.0 percent decrease in core capital against 8.0 percent growth in risk weighted adjusted assets over the same period. Despite the decrease, the banking sector capital position provides sufficient cushion to cover losses that may arise in the normal course of business to avoid insolvency. However, with the growing trend of non-performing loans, it is anticipated that the capital build up might be affected by increasing levels of specific provisions unless the situation is appropriately contained.

### 2.1.1.2 Earnings

The capital position of the banks is constantly enhanced by the profitability of the sector. In the six months period to September 2012, the banking sector registered an increase in the return on equity (ROE) to 37.9 percent from 34.5 percent in March 2012.

ROE reflects the banking institutions' efficiency in using capital and over time, it provides information on the sustainability of deposit-takers' capital positions. Similarly, return on assets (ROA), which is a measure of deposit-takers' efficiency in using assets of the banking institutions, increased to 5.3 percent in September 2012 from 5.0 percent in March 2012.

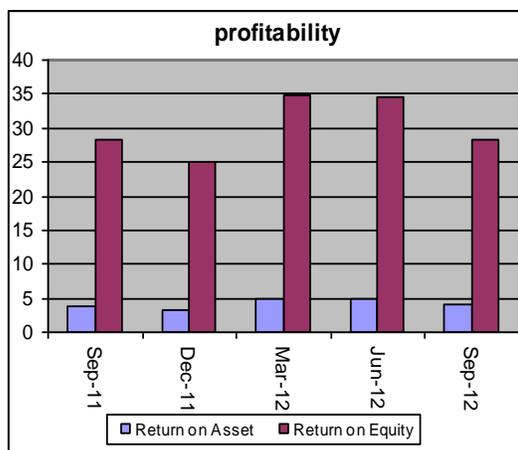
An analysis of earnings of the banking sector indicates that the sector still relies strongly on income from non-traditional banking business, with non-interest income constituting 46.0 percent of the total income as at September 2012 and 48.0 percent as at March 2012. Income from foreign exchange transactions contributed 64.0 percent and 57.0 percent of non-interest income as at September and March 2012, respectively.

### 2.1.1.3 Liquidity

Liquidity is critical to the survival of the banking sector as banks need to settle any claims as they fall due. The minimum regulatory liquidity ratio is 30 percent which represents liquid assets as a proportion of deposits and short term liabilities<sup>7</sup>.

<sup>7</sup>Liquid assets as a percentage of total assets referred to as the liquid-asset ratio, is an asset-based financial soundness indicator that reflects the liquidity available to meet expected and unexpected demands for cash.

**Chart 2.5 Banking Industry Profitability**

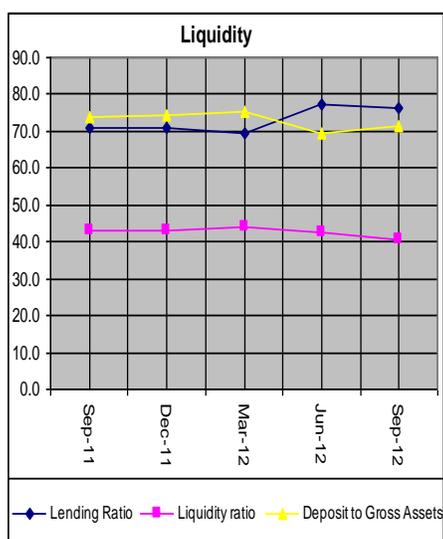


Source: Reserve Bank of Malawi

The liquidity ratio of the banking industry was at 40.7 percent, which was above the regulatory requirement. This ratio slightly declined from 42.8 percent as at March 2012.

Although the banking sector ratio was above the minimum regulatory benchmark, some individual banking institutions failed to meet on a consistent basis the minimum liquidity ratio over the six months period to September 2012. Generally, the period under review witnessed unprecedented levels of liquidity shortages in the banking sector. As a result, the average discount window accommodation increased to K14.32 billion in September 2012 from K0.45 billion in March 2012. In addition, the interbank market rates rose to 21.8 percent in September 2012 from 5.7 percent recorded in March 2012.

**Chart 2.6 Banking Industry Liquidity**



Source: Reserve Bank of Malawi

Also of worth noting is the growing trend in the lending ratio (Total loans and leases to Total deposits). This ratio provides an indication of the extent to which a bank has invested its deposits in liquid or non-liquid assets (loans and leases). The banking sector lending ratio at 76.4 percent in September 2012 increased from 70.3 percent in March 2012. This position indicates that the banks are investing more in loans and leases out of the mobilized deposits. In view of the increasing trend in non-performing loans, this position points to potential liquidity challenges arising out of cash flows that banks would not get due to defaults.

### 2.1.2 Banking Sector Risks and Remedial Measures

A large concentration of credit in a specific economic sector or activity has the potential of increasing the vulnerability of the banking sector to negative developments in that sector or activity. Studies have revealed that a number of previous financial crises were precipitated or amplified by downturns in particular sectors of the economy spilling over into the financial system. Thus, loan concentrations in the corporations, and individual and household sectors, necessitate close monitoring. The surveillance should focus on repayment capabilities as higher repayment burdens increase the vulnerability of the private sector to adverse economic shocks.

Another risk facing the banking sector in Malawi emanates from unavailability of foreign exchange. The prevailing global liquidity constraints could likely curtail credit lines by correspondent banks thereby reducing letters of credit and foreign exchange business in general.



As a result, the profitability of banks would decline. In the same vein, low foreign exchange reserves for Malawi could effectively deny commercial banks an important source of funding thereby affecting their profitability. Unavailability of foreign exchange can be attributed to poor performance of tobacco sales at the auction floors. To counter this challenge, the Malawi Government has established the Export Development Fund (EDF) and the National Export Strategy which are geared towards raising foreign exchange for the country through the financing of non-traditional exports and prioritizing of agricultural products like soya beans and sugar.

## **BOX 2.1: BASEL II AND FINANCIAL STABILITY**

The Reserve Bank of Malawi took policy position in 2005 to adopt Basel II in its supervisory work. Currently, Malawi is under Basel 1 and preparations are under way to adopt Basel II by 2014. It is believed that adoption of Basel II will promote financial stability since under Basel II regulation of bank capital plays a key role in banks' soundness, risk-taking incentives and corporate governance. This is because poorly capitalized banks are likely to spur systemic risk and hence threaten financial stability.

### **What is Basel II?**

Basel II is a revision to the 1988 Basel Capital Accord (commonly known as Basel 1) produced by the Bank for International Settlements (BIS) headquartered in Basel, Switzerland. Basel 1 was intended to provide a framework within which internationally active banks mainly in G10 countries could compete on a level playing field with regards to regulation. However, due to regulatory arbitrage the Basel Committee on Banking Supervision (BCBS) proposed a revised capital framework in 1999 which was approved in June 2004. The new framework aims to reduce the scope of regulatory arbitrage by improving the measurement of risk and better aligning risk weights with the underlying risks. The overarching goal for the Basel II Framework is to promote the adequate capitalization of banks and to encourage improvements in risk management, thereby strengthening the stability of the financial system. This goal will be accomplished through the introduction of the "three pillars" that reinforce each other and that create incentives for banks to enhance the quality of their control processes. Whereas the structure of Basel 1 was premised on one pillar (i.e. minimum capital requirements), Basel II is premised on three pillars as follows;

**"Pillar 1"** of the new capital framework revises the 1988 Accord's guidelines by aligning the **minimum capital requirements** more closely to each bank's actual risk of economic loss.

**"Pillar 2"** of the new capital framework recognises the necessity of conducting effective **supervisory review** of banks' internal assessments of their overall risks to ensure that bank management is exercising sound judgement and has set aside adequate capital for these risks.

**"Pillar 3"** leverages the ability of **market discipline** to motivate prudent management by enhancing the degree of transparency in banks' public reporting. It sets out the public disclosures that banks must make that lend greater insight into the adequacy of their capitalisation.

The New Basel Capital Accord envisages a greater role for supervisory judgment in determining capital adequacy and increased use of rules of disclosure to impose market discipline on bank behaviour; thereby addressing many standard criticisms of the original 1988 Accord. Further, it is argued that the New Basel Capital Accord has the potential of significantly improving risk management practices in banking systems around the world, and that it would eventually increase the efficiency of the financial system.

### **Impending Basel II Regulations**

As part of preparations towards the adoption of Basel II Framework, the Reserve Bank of Malawi has developed a number of guidelines that will govern implementation of the Three Pillars of the Accord. The guidelines are expected to be issued to the market by December 2012. These include Credit Risk Guidelines, Market Risk Guidelines, Operational Risk Guidelines, Internal Capital Adequacy Assessment Process (ICAAP) Guidelines, Stress Testing Guidelines and Market Disclosure Guidelines.

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**BOX 2.2: SELECTED KEY FINANCIAL SOUNDNESS INDICATORS**

Key Ratio	QTR END 30 Sept 12	QTR END 30 June 12	QTR END 31 Mar 12	QTR END 31 Dec 11	QTR END 30 Sept 11
<b>Capital Adequacy</b>					
1. Tier 1	16.6	16.2	18.7	16.5	17.2
2. Total Capital	19.5	19.2	22.1	20.1	20.1
<b>Asset Quality</b>					
1. Non-performing loans to Gross loans	6.7	5.5	5.0	3.6	3.7
2. Specific provisions to Non-performing loans	34.6	30.5	20.9	36.9	29.9
<b>Earnings</b>					
1. ROA	5.3	5.1	5.0	3.5	2.9
2. ROE	37.7	35.7	34.5	24.7	20.6
3. Non-Interest expenses to Total Income	42.9	44.3	45.4	50.5	48.2
<b>Liquidity &amp; Funds Management</b>					
1. Liquid assets to deposits & short-term liabilities	40.5	42.5	42.9	43.0	42.9
2. Gross loans to Total deposits	76.2	75.9	70.3	70.9	71.0

## 2.2 THE BANK LENDING SURVEY

The lending survey is undertaken by the Research Department of the Reserve Bank of Malawi bi-annually in April and October. The main objectives of the survey are to:

- Supplement statistics on credit market conditions in order to broaden the assessment of monetary and economic developments as an input into monetary policy decisions;
- Enhance RBM's assessment of the usage of private sector credit in order to ascertain whether the bulk of the credit is being channelled to productive avenues;
- Facilitate the preparation of economic forecasts as information regarding expected changes in credit conditions could enhance the precision of economic projections; and
- Bolster the assessment of systemic risks through acquisition of information regarding the commercial banks' pricing of risk.

### 2.2.1 Response Rate

Questionnaires were sent to twelve commercial banks and all twelve responded, yielding an overall response rate of 100 percent.

### 2.2.2 Credit Developments April 2012 - October 2012

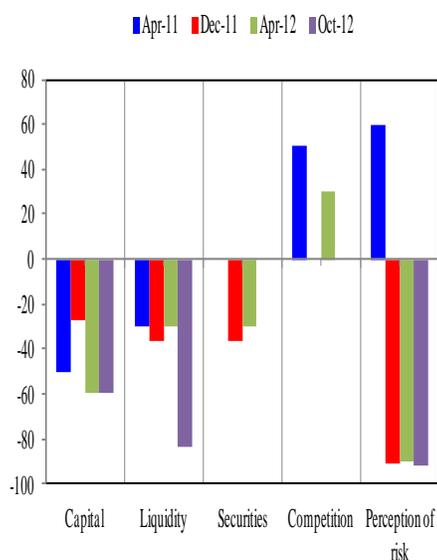
The Reserve Bank of Malawi (RBM) adjusted the Bank rate twice from 13 percent to 16 percent in May 2012 and 21 percent in July 2012. The RBM also temporarily introduced non-collateralized lending to support Banks' liquidity at 4 percent above each institution's base lending rate. Concurrently, commercial banks adjusted their lending rates from 18.2 percent to 20.6 percent in May 2012 and 31.4 percent in July 2012. Evidently, the spread between the Bank rate and the lending rate more than doubled from an initial level of 4.6 percent in May 2012 to 10.4 percent in July 2012. The disproportionate widening of the premium was attributed to the money market rates underpinned largely by the rates prevailing on the RBM's non-collateralized discount window as well as cost of funds considerations. The high rates notwithstanding, gross credit by the commercial banks amounted to K25.2 billion against recoveries of K232.6 million yielding a net extension of K24.9 billion in the six months to October 2012. Overall, 10 out of the 12 banks recorded net extensions whilst net recoveries were registered at only 2 of the banks. In terms of sectoral

Table 2.1 Growth by Sector

GDP GROWTH BY SECTOR	April-BLS Oct-BLS					
	2008	2009	2010	2011	2012	2012
Agriculture, forestry and fishing	4.2	13.1	2.0	6.3	4.1	-2.9
Mining and quarrying	35.8	4.9	80.2	-4.5	13.9	18.7
Manufacturing	19.5	4.8	2.2	1.6	2.0	-6.4
Electricity, gas & water supply	5.0	6.6	4.0	4.4	2.0	3.3
Construction	2.7	7.4	16.1	-2.4	4.2	10.5
Wholesale and retail trade	19.2	6.6	8.0	3.5	5.0	2.9
Transportation and storage	16.3	8.9	4.2	2.7	4.2	4.8
Accommodation and food services	7.6	13.2	8.4	0.4	6.0	3.5
Information and communication	58.1	10.5	10.0	6.5	7.5	11.9
Financial and insurance activities	-14.7	7.8	10.6	10.0	8.7	5.9
Real estate activities	19.7	12.1	11.0	2.6	2.6	4.1
Public administration and defense	7.4	4.9	5.8	-1.8	1.1	5.8
<b>GDP at constant market prices</b>	<b>8.3</b>	<b>8.9</b>	<b>6.7</b>	<b>4.3</b>	<b>4.3</b>	<b>1.9</b>

Source: Ministry of Economic Planning and Development

Chart 2.7 Credit Standards



*The positive value refers to credit standards easing or that the factor has impacted the easing of credit standards while the negative balance refers to credit standards tightening or that the factor has affected the tightening of credit standards*

contribution, the commercial and industrial sector accounted for 46.1 percent of the resources extended, up from 42.2 percent in the April 2012 survey. Notably, foreign exchange loans benefited 33.7 percent of the resources reflecting largely exchange rate valuation. Households and individuals only accessed 13.4 percent of the credit in contrast to 34.1 percent in the April 2012 survey. Notably, commercial banks' provision for bad debt rose by 8 percent in the six months to October 2012.

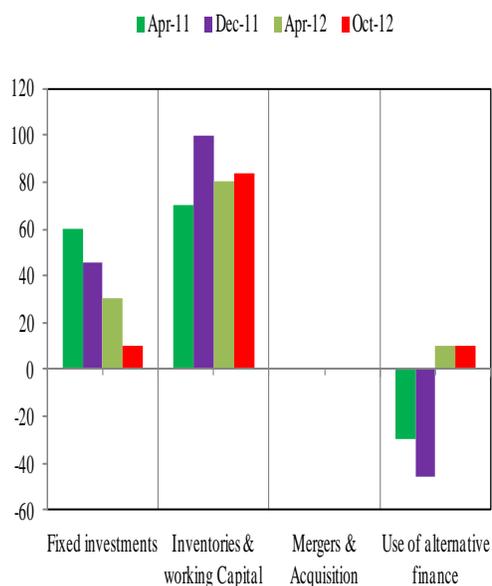
### 2.2.3 Developments in Credit Standards

Despite fresh impetus to market confidence in the aftermath of the transition of Government, the October 2012 bank lending survey (BLS) shows that the net tightening of banks' credit standards was broadly stable at the commercial banks. The maintenance of the status quo was applied to both households and corporations. In net terms, tight credit standards remained virtually unchanged for small and medium enterprises whilst overall limited changes of terms and conditions on loans to corporations were effected.

Developments in credit standards were attributed to several factors. Banks' risk perceptions continued to bias the net tightening of credit standards. Albeit a better industry specific outlook following improved availability of foreign exchange and fuel, participating banks reiterated that the impact of expectations regarding general economic activity contributed more to tighter credit standards. Growth was revised downwards to 1.9 percent for 2012 from an earlier estimate of 4.3 percent. Aligned with these projections, 91 percent of the reporting institutions, slightly up from 90 percent, indicated stronger impact of risk perception.

The percentage of commercial banks reporting that cost of funds and balance sheet constraints contributed to a tightening of credit standards on loans to enterprises increased in October 2012. In particular, Banks reported an increase in the net tightening contribution from liquidity and access to market funding from 30 percent and 10 percent to 83 percent and 66.7 percent, respectively. A general liquidity crunch ensued in the aftermath of the devaluation which also led to a dry interbank money market. This situation compelled the central bank to avail resources on a non-collateralized discount window to bridge the depository corporations' operational and prudential needs. At the same time, banks' capital position continued to exert pressure on supply as the depository corporations weighed in on the optimal balance

**Chart 2.8 Factors Affecting Demand For Loans**



*The positive balance shows an increase of the demand or that the factor has contributed to increased demand, while the negative balance reveals a fall of demand or that the factor has contributed to decreased credit demand.*

considerations to match their growing liabilities. In contrast, counterbalancing factors like pressure from competition, which generally works in the direction of easing of credit standards, were non-aligned to credit supply standards developments.

#### 2.2.4 Developments In Demand for Loans

Commercial banks continued to report a pronounced net increase in demand for loans at 83.3 percent in October 2012, compared to 70.0 percent of April 2012. The net increase was attributed mainly to large enterprises whose demand surged to 83.3 percent and SMEs demand remained virtually unchanged at 80 percent. The main drivers of the net increase were working capital and inventories demand whose contribution increased to 83.3 percent in October 2012 from 80 percent in April 2012. Demand for facilities surged in the aftermath of the devaluation and subsequent floatation of the kwacha in May 2012. The situation was reinforced by inflationary pressures propelled largely by the depreciation of the currency and the adoption of an Automatic Pricing Mechanism for fuel which translated into monthly adjustments of pump prices. The improved availability of foreign exchange since May 2012 also exerted pressure on Banks' facilities as economic agents began to settle their outstanding foreign exchange obligations. Subsequently, net demand for loans increased as manifested in episodic requests for possible enhancement of credit limits. For most SMEs, demand remained strong despite higher interest rates. Financing needs for fixed investments and use of alternative finance contributed somewhat less to the net increase in demand at equivalent levels of 10 percent, respectively.

For households, Banks reported a contraction in demand for mortgage loans at a pace of -25 percent in October 2012. Both housing market prospects and consumer confidence contributed to the considerable net decline in demand for housing loans underpinned largely by lower economic activity and high servicing costs.

#### 2.2.5 Prospects For November 2012 - April 2013

The Banks' experts assess credit standards as applied to loans to enterprises and households to tighten further in the six months to April 2013. The pessimistic outlook is premised on several factors. Firstly, the weaker economic prospects and the high interest rates have elevated the threat of non-performing loans and probability of high default rates. As a result, Banks are likely to increase their provisions for bad debt. The cleaning up of the loan



book should come at a cost of more financing of private sector activities. Secondly, liquidity constraints at most banks' has led to deposit mobilization campaigns and interbank activity at higher rates hence the cost of funds considerations should work in the disfavour of extending loans. Thirdly, the Banks indicated that BASEL II considerations regarding the optimal level of risk weighted assets of the loan book to meet capital requirements should compel most depository institutions to trim the loan book hence lend less in the process.

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## 2.3 STRESS TESTING

Stress testing generally is used as a generic term for the assessment of the vulnerability of individual financial institutions or the financial system to shocks. Typically, stress testing is the application of “what if” scenarios, especially interested in the problematic identification of low frequency but high severity events. It focuses on capturing the impact of “large, but still plausible events”; and understanding the overall risk profile in a coherent and consistent framework, including impact analysis on earnings, solvency and liquidity. Stress testing makes risks more transparent by estimating the potential losses in abnormal markets.

Portfolio-level stress testing aims to examine potential vulnerabilities faced at the portfolio or institutional level; whilst macro, or aggregate, stress testing is used to assess the overall stability of the financial sector by stress testing the vulnerability of systemically important financial institutions to adverse macroeconomic events. Macro stress testing also aims to identify common vulnerabilities across institutions that could undermine the overall stability of the financial system and seeks to understand how major changes in the economic environment may affect the financial system as a whole.

The two key words used to define a stress event are 'exceptional' and 'plausible'. Stress-testing assesses effects of only exceptional, that is low probability, events. Stress testing permits a forward-looking analysis and a uniform approach to identifying potential risks generated by exceptional but plausible shocks to individual institutions and/or the financial system as a whole. It also examines potential vulnerabilities faced by institutions that may not be revealed by quantitative risk management models. Stress testing supplements the output of quantitative risk management models such as Value at Risk (VAR), and have the advantage over VAR of explicitly linking potential large losses with specific events. Stress testing also enables management to better understand the nature of risks embedded in business lines and may also help to initiate dialogue in order to quantify the effects of exceptional events on various risk types in isolation and on combinations of risks.

Finally, stress tests can assist institutions in conducting appropriate contingency planning for periods of stress and contribute to the process of allocating capital within the financial institution.

The Reserve Bank of Malawi conducted stress tests on 11

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banking institutions based on data as at end June 2012. Emphasis was put on trying to establish relevant links between the macro shocks and the variables in the stress testing spread sheet. In addition to shocks affecting single risk types (e.g. credit risk and foreign exchange risk), shocks were combined in order to look at the combined effects on the banks' financial positions, mainly their Tier 1 ratios. The results for the whole banking sector were analyzed and are discussed below.

A range of macro shocks and combination of shocks were used. The results indicated that, in general, the single biggest risk of most of the banking sector stems from concentration risk related to large borrowers. The effect of shocks to the sector's net interest income and income from foreign exchange trading activities on the tier 1 capital and return on assets (ROA) were also analyzed and discussed. The results indicated that the shocks have a large effect on most of the banks' tier 1 capital and ROA. Six banks would have a negative ROA in the first scenario and in the second scenario seven banks would have a negative ROA owing to their high dependence on income from foreign exchange trading.

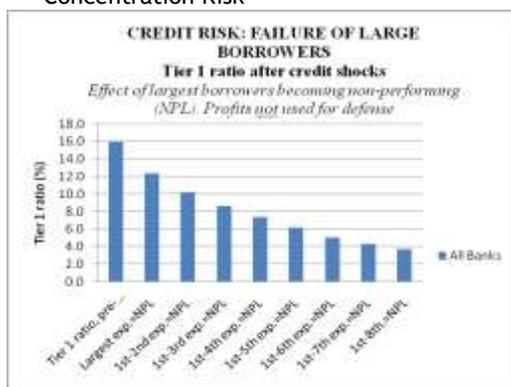
The results further indicated that some banks are considerably more exposed to liquidity risk than others. For example, if there was a sudden withdrawal of 20 percent of the banks' domestic deposits and a 5 percent withdrawal of their foreign currency demand deposits, three banks would be illiquid after two days.

More detailed results of the stress tests are provided below. However, the exact identities of the banking institutions have been intentionally omitted. For discussion of weaknesses/limitations of the model and data used in the stress tests please refer to Boxes 2.3 and 2.4.

### **2.3.1 Large Exposures Concentration Risk**

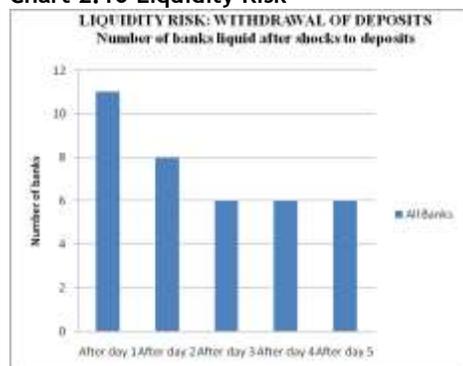
Risk concentration towards large loan exposures is probably the single largest risk exposure of the banks in Malawi. As per chart 2.9, there is a considerable decrease in Tier 1 ratio even if only the largest exposure in each bank becomes NPL and the loan loss provision is 50 percent. Tier 1 ratio for the banking sector declines from 16.0 percent to 12.4 percent; and after the first to sixth largest exposures fail, tier 1 ratio for the banking sector declines to 5.1 percent (that is below the regulatory minimum of 6.0 percent). Two banks would have their tier 1 ratio below the regulatory minimum just after the first

Chart 2.9 Largest Exposure Concentration Risk



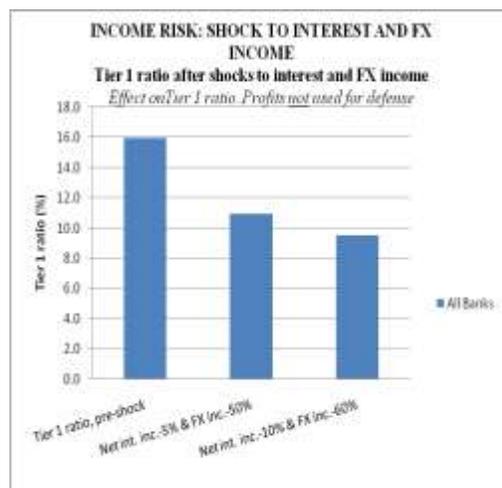
Source: Reserve Bank of Malawi

Chart 2.10 Liquidity Risk



Source: Reserve Bank of Malawi

Chart 2.11 Effect of Income Shocks on Tier 1 Ratio



Source: Reserve Bank of Malawi

to second largest borrowers failed. The results highlight the considerably large exposure concentration risk the banks are subject to.

- i. The following assumptions were made:
- ii. The first largest borrower fails.
- iii. The first and second largest borrowers fail.
- iv. The first, second and third largest borrowers fail.
- v. The first, second, third and fourth largest borrowers fail.
- vi. The first, second, third, fourth and fifth largest borrowers fail.
- vii. The first, second, third, fourth, fifth and sixth largest borrowers fail.
- viii. The first, second, third, fourth, fifth, sixth and seventh largest borrowers fail.
- ix. All the eight largest borrowers fail

### 2.3.2 Liquidity Risk

As per chart 2.10, the results show that three banks will be illiquid, i.e. the net cash outflow from the assumptions is larger than the cash available from the assumptions, after day 2. After day 3, other two banks will be illiquid. By the end of day 5, only six banks remain liquid.

The following assumptions were made:

- i. A withdrawal of 20.0 percent of both domestic demand and time deposits each day for five days.
- ii. That only 5.0 percent of the foreign currency deposits are withdrawn as a result of the shock.
- iii. That the banks do not use the “discount window” or other funding alternatives to compensate for the lost deposits.
- iv. 80.0 percent of the liquid assets and 1.0 percent of the non-liquid assets were assumed to be available each day.

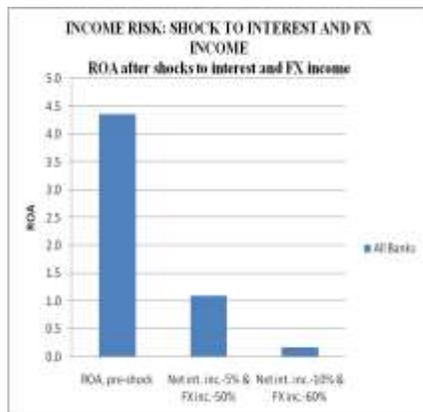
### 2.3.3 Effect of Shocks to Interest and Foreign Exchange Income on Tier 1 Ratio

As per chart 2.11, tier 1 ratio for the banking sector declines from 16.0 percent to 11.0 percent in the first scenario and further declines to 9.5 percent in the second scenario. Tier 1 ratio for three banks declines below the regulatory minimum after being subjected to the shocks as assumed in chart 2.11.

The following assumptions were made:

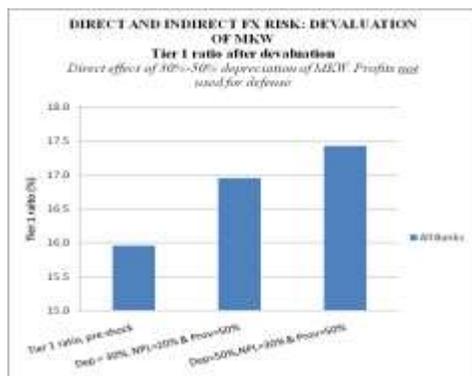
- i. In the first scenario a shock of 5.0 percent to
- ii. net interest income and 50.0 percent shock to forex income.

**Chart 2.12 Effect of Income Shocks on ROA**



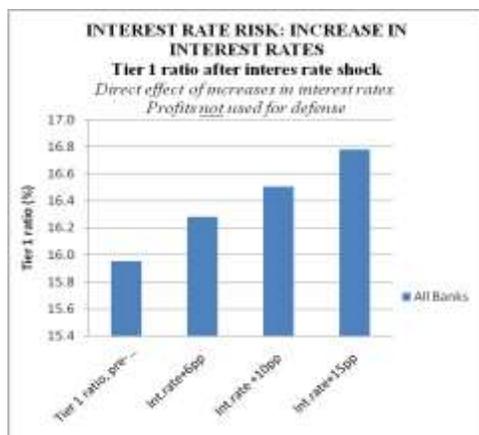
Source: Reserve Bank of Malawi

**Chart 2.13 Direct and Indirect Effect of Devaluation**



Source: Reserve Bank of Malawi

**Chart 2.14 Tier 1 Ratio After Increase in Interest Rates**



Source: Reserve Bank of Malawi

iii. In the second scenario a shock of 10.0 percent to net interest income and 60.0 percent shock to forex income.

### 2.3.4 Foreign Exchange Risk

A bank might be exposed to both direct and indirect foreign exchange risk. The direct risk reflects the net open exposure of all foreign currency positions, while the indirect risk reflects the risk a bank faces from loan customers who have borrowed in a foreign currency. Chart 2.13 above shows the direct and indirect effects of the shock on all banks. As seen, the banking sector will actually benefit slightly even if the NPL on foreign exchange loans is 30 percent and the loan loss provision is 50 percent.

The following assumption was made; banks are exposed to both direct and indirect foreign exchange rate risk.

The direct risk reflects the net open exposure of all foreign currency positions, while the indirect risk reflects the risk a bank faces from loan customers who have borrowed in a foreign currency.

In the first scenario there is a 30.0 percent depreciation of the Malawi Kwacha (MKW). 20.0 percent of the banking sector foreign exchange loans become NPLs and that the loan loss provision on these loans is 50.0 percent.

In the second scenario there is a 50.0 percent depreciation of the MKW. 30.0 percent of the banking sector foreign exchange loans become NPLs and that the loan loss provision on these loans is 50.0 percent.

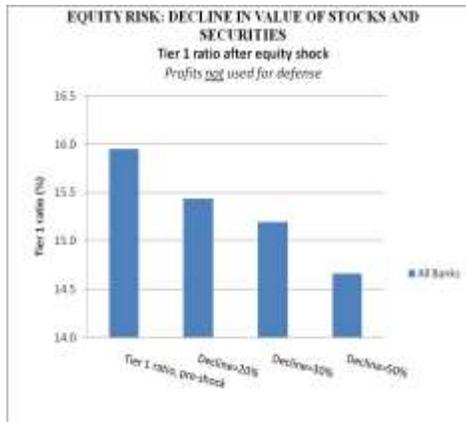
### 2.3.5 Interest Rate Risk

The results indicate that only one bank will experience a substantial drop in tier 1 ratio as a direct result of an increase in interest rates of 15 percentage points (i.e. from 11.4 percent to 5.9 percent). Overall, six banks experience a drop in tier 1 ratio; and five banks experience substantial gain in tier 1.

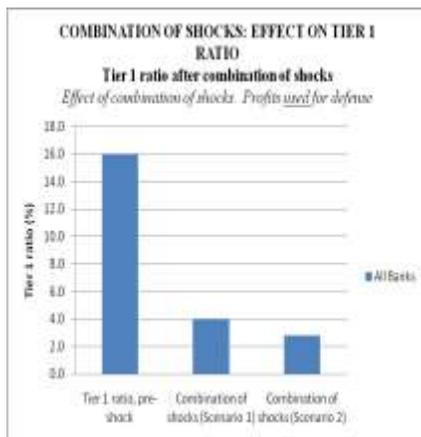
### 2.3.6 Equity Risk

The banking sector holdings of shares listed on the MSE and other non-listed securities are rather small. This implies that even large shocks (for instance, 50.0

**Chart 2.15 Tier 1 Ratio After Equity Shock**



**Chart 2.16 Tier 1 Ratio After Combination of Shocks**



percent) to the value of locally held stock will not affect the banking sector Tier 1 ratio to a critical extent, although its profits will deteriorate to some extent. Only one bank will experience a substantial drop of its tier 1 ratio as a result of this shock, that is, from 21.0 percent to 10.7 percent. Chart 2.15 shows the effects of 20.0 percent, 30.0 percent and 50.0 percent decline in the value of locally held stocks. The assumption of a reduction of 20.0 percent, 30.0 percent and 50.0 percent in the value of domestic stocks is employed.

**2.3.7 Combination of Agricultural Shock and Other Shocks**

In the stress tests above, it is assumed that the effects of the shocks are deducted *directly* from the Tier 1 capital, keeping all other factors constant. This is a “static” approach, in which it is assumed that the banks do not carry on with their activities during the stress testing period.

The effect of combined shocks is that in the second scenario five banks are particularly hard hit with their tier 1 ratios turning negative. Three banks also have their tier 1 ratios below the regulatory minimum. The effects of the combined shocks on the banking sector are shown in chart 2.16.

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### **Box 2.3: MODEL ISSUES**

For the purpose of this stress testing project it was decided to use the stress testing model developed by Mr. Martin Cihák of the IMF as a starting point. The model has been modified and adapted at various stages in order to incorporate the particular aspects of the economy and banks of Malawi. The modified version includes a function for stress testing equity risk and shocks to the banks' net income from foreign exchange trading. A function for combining shocks to the banks' net interest income and/or net foreign exchange income with other shocks is also included in the modified version. In its present form, the stress testing spreadsheet only allows analysis of the effect of the various stress testing scenarios on one measure of capital adequacy. For the purpose of this project, the Tier 1 capital ratio is chosen. However, other types of capital adequacy may be selected, e.g. Tier 1 and 2 ratio, Total equity/Risk weighted assets or Total equity / Total assets.

Furthermore, it is also worth mentioning that stress testing results based on the current spreadsheet might miss the next shock or crisis situation as it is based on the last (relevant) available historical data, and hence may not capture changes in the future risks should the banks change behavior and strategy. For example, if the banks enter into new activities or start selling new financial products, this will not be captured by stress tests based on historical data. Finally, many types of stress tests, including the ones conducted using the current spreadsheet, do not take account of any second round or feed-back effects in the banking sector. For example, in real life it is reasonable to assume that banks will change their behavior in a shock or crisis situation (reduce lending, inject new capital, sell off assets, etc).

Lack of relevant historical data and a more sophisticated model framework meant that this process to a large extent is relying on subjective and qualitative judgments. In order to compensate for this, a range of alternative scenarios were conducted for each risk type and combinations of risks and macro shocks. An advantage of using a subjective and qualitative approach is that one then may be more able to capture "new" shocks and the effects of these shocks. Even advanced stress testing models may not be able to capture such shocks because they are usually estimated on historical data.

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**Box 2.4: DATA ISSUES**

Some data gaps and mismatches were discovered, particularly related to the banks' sector exposures. Nevertheless, the data work and controls indicate that in general the quality of the data is acceptable for the purpose of this stress testing exercise. However, this does not necessarily imply that all the individual data items are of good or acceptable quality. It is difficult to evaluate the true quality of the data items without a thorough on-site inspection, and even then it is difficult. This particularly relates to the non-performing loans and loan-loss provisions, which are of crucial importance in stress testing. There is a considerable element of subjective evaluation of future events related to these items, and the "correct" answer is only known in retrospect, if at all.

The quality of the sector loan exposures can be questioned. One reason is that some sectors might be overrepresented and some underrepresented by the fact that a loan customer normally only has one sector code. For example, a customer might be involved in agriculture, manufacturing and trade. But because it is difficult or impossible for the bank to make a distinction between the various activities, it has to choose one sector code. This problem is difficult to avoid, although it might be worthwhile to make an effort to differentiate between the various sector activities of the largest loan customers, for which this problem is usually most serious.

### Main Message

The financial strength of the life insurance sector for the 6 month period up to end September 2012 was assessed as stable. Malawi's life insurance companies in terms of core capital are largely adequately capitalized on a consolidated basis. The major risks relate to asset concentration, mainly due to the limited long-term investment avenues available to the life insurance companies. The non-life, or general insurance sector is adequately capitalized on a consolidated basis. However, some individual insurers, who account for less than 15 percent of the market, and hence not deemed to be individually systemic to the sector have inadequate capital and solvency levels. Recovery plans submitted by these companies indicate that most of them will be compliant by 31 December 2012.

## 2.4 THE INSURANCE SECTOR

### 2.4.1 Assessment of Soundness of the Insurance Sector

#### 2.4.1.1 Capital Adequacy

The core capital of life assurance companies (Chart 2.17) is rated fair. Life assurance companies in Malawi have a statutory requirement to maintain minimum capital of K75.0 million. Only one company, which is viewed as not systemically important since it accounts for only 0.17 percent of the total industry assets, did not meet this requirement. This insurer however has strong reinsurance arrangements in place and its recapitalization plan indicates that the company will be compliant by end December 2012.

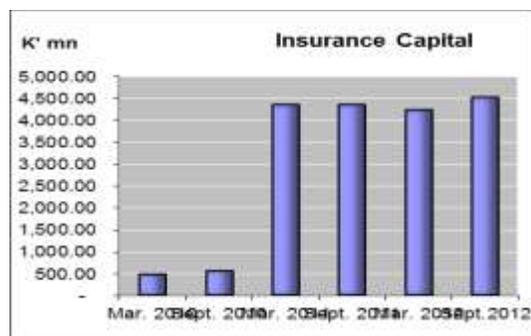
#### 2.4.1.2 Asset Mix

The asset mix of the life assurance industry (chart 2.18) showed a slight movement in the concentration levels of the industry's investment assets. The major concern still remains the high concentration of assets in equities resulting in the insurers being exposed to significant and adverse changes in the stock market, as well as an asset liability mismatch that may give rise to reinvestment risk. Life insurance companies held 48.9 percent of their assets in equities, followed by fixed deposits (22.9 percent) and government securities (11.6 percent) as at the end of September 2012. Although the level of investments in equities remains significantly high between the period April to September 2012, investments in equities and fixed deposits has slightly decreased from 51.1 percent and 24.7 percent to 48.9 percent and 22.9 percent, respectively. This could be as a result of the high interest rates prevailing in the money market. We therefore expect life insurers to shift from equities and fixed deposits to relatively higher yielding money market instruments including government securities. Currently, there are limited investment channels in Malawi and as such the asset mix is not expected to significantly change in the short term.

#### 2.4.1.3 Liquidity

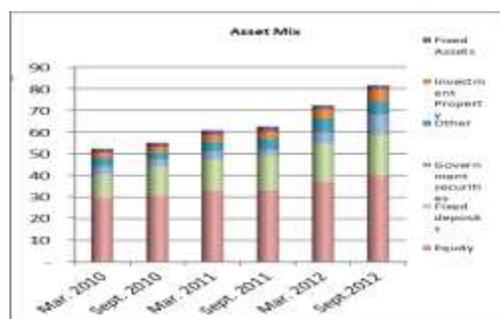
The liability to asset ratio measures the liquidity of the life company, with a higher ratio signifying a worsening liquidity position. The ratio deteriorated to 89.3 percent as at end September 2012 from 77.4 percent as at end March 2012 (Chart 2.19). This however was still below the threshold of 100 percent rule of thumb and can be deemed marginally acceptable. The decline was mainly due to a

Chart 2.17: Insurance Capital



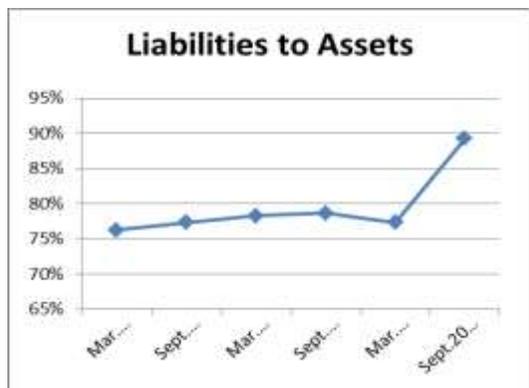
Source: Reserve Bank of Malawi

Chart 2.18 Insurance Asset Mix



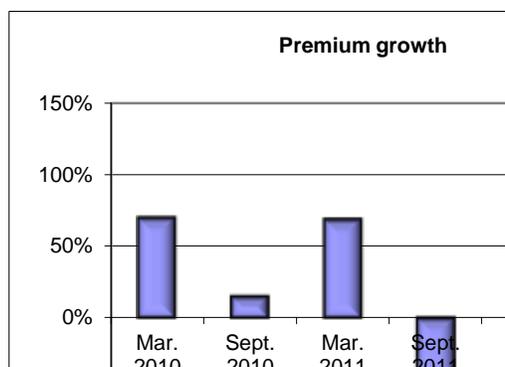
Source: Reserve Bank of Malawi

Chart 2.19 Liquidity in the Insurance Industry



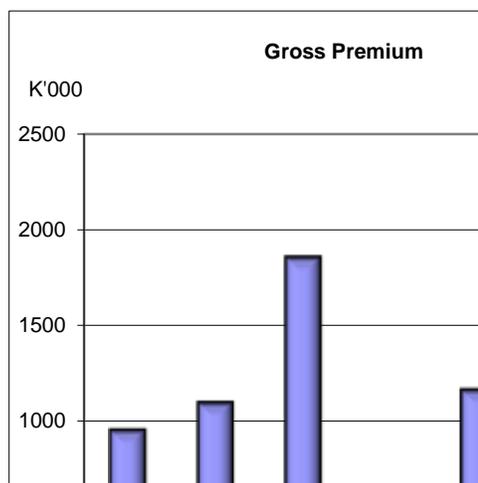
Source: Reserve Bank of Malawi

Chart 2.20 Premium Growth



Source: Reserve Bank of Malawi

Chart 2.21 Gross Premium



Source: Reserve Bank of Malawi

reclassification of liabilities. A significant portion of policyholder funds were previously classified as shareholder funds for one of the major life insurers. The reclassification had the effect of increasing policyholder funds by K8.0 billion.

#### 2.4.1.4 Premium Growth

The life insurance industry registered a substantial growth in gross life premiums for the period between April and September 2012. Premiums increased from K0.5 billion registered for the period April to September 2011 to K2.2 billion for the similar period in 2012 representing a 327.1 percent growth. The growth has emanated mainly from the implementation of the Pension Act 2011 which requires employers to maintain a mandatory group life insurance cover for all their employees.

#### 2.4.2 Insurance Sector Risks and Remedial Measures

The major risk in the life insurance sector still remains concentration risk. Assets of the sector are highly concentrated in stocks and therefore exposed to movements in the stock market. On the other hand, the mismatch of long term liabilities with short term assets poses a reinvestment risk to the industry. This asset structure is expected to continue for the short to medium term until the capital market deepens and broadens particularly in the area of long-term investments.

The general insurance sector's major risks remain solvency, liquidity and credit risk. The credit risk is as a result of high premium dues, which is affecting the liquidity and solvency of insurance companies. The solvency risk relates to the inability of an insurer to hold sufficient capital resources to underwrite various insurance policies. The liquidity risk relates to the inability of an insurer to meet payments of claims and benefits to policyholders as and when they fall due. While liquidity risk can be seen as short term, coupled with emergence of solvency risk, can be an early warning sign that the institution is in financial distress and could affect other insurers through the inability to meet co-insurance agreements.

The solvency risk is expected to decrease after the Registrar engaged some of the distressed general insurers which resulted in the injection of capital by shareholders and improved trading operations by some insurance companies.



The credit and liquidity risk in the general insurance sector are decreasing as a result of the implementation of the Premium Payment Directive which requires policyholders to pay insurance premiums in advance. It also requires that premium payments made by cheque should be written in the name of the insurance company even if the policyholder is paying through a broker. This has reduced the level of premium debts and improved the liquidity position of insurers.

### **Main Message**

*The Reserve Bank of Malawi commenced regulation of the pension sector with the passing of the Pension Act in March 2011. Due to the size of the assets of the pension sector and its interconnectedness with banks and the stock market, the sector has the effect of influencing the prices and yields in the financial sector. The pension sector assets are envisaged to grow at a brisker pace per annum and the assets are mainly in the financial and real estate sectors. If there is not sufficient deepening and widening of the financial markets, the additional inflows are likely to distort prices and yields in the financial sector and may cause a property bubble in the real estate market.*

## **2.5 THE PENSION SECTOR**

### **2.5.1 Assessment of Soundness of the Pension Sector**

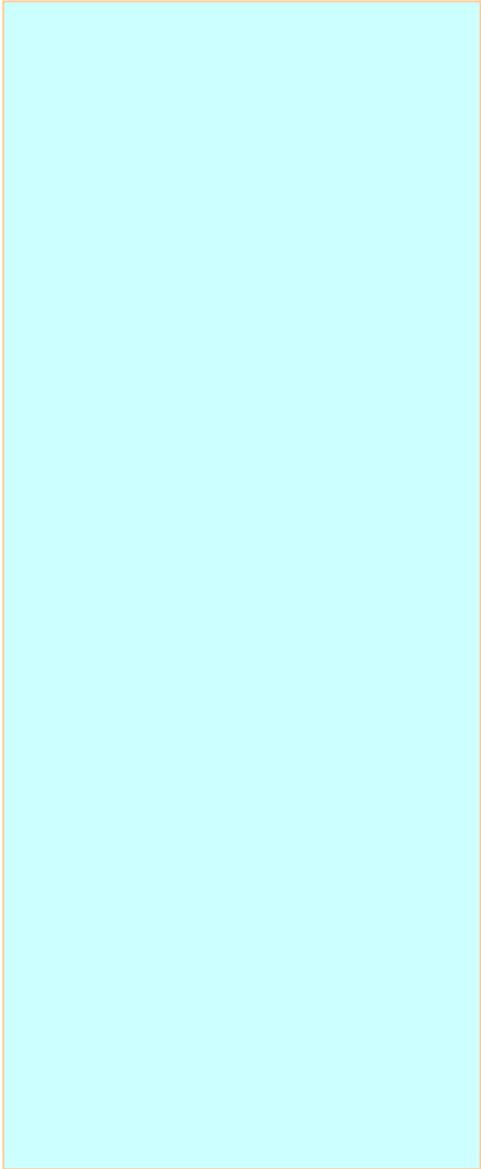
The Reserve Bank of Malawi commenced regulation of the pension sector with the passing of the Pension Act in March 2011. Entities that are now under the supervisory ambit of the Reserve Bank include pension funds, pension administrators, investment managers and custodians. It is estimated that there are currently around 900 pension funds, of which at least 14 are self-managed funds and the remaining are managed by pension administrators currently operating in the market. Current statistics show that there are about 102,505 employees on pension, excluding the civil servants on the civil service pension scheme. Total assets of the pension industry in 2011 were recorded at K67.7 billion which is about 7.1 percent of GDP in 2011 or 18.2 percent of the banking industry assets.

The passing of the Pension Act, which has made pension compulsory, is projected to improve the social welfare of the employees in retirement and increase household savings which are in turn expected to stimulate a number of economic benefits. The savings are also expected to stimulate capital market development particularly in long-term investments, in turn improving the risk-taking capacity of the market since pension funds, as long-term investors, are better able to tolerate short-term volatility. This is consequently expected to increase stability of the financial sector. Capital market development is likely to enhance tax revenues and also stimulate foreign direct investment as it increases the range of investment opportunities available to foreign investors. The pension industry is therefore expected to have a notable impact on the financial sector as it also has high deposits in banks which can result in liquidity problems for the banking sector if the pension sector is in distress.

### **2.5.2 Pension Sector Major Risks**

The major risks in the sector relate to the mismatch of liabilities and assets as well as the concentration risk. Due to limited long-term investment instruments available to pension fund investors, the investments are concentrated in the stock market, real estates and short term government bills making the pension sector vulnerable to any negative movements in the sectors. The mismatch of long term liabilities with

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short term assets poses a reinvestment risk to the pension industry. By making the provision of pension to all employees mandatory and enforcing preservation of pension by limiting access to pension funds it is envisaged that this will result in a significant net increase of pension funds per annum. Preservation of pension has the latent effect of increasing financial stability of the pension sector as funds are saved for retirement and accessed at retirement, affording pension funds some certainty on withdrawals and hence improving their investment strategies. Unless more investment avenues are created the injection of funds into the financial system will put pressure on existing investments and may drive down the returns on the market. From a compliance point of view, the civil service scheme is required to comply with the Pension Act by 31<sup>st</sup> June 2013. The failure by the Government to meet the deadline may pose a compliance risk and may cause instability in the sector.

### **2.5.3 Pension Sector Remedial Measures**

A possible remedy to challenges in investment opportunities is the relaxing of offshore investments for pension funds. The Pension Act limits investments of pension funds to within Malawi. However, in view of the challenges and in a bid to diversify the risk, there may need to allow offshore investment of pension funds. In the very short run, the opening up of investments outside Malawi may lead to increased pressure on the limited foreign exchange resources. However, in the medium to long run, the situation could reverse as dividends and returns from these offshore investments start providing a steady stream of foreign exchange inflows.

### **Main Message**

*The microfinance industry is still in its infancy stage and therefore its impact on the overall financial industry and stability remains minimal. However, it has been noted that banks have engaged themselves in wholesale credit to microfinance institutions that, in turn, use the funds for on-lending. There is therefore increased likelihood that negative events in the microfinance industry would negatively affect the financial sector.*

## **2.6 THE MICROFINANCE SECTOR**

### **2.6.1 Overview of the Microfinance Industry**

Currently, there are about 20 microfinance institutions (MFIs) and about 46 financial cooperatives (popularly known as SACCOs) with K15.0 billion in total assets. Out of the 46 existing SACCOs, 28 have been granted provisional licenses. A total of nine (9) applications were received from 20 institutions plying microfinance business in the industry. The applications are currently being assessed. The formalization of the industry is expected to bring sanity and confidence. The industry continues to operate using shareholder or promoter resources coupled with both local and external borrowing.

### **2.6.2 Regulatory Framework of the Microfinance Industry**

The microfinance industry previously operated under an array of laws namely: the Companies Act, Banking Act, Cooperatives Societies Act, Trustees Incorporation Act and the NGO Act. However, the industry practitioners currently fall under the regulatory and supervisory authority of the Registrar of Financial Institutions. Malawi enacted a number of financial services laws aimed at creating an enabling environment for the development of the financial sector and improvement of access to finance. Some of these laws namely, the Financial Services Act 2010, the Microfinance Act 2010, and the Financial Cooperatives Act 2011 coupled with the 2012 revised CGAP Guide to Regulation and Supervision of Microfinance, have created a complete change in the microfinance regulatory and supervisory arrangement both at global and national levels. Regulations (directives) supporting the legal instruments are either under formulation or already in place to complete the microfinance supervisory equation.

The industry practitioners are making final preparations through transformation, restructuring and recapitalization to formalize their operations. SACCOs are expected to be granted provisional licenses until expiry of the transition period in 2015. It is expected therefore that shareholders/financiers are likely to increase their stakes in the entities in a bid to meet minimum regulatory requirements. On the part of banks, the wholesale lending is also likely to increase now that they will be dealing with regulated entities.

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### 2.6.3 Recent Developments and Trends

Like the banks, SACCOs and MFIs were also faced with liquidity challenges during the review period, such that aggregate cash holdings fell significantly. The current ratio fell to 241 percent from 291 percent recorded in March, 2012. The cash ratio (cash-to-current liabilities) fell even further to just 53 percent from 82 percent recorded in March, 2012. Cash holdings during the period were mainly diverted to operational costs and the sector is now more reliant on short-term loans to settle its current obligations. Issues of new loans reduced. This scenario perpetrated low repayments of loans by MFIs. The increase in Bank rate (16 percent to 21 percent) which induced increases in banks' lending rates also adversely affected the liquidity of the industry and loan repayment. This outturn is likely to persist in the months to April/May 2013 as we approach lean liquidity season.

Owing to the increase in the cost of funds, MFIs were forced to revise their lending rates. The effective interest rate increased from 48.4 percent recorded in the previous period to about 81 percent as at end September 2012. The increase in effective interest rate resulted in a reduced demand for credit as well as high levels of non-performing loans. The loan book for MFIs, which stood at MK 8.76 billion as at end of March, 2012, decreased by 17.4 percent to MK7.24 billion at end of September 2012. The overall industry repayment rate deteriorated from 93 percent to 64 percent during the same period. Looking forward, the repayment rate is likely to continue deteriorating during the agriculture growing season and also in the wake of increasing cost of living and deteriorating business environment.

Negative media reports decreased within the period. Microfinance remains an industry characterized with negative publicity owing to perceived abusive lending and loan collection practices, less transparent pricing, political interference, and direct government involvement. The advent of the regulation has led to

improving industry reputation as practitioners strive to adopt transparent pricing and fair loan collection practices.

This is likely to continue as full implementation of the laws and directives gains force. However, complaints

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being lodged by clients to the Reserve Bank may increase as borrowers become aware of reporting obligation, courtesy of the consumer education program.

#### **2.6.4. Potential Risks**

The increase in the lending rates in commercial banks owing to the upward adjustment in the Bank rate in the period up to September, 2012 is likely to shake the sector as practitioners will be grappling with revising effective interest rates.

There was increase in deposits for SACCOs in the period to September 2012. This raises concerns about the potential risks from capital flow volatility in case of MFIs and whether the sector has adequate liquid assets to fund their operations including withdraws and further loan disbursements in a period of stressed liquidity. Risks could therefore arise by way of a slowdown in funding from offshore shareholders, tightening of credit conditions by commercial banks and reduced repayment rates.

A further deterioration in the quality of assets for the industry would negatively affect the industry's capital.

#### **2.6.5. Future Outlook of the Microfinance Industry**

The prevailing weak economic environment and high inflation translated into reduced loans and slow asset growth. In addition, deposit growth in SACCOs did not change significantly in the six months to June 2012 leading to tight liquidity and funding conditions for SACCOs. These trends affected the industry's performance in terms of loan quality as many loans went bad and credit growth slowed down. Going forward into the ensuing six months, the industry will continue to face similar challenges.

The Bank in conjunction with relevant stakeholders will continue to implement policies aimed at stabilizing the economy and reining in inflation and exchange rate volatility. In order to more firmly anchor soundness of the sector's market conduct, the Regulator will enhance surveillance of MFIs and SACCOs whose stability is substantially affected by non-performing loans to ensure that lending standards remain high and that loan quality does not deteriorate further.

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### **BOX 2.5 MAIN PROVISIONS OF THE MICROFINANCE ACT, 2010**

The Microfinance Act, 2010 is a new legislation that introduces the regulation and supervision of microfinance service providers. Before its promulgation, microfinance institutions operated under different legislative instruments such as the Banking Act, Trustees Incorporation and Companies Act.

The main objective of the Microfinance Act is to ensure that no person carries on business as a microfinance institution unless they are registered as a Microcredit Agency, licensed as a Non Deposit Taking microfinance institution or licensed as a Deposit taking microfinance institution under the Financial Services Act, 2010. Any person providing microfinance services outside of the above stated regulation shall be doing so illegally and risks prosecution.

The Microfinance Act provides for other financial institutions, licensed under the Financial Services Act 2010, to apply for approval from the Registrar of Financial Institutions if they are interested to offer microfinance services, alongside their mainstream financial business.

The Act also states that applicants to conduct microfinance business shall apply for a registration certificate, a license or an approval using a prescribed format to be provided by the Registrar. The applicant shall submit an application form, an application fee and any other documents as determined by the Registrar. Upon receipt of a full application package, the Registrar shall, within sixty (60) days, grant a registration certificate, a license or approval; or shall refuse to grant a registration certificate, license or approval to the applicant. This decision shall be communicated in writing to the applicant. The applicant may re-apply if they have addressed the issues that led to the denial of registration, license or approval.

The Act provides for two types of regulation for the microfinance sector: Market conduct for Micro credit agencies and prudential regulation for large Non Deposit Taking Microfinance Institutions and Deposit Taking Microfinance Institutions. Market conduct regulation involves information disclosure to an institution's clients about its lending policies and prudential regulation involves the comprehensive and detailed supervision of an institution's governance, internal controls and entails detailed and frequent reporting.

The Registrar may issue directives pertaining to the operations of the microfinance institutions. These directives may classify the type of services that a microfinance service provider, may provide which may vary according to different categories of microfinance institution. The directives may also include corrective action or administrative sanctions for non compliance as the Registrar may determine from time to time.

### Main Message

Main Message: The high interest rates currently prevailing in the market means that investors are pulling out of the stock market to invest in money market instruments.

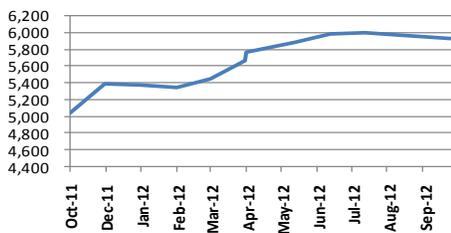
## 3.0 FINANCIAL MARKETS

### 3.1 THE CAPITAL MARKET

#### 3.3.1 Recent Trends

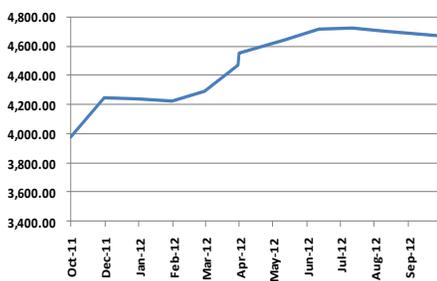
The first two quarters of 2012 saw continued steady increase in share prices on the Malawi Stock Exchange, with the Malawi All Share Index (MASI) gaining 636 points from 5347 in January 2012 to 5983 in June 2012. The trend slowed down and in other cases completely reversed in the third quarter with the MASI losing 57 and closing at 5926 by September 2012. Refer to Chart 3.1). The declining trend is mainly attributable to the Domestic Share Index (DSI) which lost 48 points in the third quarter from 4717 in June 2012 to 4669 by September 2012 although the index had gained 252 points and 245 points in the first and second quarters, respectively. (Refer to Chart 3.2). Further, the Foreign Share Index (FSI) rose by 38 points only in the third quarter from 653 in June 2012 to 691 in September 2012, after rising by 42 points and 76 points in the first and second quarters, respectively.

Chart 3.1 Malawi All Share Index (MASI)



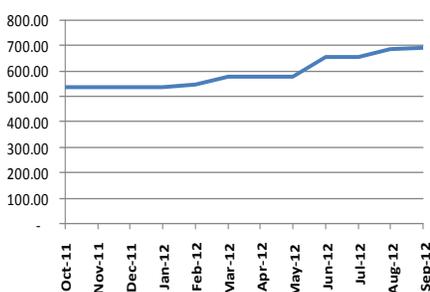
Source: Reserve Bank of Malawi

Chart 3.2 Domestic Share Index (DSI)



Source: Reserve Bank of Malawi

Chart 3.3 Foreign Share Index (FSI)



Source: Reserve Bank of Malawi

#### 3.3.2 Risks To The Capital Market

The high interest rates currently prevailing in the market mean that investors are re-aligning their portfolios out of the stock market to invest in money market instruments. Nevertheless, it is expected that the current exchange rate regime will encourage foreign investors to come back to the market which would provide a boost the stock market. This will depend on the ease with which investors can liquidate their investments and repatriate the proceeds.

The stock market has stagnated with no new listings on the market for the past 4 years. This is mainly due to low investor confidence as well as the tough economic condition over the past few years. Therefore, the number of listed companies on the Malawi Stock Exchange (MSE) remains at 14 and consequently investment opportunities remain limited and illiquid.

#### 3.3.3 Remedial Options For The Capital Market

The performance of the capital market is expected to remain fragile in the short-term in view of competitive interest rates obtaining in the money market. Therefore the performance of the capital market is likely to improve if the macroeconomic situation in the country improves. On the other hand, the problem of an illiquid market will probably be solved by the increase of investment opportunities on the market.

### **Main Message**

*There was a substantial increase in monthly average throughput to K825.8 billion recorded in the month of September 2012 from K308.8 billion in April 2012, representing an increase of 167.4 percent. The increase was largely due to discount window accommodation which RBM provided to the banking system to ease liquidity pressures which the system was experiencing after the Kwacha devaluation. The settlement process in MITASS as a whole proceeded smoothly despite the liquidity squeeze in the financial system that characterised the period under review.*

*Proportionally, the percentage contribution of FSIs to total throughput increased from 75 percent in April 2012 to 85 percent in September 2012, representing a 10 percentage point improvement and which was way above the set target of 75 percent. The improvement in system utilisation by MITASS participant reflects the positive impact of sensitisation efforts by RBM.*

*In terms of availability, MITASS was, largely, stable during the period under review.*

## **4.0 FINANCIAL INFRASTRUCTURE AND REGULATION**

### **4.1 MITASS and Financial Stability**

As a real time gross settlement system (RTGS), the role of the Malawi Interbank-funds Transfer and Settlement System (MITASS) in the country's financial stability efforts is reflected in 3 key issues; its availability, the degree of utilisation and participants capability to honour/settle their obligations. However, the overriding objective embedded in the analysis of these 3 key issues is the need to mitigate various financial and operational risks that threaten stability of the country's financial system.

### **4.2 MITASS and Financial Risks**

#### **4.2.1 System Design vs. Credit Risk**

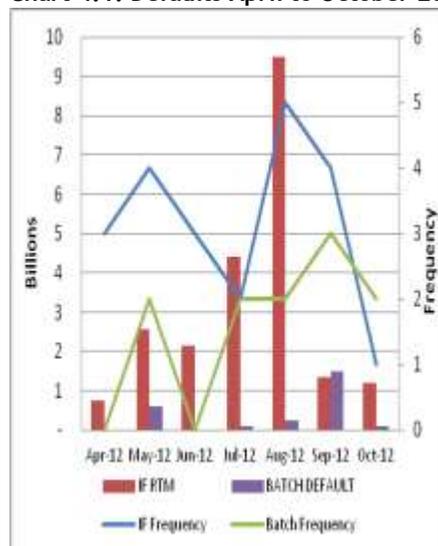
MITASS was designed based on the 'credit push' principle which means that participants must at all times ensure availability of sufficient funds in their settlement accounts domiciled at RBM. As such, interbank transactions are settled on a gross (i.e., order by order) basis drawing against balances in the respective participant's settlement accounts. Since it is not possible for the system to settle transactions against negative settlement account balances, credit risk is largely non-existent in MITASS.

#### **4.2.2 System Design vs. Liquidity Risk**

The requirement to prefund settlement accounts in MITASS may at times exert some liquidity pressure on settlement participants which is mostly manifested in participants' inability to honour their settlement obligations as and when required. To this end, the liquidity problems experienced by the banking system after the Kwacha devaluation meant insufficient funds in some MITASS participants' settlement accounts that led to a sharp increase in the frequency and amount of settlement defaults by the affected MITASS participants.

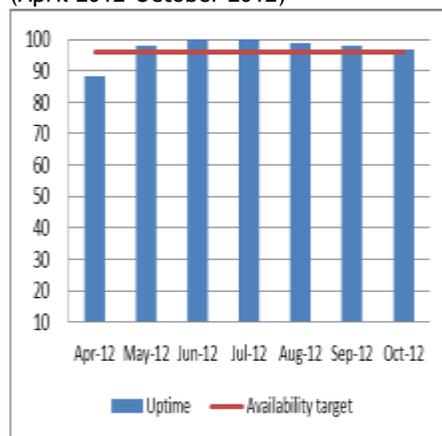
Total industry defaults for the period April to September 2012 therefore surged to K 23.1 billion from K 2.3 billion recorded for the period October 2011 to March 2012. However, a month to month analysis of the defaults during the period under review shows that the highest amount of defaults was registered during the month of August 2012 (i.e. 42.2 percent). In total, there were 21 cases of insufficient funds defaults on Funds Settlement Instructions (FSIs) and 9 cases of defaults on batched cheque transactions.

**Chart 4.1: Defaults April to October 2012**



Source: Reserve Bank of Malawi

**Chart 4.2 MITASS DOWNTIMES**  
(April 2012-October 2012)



Source: Reserve Bank of Malawi

The 3 highest defaulting banks during the period respectively accounted for 59 percent, 19 percent and 10 percent of the total default value.

There was a 71 percent drop in the total value of settlement defaults by September 2012 as the amount declined to K2.8 billion from K9.7 billion in August 2012 before dropping further to K1.3 billion in October 2012 (chart 4.1). The drop in settlement defaults reflects an improvement in the liquidity positions of MITASS participants as the banking system began to recover from the negative effects of the Kwacha devaluation.

### 4.3 MITASS and Operational Risks

#### 4.3.1 Availability and Reliability of MITASS

An equally important aspect of MITASS relating to its role and reputation in the country’s financial stability initiatives is its availability for real time settlement of large value transactions. MITASS downtime (i.e. system failure/unavailability) is a key indicator of operational risk in terms of system stability and reliability. While the ultimate goal of central banks is to make the RTGS system 100 percent available to participants, MITASS availability target stands at 96 percent in view of the nature of the prevailing physical infrastructure.

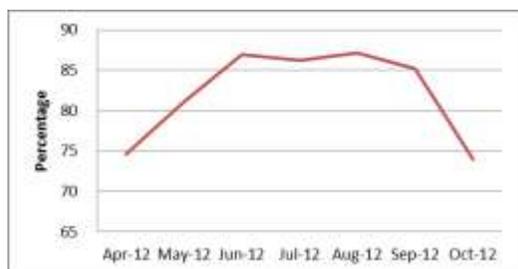
As can be depicted from Chart 4.2, overall MITASS availability for the review period stood at 97 percent reflecting a percentage point increase over the 96 percent recorded for the preceding six months. This implies that the system was not available for transaction purposes for a total of 30.5 hours during the review period, a decrease from the 43 hours recorded in the preceding period. On average, monthly down-time decreased from 7.2 hours in the preceding period to 5.1 hours in the review period. All efforts are therefore being made to minimise disruptions to the system.

On a month to month basis, MITASS uptime was lower than the desired availability target of 96 percent only in the month of April 2012 when it was available for 88 percent of the time. This was as a result of technical problems experienced during the month. However, system availability exceeded the desired availability target in the five months from May 2012 to September 2012.

#### 4.4 Utilization of MITASS

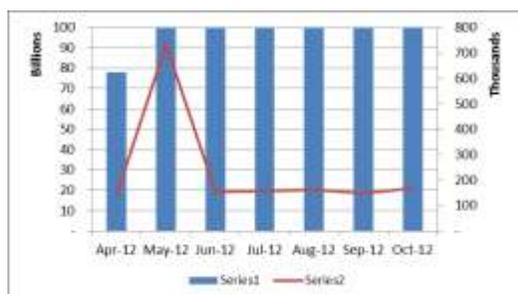
Optimal utilization of MITASS is measured by the ratio of the total value of funds settlement instructions (FSI) to

**Chart 4.3: Trend in Real Time Transactions (Gross as a percentage of throughput)**



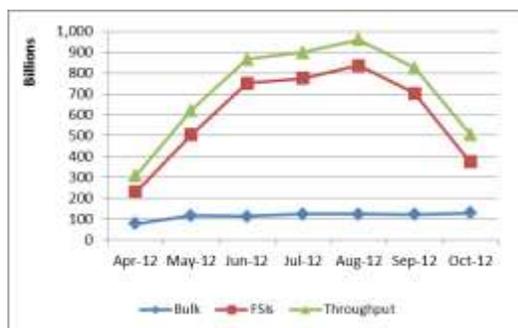
Source: Reserve Bank of Malawi

**Chart 4.4: ECCH Volumes and Values**



Source: Reserve Bank of Malawi

**Chart 4.5: Gross vs. Bulk Settlement (K'billions)**



Source: Reserve Bank of Malawi

total value of transactions settled in the system (i.e. total throughput). FSIs refer to instructions to the central bank to effect settlement obligations which are transmitted in the system on an individual, real time basis. Once the payments are effected, they are final and irrevocable. A high proportion of FSIs to cheques and smartcards in MITASS throughput is desirable since it implies low level settlement risk/uncertainty associated with delayed transfers of value.

During the period under review, the share of FSIs to total throughput increased from 75.0 percent in April 2012 to 85.0 percent in September 2012. The percentage contribution of FSIs in September 2012 is way above the set target of 75.0 percent. This trend is expected to continue on account of sensitization efforts by RBM.

Chart 4.4 also shows an increase in the total cheque values and volumes respectively. On average, the cheque values increased from K78 billion in April 2012 to K141.7 billion in September 2012, representing a 47 percent increase. Cheque volumes also increased by 7 percent from 139,045 in April 2012 to 149,292 in September 2012. The increase in cheque values was largely due to clearance of Government payments arrears.

Chart 4.5 shows overall MITASS activity during the period under review. There was a substantial increase in monthly average throughput to K825.8 billion recorded in the month of September 2012 from K308.8 billion in April 2012, representing an increase of 167.4 percent. The sharpest month-on-month increase in total throughput occurred in May and June 2012 where it rose from K308.8 billion in April 2012 to K622.2 billion and K865.6 billion in May and June 2012 respectively. On the other hand, FSIs increased by 205 percent from K230.4 billion in April 2012 to K703.3 billion in September 2012. This substantial increase was largely as a result of increased discount window transactions.

## 4.5 Other Developments in the National Payments System Infrastructure

### 4.5.1 Legislation

Enactment of the Payments Systems Bill will provide legal backing towards the various reform initiatives being undertaken in the country. The Bill is expected to be enacted in 2013.

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#### **4.5.2 MITASS User Training and Onsite Oversight Meetings**

Besides conducting training workshops for MITASS users in August 2012, RBM also carried out onsite meetings with MITASS participant institutions in October 2012. Both the users' training and meetings centred on ways of mitigating operational and settlement risks as well as promoting efficiency not only in MITASS but the entire payments infrastructure.

Going forward, it is hoped that banks' performances will improve, with respect to reduced cases of settlement defaults, owing to the user trainings and the onsite exercises that RBM undertook during the period under review.

#### **4.5.3 Update on FSTAP Projects**

Contract negotiations with the preferred bidder for the Automated Transfer System (ATS) Project were concluded in November 2012. This was followed by a project kick-off workshop with stakeholders whereby the successful vendor (Montran) showcased its product.