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1. Financial Stability : A Core Function for Morden Central Banks

1.1 Background

Achieving financial Stability[1] has become a core objective for central banks across the globe and Central Bank of Lesotho (CBL) is no exception**.** Historically, central banks have been concerned primarily with price stability and subsequently with financial stability. Since the 1990s, however, the concept of financial stability began to gain prominence among central banks; much like price stability had done in the decade before. Presently, preserving the value of money is still the pre-eminent objective of most central banks, but achieving financial stability is now recognized explicitly as a core responsibility of central banks. At a number of central banks, the growing emphasis given to financial stability has led to organizational changes, such as the creation of committees to coordinate activities across units and the establishment of units dedicated to financial stability work. The financial stability reports published by a number of central banks also bear witness to these changes.

The recent economic and financial crisis of 2007 further highlighted some weaknesses in the financial regulatory and supervisory

[1] A stable financial system must be the one allocating resources efficiently between activities and across time; assessing and managing financial risks; resilient and able to absorb both financial and real economic shocks.

systems. One of them was lack of system wide (macro-prudential) supervision which led to the failure of some of the world's leading financial service providers and of course failure of institutions which were generally regarded to be financially healthy. At the domestic level, Lesotho was not directly and heavily affected by the crisis, but it has some of the freshest examples of bank failures namely; Lesotho Bank and Lesotho Agricultural Development Bank. The failure of these banks has had a systemic impact on the local economy and slowed down economic development.

This article highlights the importance of financial stability in modern central banking, specifically for CBL. Section 1 explains why central banks should make financial stability a core function, the mandate and role of CBL in promoting financial stability in Lesotho, and the new approach to financial sector surveillance that CBL needs to adopt. Section 2, featured definition, briefly highlights the macro-prudential approach to financial sector regulation and supervision while section 3, featured economic event, outlines Basel III implementation stages. Section 4, featured descriptor, describes financial soundness indicators and section five shows selected economic indicators.

1.2 Why should central banks be concerned with achieving financial stability?

Financial Stability does not have one or a globally agreed definition but can generally be defined as a situation in which the financial system: timeously, efficiently and smoothly allocate resource from savers to investors, enables accurate assessment and pricing of financial risk and efficient and forward looking management of risk. A stable financial system is also resilient; it can, without any difficulty, absorb both financial and real economic shocks.

History has shown that financial instability often leads to financial crises. These are episodes of high volatility in financial markets, liquidity shortages and insolvency of most market participants, which can also affect output significantly and hamper economic growth. Because of this, and due to the fact that a central bank may have to play a prominent role in resolving banking crises, safeguarding the stability of financial systems at a macro level is an important issue for central banks, owing to the possible costs of disruptions to the whole economy. Central banks' interests in fully functioning financial systems originate in the key role that financial systems, especially banks, play in monetary policy. Disruptions in the financial system can delay or hamper the transmission of monetary policy decisions to the real economy. Asset price bubbles or a credit boom can undermine the basis for price stability in the medium to long term. Therefore, confidence in the monetary system and the functional viability of the financial system are two sides of a coin.

1.3. Mandate of the Central Bank of Lesotho and its role in financial stability

The main mandate or objective of the Central Bank of Lesotho as spelled out in the CBL Act (2000) is to achieve and maintain price stability. The Act also provides a number of functions but the most relevant for financial stability are: (i) to foster the liquidity, solvency and proper functioning of a stable market-based financial system; and (ii) to promote the safe and sound development of the financial system. It is evident that financial stability has been implicitly part of CBL's mandate. Practically, it would be difficult to maintain price stability in an unstable financial system as this could hamper monetary policy transmission to the real economy. For the CBL, this function has been carried out, partly, by promoting effective supervision of banks and other financial institutions (micro-prudential) and without a specific oversight framework (macro-prudential). As a result the current approach fell short of producing the optimal result.

The absence of a system-wide assessment of risk has made it hard to draw informed policy decisions and as such respond to cross-cutting financial sector challenges. Furthermore, it has also led to weak coordination of different financial sector regulators. Amongst challenges, lack of harmonization in legal frameworks; overlapping roles of different stakeholders; weak regulations, standards and market discipline; and lack of adequate data stood out as main hurtles to proper financial system surveillance.

Several studies, including a Baseline Assessment of Banking System Stability of March, 2012 conducted by the IMF, further showed that the current supervisory framework is weak and that the absence of an effective framework and adequate data and tools for financial sector surveillance, were a huge threat to financial stability in Lesotho. The study further raised important financial stability issues which among others entailed exposure of local banks to South African parent companies, as the banking sector mostly dominate the financial sector in Lesotho.

1.4 A new approach

Even though generally Lesotho's financial system, which is mostly dominated by subsidiaries of South African banks, appears to be stable, it is not immune to risks. Capital ratios are currently above regulatory minimum, non-performing loans are low, profitability is high and by standard measures of liquidity the banking system is highly liquid. However, there are still several risks emanating from both domestic and foreign sources. Domestically, most threatening risks are concentration in banks' loan books and among depositors, and

liquidity and credit risk. The most significant foreign risk is cross-border contagion from South Africa.

Given the prevailing status, CBL management has realized the need and scope to strengthen its structures and capacity for safeguarding financial sector stability. A reform programme has been proposed and, among others issues, include strengthening institutional arrangements, identifying gaps and strengthening data sources, developing appropriate tools of analysis, and building human and technical skills for effective assessment of financial sector risks. To implement the concept a decision has been reached to establish a stability function which includes a financial stability committee (FSC) and financial stability unit (FSU).

FSC will be responsible for making decisions on the financial sector policy and stability issues; reviewing the periodic reports on the development, risks and performance of the financial sector; providing recommendations on regulatory policies that would limit financial risks; and developing guidelines and procedures for the FSU. FSU on the other hand will be responsible for safeguarding the entire financial sector stability focusing on both banks and non-bank financial institutions; informing policy makers and banks about the possible risks to the financial system; providing recommendations on regulatory policies that would limit risks; and resolving problems in the financial system in an efficient manner.

This featured article benefited from:

-Nier, E. W. (2009) "Financial stability frameworks and the role of Central Banks: lessons from the crisis" International Monetary Fund Working Paper no 09/70

-Batunanggar, S. and Santos, W. (2007) "Effective Financial System Stability Framework" The South Eastern Asia Central Banks Research Training Center Occasional Paper No. 45

-IMF, (2012) "A Baseline Study of Banking System Stability in Lesotho" Monetary and Capital Markets Department

2. Featured Definition

Macro-prudential regulation: The term macro-prudential regulation characterizes the approach to financial sector regulation aimed at mitigating systemic risk. It is an oversight regulatory and supervision function that focuses on the stability of a financial system as a whole, rather than the safety and soundness of individual institutions on a stand-alone basis. The need for macro-prudential regulation of the system arises because the actions of individual companies acting prudently within guidelines may collectively result in the instability of a financial system. For example, if all lenders restrict lending or all companies sell assets at the same time.

Table 1: The macro- and micro-prudential perspectives compared

	Macro-prudential	Micro-prudential
Proximate objective	limit financial system-wide distress	limit distress of individual institutions
Ultimate objective	avoid output (GDP) costs	consumer (investor/depositor) protection
Characterisation of risk	Seen as dependent on collective behaviour ("endogenous")	Seen as independent of individual agents' behaviour ("exogenous")
Correlations and common exposures across institutions	important	irrelevant
Calibration of prudential controls	in terms of system-wide risk; top-down	in terms of risks of individual institutions; bottom-up

Source: Borio (2003)

The feature article benefited from: Borio, C.(2003) "Towards a macropudential framework for financial supervision and Regulation" BIS Papers, no. 128

3. Featured Economic Event

Implementation of Basel III: Basel III is the third generation accord of Basel Committee on Banking Supervision[2] (BCBS) developed to strengthen the regulation, supervision and risk management of the banking sector. Primarily it is aimed at (i) improving the banking sector's ability to absorb shocks arising from financial and economic stress; (ii) improving risk management and governance; and (iii) strengthening banks' transparency and disclosures. The official starting date for the implementation was set for 1 January, 2013 and expected to continue gradually through to the end of 2019. However, countries were expected to have done most preparatory work prior to this date, such as drafting regulations and guidelines. Main elements for the planned implementation of key components of Basel III are briefly discussed below.

[2] BCBS is the Bank for International Settlement committee which is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.

Capital requirements

Basel III reforms' highest priority is to strengthen the quality, consistency, and transparency of the regulatory capital base and to ensure that the capital base of every internationally active bank is backed by a high-quality buffer that can absorb losses during periods of economic distress. Capital requirements were put into effect on 1 January 2013. Thus, legislation and regulations had to be amended during the period prior to that date. From 1 January 2013 onwards, banks had to meet the following minimum capital requirements expressed in risk-weighted assets: 3.5% share capital, 4.5% Tier-1 capital and 8% total capital. During the transitional period from 1 January 2013 up to and including 2019, these ratios will gradually be stepped up to 4.5% share capital, 6% Tier-1 capital and 8% total capital.

Deposit taking institutions are expected to gradually build conservation buffer[3] to a percentage of 2.5% from 1 January 2016 through 1 January 2019. Thus, banks will ultimately have to hold 10.5% of their total capital expressed in risk-weighted assets. National supervisors will have to gradually introduce additional allowable deductions from bank capital such as deferred tax assets and investments in financial institutions from 1 January 2014 through 1 January 2018.

[3] Mandatory extra capital deposit taking institutions are required to build at all times which is intended to ensure that institutions are able to absorb losses in stress periods lasting for longer periods.

Leverage ratio

In light of the notion that capital requirements should not be solely maintained on the basis of risk weighted assets, BCBS adopted an additional measure to reinforce existing risk-based capital requirements, Leverage Ratio. As regards the introduction of the Leverage Ratio, from 1 January 2011 onwards, the supervisors concentrated on the development of templates to consistently monitor the components of this ratio. The period from 1 January 2013 through 1 January 2017 will be a parallel run period, during which the development of the Leverage Ratio will be monitored. The intention is to migrate the Leverage Ratio into the Pillar 1 requirements as from 1 January 2018.

Liquidity ratio

Strong capital requirements are a necessary condition for banking sector stability but by themselves are not sufficient. A strong liquidity base reinforced through robust supervisory standards is of equal importance. To date, however, there have been no internationally harmonised standards in this area. The Basel Committee is therefore introducing internationally harmonised global liquidity standards. As with the global capital standards, the liquidity standards will establish minimum requirements and will promote an international level playing field to help prevent a competitive race to the bottom. As from 2011, the Liquidity Coverage Ratio had to be monitored by both the BCBS and

the supervisor in order to officially make it mandatory with effect from 1 January 2015. While the Net Stable Funding Ratio's introduction as a minimum standard is planned for 1 January 2018.

The feature article benefited from: BIS, (2012) "Progress Report on Basel III Implementation" [Online] Available from < http://www.bis.org/publ/bcbs232.htm >

4. Featured Descriptor

Financial Soundness Indicators (FSIs): *FSIs* are statistical measures developed by the International Monetary Fund (IMF), together with other international organisations, such as the World Bank, the Bank for International Settlements, the Organisation for Economic Co-operation and Development (OECD), and the European Central Bank (ECB), plus IMF member countries in all geographic areas, with the aim of supporting macro-prudential analysis and assessing strengths and vulnerabilities of financial systems. They are used to monitor the financial health and soundness of a country's financial sector, along with corporate and household counterparts. A distinction is made between a list of 12 core indicators covering only deposit taking institutions and a list of 27 encouraged indicators meant for other economic sectors and markets.

Table 2: Financial Soundness Indicators: The Core and Encouraged Sets

Core Set	
Deposit-taking institutions	
Capital adequacy	Regulatory capital to risk-weighted assets Regulatory Tier I capital to risk-weighted assets
Asset quality	Nonperforming loans to total gross loans Nonperforming loans net of provisions to capital Sectoral distribution of loans to total loans
Earnings and profitability	Return on assets Return on equity Interest margin to gross income Noninterest expenses to gross income
Liquidity	Liquid assets to total assets (liquid asset ratio) Liquid assets to short-term liabilities
Sensitivity to market risk	Net open position in foreign exchange to capital
Encouraged Set	
Deposit-taking institutions	Capital to assets Geographical distribution of loans to total loans Spread between reference lending and deposit rates

	Spread between highest and lowest interbank rate Customer deposits to total (non-interbank) loans Foreign currency-denominated loans to total loans Foreign currency-denominated liabilities to total liabilities Net open position in equities to capital Large exposures to capital
Other financial corporations	Assets to total financial system assets Assets to GDP
Nonfinancial corporate sector	Total debt to equity Return on equity Earnings to interest and principal expenses Net foreign exchange exposure to equity Number of applications for protection from creditors
Market liquidity	Average bid-ask spread in the securities market Average daily turnover ratio in the securities market
Households Real estate markets	Household debt to GDP Household debt service and principal payments to income Real estate prices Residential real estate loans to total loans Commercial real estate loans to total loans

Source: IMF Compilation guide on Financial Soundness indicators

5. Selected Economic Indicators

Table 3: Selected Economic Indicators

	Jul 2013	Aug 2013	Sep 2013
1. Interest rates (% Per Annum)			
1.1 Prime Lending Rate (Lesotho)	9.92	9.92	9.92
1.2 Prime Lending Rate (South Africa)	8.50	8.50	8.50
1.3 Treasury Bill Discount Rates			
- *91-day*			
Lesotho	5.52	5.36	5.38
South Africa	5.09	5.10	5.06
- *182-day*			
Lesotho	5.24	5.27	5.32
South Africa	5.26	5.31	5.34
- *273-day*			
Lesotho	5.34	5.34	5.43
South Africa	5.35	5.38	5.41
- *364-day*			
Lesotho	5.47	5.42	5.29
South Africa	5.40	5.51	5.55
2. Reserve Money – In Million Maloti			
2.1 Maloti in Circulation	830.9	804.0	864.2
2.2 Bankers' Deposits	6901.5	7330.8	7583.9
2.3 Reserve Money Target	900	900	900
3. Broad Money (M2)			
3.1 Narrow Money (M1)	5609.3	4657.2	4869.8
3.2 Quasi Money	1597.0	1850.9	2079.0
4. Net International Reserves (NIR) – In US$			
4.1 Actual NIR	1311.9	1146.6	1106.2
4.2 NIR Target – Extended Credit Facility	1083	1157	1157
4.3 NIR Target – Monetary Policy Committee	987	1157	1157
5. Inflation Rate (Annual Percentage Changes)	4.6	5.3	4.8
6. Exchange Rates (Monthly Averages)			
6.1 Loti/United States Dollar (US$)	9.92	10.07	9.97
6.2 Loti/Pound Sterling (£)	14.97	15.61	15.82
6.3 Loti/Euro (€)	12.97	13.41	13.32