



2020 FINANCIAL STABILITY REPORT

CENTRAL BANK OF LESOTHO
BANKA E KHOLO EA LESOTHO



CENTRAL BANK OF LESOTHO

FINANCIAL STABILITY REPORT

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The *Financial Stability Report* is available on the Central Bank of Lesotho website at www.centralbank.org.ls.

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GOVERNANCE, MISSION & OBJECTIVES

Ownership and Governance

The Central Bank of Lesotho is a statutory organisation fully owned by the Government of Lesotho.

The Central Bank enjoys a fair amount of independence in formulating and implementing monetary policy. The Governor, who is also the chairman of the Board of Directors, together with the two Deputy Governors, are appointed by His Majesty The King on the advice of the Prime Minister. The Minister of Finance appoints the other Board Members.

Mission Statement

The Mission of the Central Bank of Lesotho is to achieve and maintain monetary and financial system stability to support balanced macroeconomic development of Lesotho.

Objectives

The principal objective of the Central Bank of Lesotho, as stipulated in the Central Bank of Lesotho Act of 2000, is to achieve and maintain price stability.

Other related objectives which are supportive to this mission are:

- To foster the liquidity, solvency and proper functioning of a stable market-based financial systems;
- To formulate, adopt and execute the monetary policy of Lesotho;
- To issue, manage and redeem the currency of Lesotho;
- To formulate, adopt and execute the foreign exchange policy of Lesotho;
- To license, register and supervise institutions pursuant to the Financial Institutions;
- To own, hold and manage its official international reserves;
- To act as a banker and advisor to, and as fiscal agent of the Government of Lesotho;
- To promote the efficient operations of the payments system;
- To promote the safe and sound development of the financial system; and
- To monitor and regulate the capital market.

PREFACE



Financial stability refers to the resilience of the financial system to adverse shocks while continuing to function smoothly and supporting the ability of households and firms to use their financial assets with confidence. A stable financial system contributes towards broader economic growth and improved standard of living for all people.

The CBL has the mandate to promote the stability and soundness of the financial system of the country. It achieves this objective through delivering on its core functions, notably: fostering the liquidity, solvency, and proper functioning of a stable market-based financial system; promoting the safe and sound development of the financial system; conducting effective supervision and regulation of banks; and providing efficient, reliable and safe payment and settlement systems.

This Financial Stability Report is a tool used by the Central Bank of Lesotho (CBL) for financial stability surveillance. The report seeks to play a role in preventing crises by identifying risks and vulnerabilities in the financial system and assesses the resilience of the financial system to domestic and external shocks, as well as highlighting policies that may mitigate systemic risks, thereby contributing to global financial stability and the sustained economic growth. The CBL publishes the Financial Stability Report once a year, in March. Through this Report, the CBL seeks to enhance awareness of the soundness of Lesotho's financial system ▣

LIST OF ABBREVIATIONS

AGOA	Africa Growth Opportunity Act
BIS	Bank for International Settlements
CAR	Capital Adequacy Ratio
CBL	Central Bank of Lesotho
CMA	Common Monetary Area
CPSS	Committee on Payment and Settlement Systems
CSD	Centralised Securities Depository
EU	European Union
EWI	Early Warning Indicator
GDP	Gross Domestic Product
IOSCO	International Organisation of Securities Commission
LACH	Lesotho Automated Clearing House
LSW	Lesotho Wire
MNO	Mobile Network Operators
MFI	Micro-finance Institution
MTI	Money Transfer Institution
NPL	Non-performing Loans
NSDP	National Strategic Development Plan
OFC	Other Financial Corporations
PAL	Payments Association of Lesotho
PFMI	Principles for Financial Market Infrastructures
ROA	Return on Assets
ROE	Return on Equity
RTGS	Real Time Gross Settlement System
RWA	Risk Weighted Assets
SA	South Africa
SACU	Southern African Customs Union
SIPS	Systemically Important Payment Systems
UK	United Kingdom
US	United States
MoF	Ministry of Finance

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EXECUTIVE SUMMARY

- 1. The Global financial system has weathered the Covid-19 pandemic shock well.** The unprecedented and timely policy response¹ put in place by authorities has helped sustain the flow of financing to the real economy, preserve financial resilience and avoid adverse macro-financial feedback loops, laying a strong foundation for recovery. However, financial stability concerns are intensifying in many countries due to growing vulnerabilities. The deteriorating credit quality of non-financial borrowers, increasing debt levels to cope with cash shortages, and widening fiscal deficits pose major risks to the financial sector.
- 2. Despite the realised recovery in economic activity over the second half of 2020, there is considerable uncertainty surrounding the near-term and long-term global financial stability outlook.** The resurgence of Covid-19 across the globe, protracted trade tensions, as well as rising geopolitical risks and policy uncertainty in major economies, have led to further deterioration in risk sentiment, triggering a broad-based uncertainty in global capital markets and easing of global financial conditions. This will further push growth down and have large spillover effects to the rest of the world.
- 3. Economic activity in South Africa (SA) has fallen abruptly as a result of the Covid-19 pandemic, and the economy has slipped into a deep downturn.** Lockdowns associated with combating the Covid-19 pandemic plunged SA into its sharpest quarterly economic contraction in the second quarter of 2020, leading to a large widening of the fiscal deficit and rapidly rising government debt. SA experienced further credit rating downgrades and power supply disruptions. The downgrades will extend the impact of lockdown restrictions and translate to unaffordable debt costs, deteriorating asset values (such as retirement, other savings, and property), and a reduction in disposable income for many. Furthermore, SA's capacity to mitigate the shock over the medium term is lower than that of many sovereigns given significant fiscal, economic and social constraints and rising borrowing costs.
- 4. The Covid-19 shock continues to weigh on the fiscal position, economic activity, and depress investment and job creation in the domestic economy.** Growth remains subdued and is expected to decline further in the near term. This sluggish growth is attributed to broad-based poor performance across major sectors of the economy. The textile production contracted due to the decline in orders from the United States of America (USA) and SA, which are the major destinations for Lesotho's exports. Conditions also remain less encouraging for diamond exports following the growth of synthetic diamonds and the low global growth exacerbated by the tension in US-China trade relations. Furthermore, low domestic and Southern African Customs Union (SACU) revenues continue to put severe pressure on the fiscal and external positions.
- 5. The favourable trends seen in the financial sector in the past years changed significantly in 2020.** The sector is exposed to risks emanating from the challenging covid-19-induced economic environment and credit concentration. While the banking sector continued to be adequately capitalised, profitability declined noticeably. Liquidity levels improved in the review period, while the quality of assets declined marginally and there was a notable increase in exposure to foreign exchange. Nevertheless, the stress-test results demonstrate that the current capitalisation, liquidity, and profitability levels guarantee a high degree of resilience to the assumed shocks.
- 6. The overall financial performance of the Other Financial Corporations (OFCs) remained robust despite the challenging economic environment.** The insurance sector continued to be resilient and financially sound with minimal systemic threats. The Credit-only Micro-finance Institutions (MFIs) sector maintained a good quality of credit portfolio and its asset base continued to grow.

¹ Fiscal support, regulatory flexibility and liquidity provision.

EXECUTIVE SUMMARY



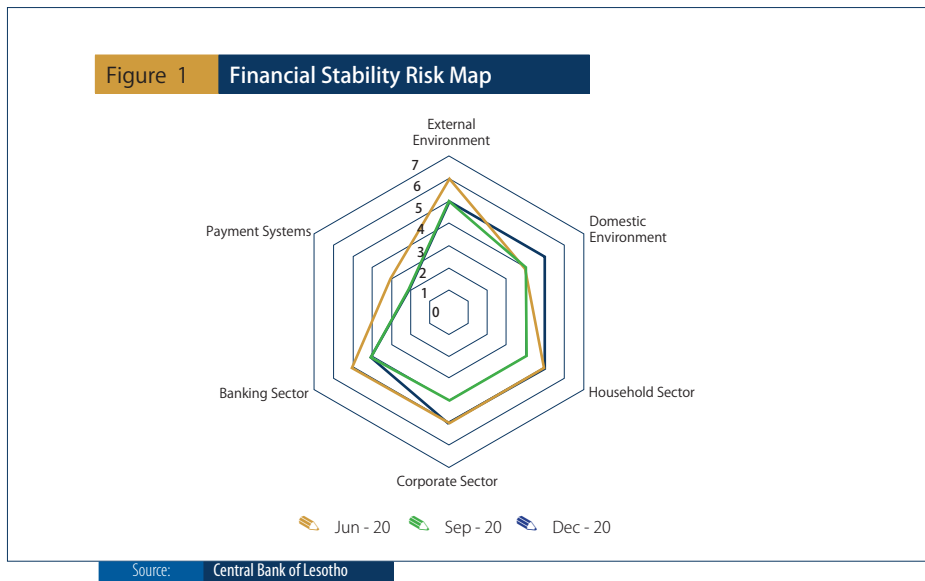
7. The payment system and infrastructure operated effectively and efficiently during 2020 and continued to anchor financial stability. The systemically important payment system maintained high system availability and registered a higher transaction density in 2020 relative to 2019. The mobile money business has grown tremendously since 2012 and has bridged the financial inclusion gap. However, growth rates have fallen significantly. This shows that the market has entered its maturity phase and much lower growth rates can be expected in the future. Vulnerabilities related to mobile money operations have been minimal during the review period and pose minimal systemic threats ▣

FINANCIAL STABILITY RISKS

1. FINANCIAL STABILITY RISKS

The financial system as a whole weathered the Covid-19 pandemic well during 2020. However, vulnerabilities are rising, intensifying financial stability concerns. Since the last Financial Stability Report (FSR), vulnerabilities emanating from

the domestic environment, corporate sector, and household sector have increased, mostly due to increasing debt levels and deteriorating fiscal position. In contrast, the external macro-environment, payment systems, and banking sector vulnerabilities remained relatively unchanged ▢



The financial system as a whole weathered the Covid-19 pandemic well during 2020.

MACRO-FINANCIAL ENVIRONMENT



2. MACRO-FINANCE ENVIRONMENT

2.1 International Developments

The global economic recovery lost momentum as the pandemic took a turn for the worse over the last quarter of 2020. New infection rates rose significantly in Europe and the US, topping the previous highs. However, the recent progress made with vaccines and treatment has lifted expectations and uncertainty has receded somewhat. As a result of the unprecedented governments and central banks action, global activity has rapidly recovered in many sectors, though some service activities remain impaired by physical distancing. The collapse in employment has partially reversed, but large numbers of people remain underemployed. Most firms have survived, albeit financially weakened in many cases. Without massive policy support, the economic and social situation would have been tragic. But despite those steps, the economic path ahead remains difficult and prone to setbacks. Growth could slow further if countries maintain social restrictions for longer than expected. In addition, a disconnect between financial markets and real economic activity poses risks to financial stability, while higher debt levels may make future investments more difficult. Financial fragilities continue to grow in most countries, as the growth shock impacts vulnerable household and business balance sheets.

Vulnerabilities and risks associated with international developments

Weak global economic activity affects the financial institutions' balance sheets through macro-financial linkages. Lesotho is a small, open economy with many industries that are dependent on the good performance of the global economy. If international growth remains weak for protracted periods, it may have major repercussions for Lesotho's economy through the export channel. Exporting companies are highly dependent on banks for their funding hence any shock to their revenues could compromise their ability to service their debt which will ultimately affect banks' profitability. In addition, with global growth expected to remain weak, amid continued uncertainty about the outlook for Covid-19 pandemic and world trade, long-

term interest rates are expected to remain low or decline further. While lower interest rates may help to cushion the economy and borrowers from the effects of weaker global growth in the short run, prolonged low-interest rates could exacerbate pre-existing debt and asset imbalances in the economy in the long run, threatening future financial stability. Low-interest rates may also reduce profitability for some financial institutions, and weaken solvency position.

The rand remains very sensitive to international policy and political developments, changes in commodity prices, global financial market developments, and investors' sentiments.

Lesotho's macroeconomic stability is anchored upon the loti's peg to the rand, which is crucial in containing inflation and strengthening the country's close economic and financial ties with SA. Therefore, a volatile rand becomes a threat to Lesotho's financial system stability. The value of loti is mostly affected by capital flows to and from SA and other EMEs, as well as global risk perception through the rand-loti peg. Depreciation of the currency against major international currencies increases headwinds to the inflation outlook and can lead to further monetary policy tightening in SA. In particular, political tensions and slow progress in SA's structural reforms, credit rating downgrades, and disruptions to the power supply could induce capital flight and weaken growth, which could, in turn, depress SACU revenues and remittances. Such downgrades, could also squeeze the funding for banks, increase the cost of borrowing for the consumers and result in increased non-performing loans.

SA's subdued economic activity and deteriorating public finances remain a potential source of vulnerabilities and spillover risk for the domestic financial system.

Loss of confidence in SA by investors could trigger capital outflows and generate negative feedback loops due to extensive macro-financial linkages between SA and the rest of the world. Such linkages could amplify shocks given SA's high reliance on external finance and banks' increasing role in intermediating capital flows. The resulting capital outflow may lead to a higher cost of capital and reduced access to funding. This increases contagion risks since two-thirds of banks operating in Lesotho are subsidiaries of South African banks.

MACRO-FINANCIAL ENVIRONMENT

Table I Selected Economic Indicators (%)									
	GDP Growth			Interest Rates			Inflation		
	2019	2020	Δ pps	2019	2020	Δ pps	2019	2020	Δ pps
Advanced Economies									
US	2.30	(2.50)	(4.80)	1.75	0.25	(1.50)	2.30	1.40	(0.90)
UK	1.10	(7.8)	(8.90)	0.75	0.10	(0.65)	1.30	0.60	(0.70)
Euro Area	1.00	(5.10)	(6.10)	0.25	0.25	0.00	1.30	(0.30)	(1.60)
Japan	(0.70)	(1.20)	(0.50)	(0.10)	(0.10)	0.00	0.80	(1.20)	(2.00)
Emerging Market Economies									
Brazil	1.70	(1.10)	(0.60)	4.50	2.00	(2.50)	4.31	4.52	0.21
Russia	2.10	(1.80)	(3.90)	6.25	4.25	(2.00)	3.00	4.90	1.90
India	4.70	0.40	(4.30)	5.15	4.00	(1.15)	7.35	4.59	(2.76)
China	6.00	6.50	0.50	4.15	3.85	(0.30)	4.50	(0.50)	(5.00)
SA	(0.50)	(4.10)	(3.60)	6.50	3.50	(3.00)	4.00	3.10	(0.90)

Source: Federal Reserve Bank, OECD data, Bank of Japan, ECB, SARB, STATA SA, Bank of Brazil, Reuters, Bank of India, Trading Economics.

2.2 Domestic Developments

The domestic economy remains under pressure because of the Covid-19 pandemic. According to the Central Bank of Lesotho (CBL) Economic Outlook², the decline in economic activity in the secondary and tertiary sectors continue to weigh down the overall economic growth. The pandemic containment measures such as national lockdowns, travel restrictions, and temporary closure of some economic activities led to low overall demand, which in turn has hurt production and employment. The global economic fallout of the Covid-19 outbreak has reduced external demand for domestic exports among Lesotho's major trading partners, especially the US and SA. This has negatively affected the textile and clothing industry. The pandemic has disrupted the supply of textile and clothing inputs from the Asian markets. As a result, businesses are likely to experience difficulties with regard to their profitability hence their ability to service debt. Moreover, some firms had to lay off some of their workforce, leading to a rise in unemployment. This will ultimately translate into a rise in non-performing loans, and adversely affect the balance sheets of the banking industry and the financial sector at large.

The macro-financial environment deteriorated further due to the Covid-19 pandemic. The loti depreciated significantly against major trading partners due to uncertainty caused by the pandemic and investors seeking safe-haven assets such as the US dollar. However, Lesotho's external position improved despite the negative impact of the pandemic on global demand and supply chains. The outlook is tilted to the downside due to probable recurring waves of the pandemic and its associated disruptions in productivity and supply chains.

The fiscal position has worsened owing to the growing deficit. The widening deficit was influenced mostly by the impact of Covid-19 and the government's mitigation measures. In addition, the SACU revenues, which finances the majority of the budgetary activities, have been below historical averages in recent times. With expenditure persistently high, the fiscal account remains under immense pressure. Consequently, domestic and foreign borrowing and probable drawdown of government deposits with the Central Bank would likely finance the fiscal deficit. With limited resources, government spending would decline, putting further pressure on businesses' performance, especially those that rely on government tenders.

² 2020-2022 (June, 2020).

MACRO-FINANCIAL ENVIRONMENT



Businesses' profitability would decline and reduce their ability to service obligations. Furthermore, businesses would lay off workers, leading to high unemployment.

Box 1 - Financial Sector response to Covid-19 Pandemic

The Covid-19 virus evolved into not only a pandemic but also into an unprecedented global macro-economic shock. At the peak of the pandemic, activity in a number of sectors – including tourism, transportation and manufacturing – collapsed globally as demand plunged due to the lockdowns and movement restriction measures implemented to contain the spread of the virus.

In response, and with the aim to mitigate the impact shock, authorities around the world have reacted by implementing a wide-range of support measures to preserve the well-functioning of core markets and maintain the provision of critical financial services to the real economy, including lending and payments, while at the same time safeguarding financial stability.

The Central Bank of Lesotho was no exception in this regard. The Bank put in place the following supervisory and policy measures to aid the financial sector:

Banking Sector

The Bank deferred implementation of Basel II.5 and reforms initiatives that were due for implementation in January 2021, and had financial implications on banks. This was done to provide relief to banks so that funds that were reserved for full compliance of these reform initiatives could be used to sustain credit extension and meet emerging liquidity needs.

Banks were also instructed to:

- Grant payment holidays to clients/borrowers whose financial position was negatively affected, based on thorough assessment of the economic and financial condition of the individual borrower;
- Submit applications for large exposures as defined by the Law to the Commissioner or Regulator for assessment and exemptions; and
- Communicate with the Commissioner any additional measures taken and proposals considered to mitigate credit risk.

Mobile Money Operators

In an effort to facilitate possible transactions on essentials, while still exercising vigilance of AML/CFT activities, the Bank directed mobile/electronic money operators (Mpesa, EcoCash & Khetsi) to:

- Reduce transactions charges particularly on low value payments from 30th March to 31st May, 2020; and
- Increase transaction limits on electronic money to facilitate a wider usage of these digital channels around the same time.

Insurance Sector

Considering the impact of the lockdown on both the insurers and the policyholders, insurers were directed to:

- Devise and implement measures to ensure that they remain liquid, solvent and well capitalized during the covid-19 and after. These include performing stress testing and submitting the results to the CBL, and non-payment of dividends;
- Allow for policies to only lapse after 3 consecutive months of non-payment of premiums; and
- Allow renewal premiums to be paid in instalments of 3 months in order to ease the burden on policy-holders.

Microfinance Institutions

The MFIs were directed to:

- Waive fees and penalties due to defaults or delayed repayments for up to three months;
- Provide moratorium on repayments only for Micro Small and Medium Enterprises (MSMEs) where such lending already exists and to the public whose income was affected by the Covid-19 pandemic; and
- Restructure loans of clients in distress without penalties and fees during the three and above months of the Covid-19 pandemic.

Pensions and Securities Sector

The Pension and Security Sector was instructed to protect the value of client's investment and their licence fees for 2022 were waived.

FINANCIAL STABILITY DEVELOPMENTS AND TRENDS

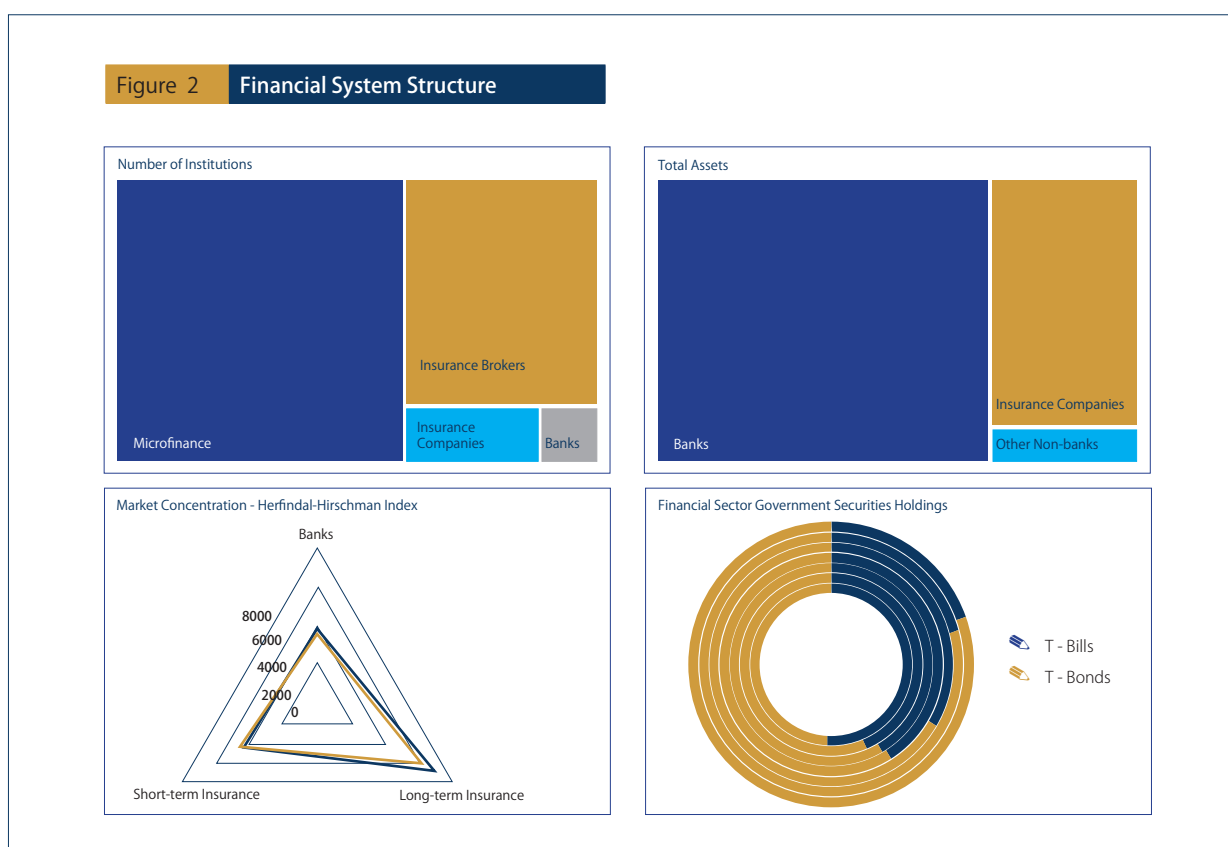
3. FINANCIAL STABILITY DEVELOPMENTS AND TRENDS

3.1 The Structure of the Financial System

Lesotho’s financial sector consists of four commercial banks (three subsidiaries of South African banks and one government-owned bank), nine insurance companies, 52 insurance brokers, 97 microfinance institutions (MFIs), two asset management firms, and two money transfer institutions (MTIs) as shown in Figure 2. The financial sector is dominated by the banking industry with total assets constituting 69.1 percent of the total financial sector assets and about 251.7 percent of the gross domestic product (GDP) at the end of December 2020. The Insurance industry is the second largest industry of Lesotho’s financial system, with

a share of 27.3 percent of the total financial system assets³ and 100.2 percent of GDP, while the share of Other non-bank financial institutions, including MFIs, to total financial system assets, stood at 30.9 percent. The total financial system assets to GDP stood at 351.3 percent. The financial markets in Lesotho comprise mainly of money markets and securities markets with the latter being the larger of the two markets. In both markets, government securities make up the entire portfolio of investments. This shows that Lesotho’s financial market is still shallow, concentrated, and has limited product options. CBL is the sole regulator of all the financial institutions in the country.

The banking sector is composed of commercial banks only, with 51 branches across the country. The sector is characterised by limited competitiveness and is highly concentrated with



³ Total financial system assets data is as at September 2020 due to a one-quarter lag in reporting for MFIs.

FINANCIAL STABILITY DEVELOPMENTS AND TRENDS

a Herfindal-Hirschman index⁴ (HHI) of 3 728. As at December 2020, the total banking industry assets were M20.0 billion. On an annual basis, the banking industry's total assets grew by 13.6 percent from M17.6 billion. The foreign-owned banks control about 90.0 percent of the banking industry's assets, revenue, and deposits.

For the period ending in December 2020, the insurance industry accounted for 88.4 percent of total financial assets for Non-Bank Financial Institutions (NBFIs). Out of the nine insurance companies, five companies provide long-term insurance, four provide short-term insurance and one provides both long-term and short-term insurance. The insurance sector is highly concentrated in both the long-term and short-term categories, with HHI of long-term and short-term categories standing at 6 843 and 4 333, respectively. The Pension industry is also under the CBL's purview following the enactment of the Pension Funds Bill. The Pension Funds Act confers powers on CBL to register, regulate, supervise, and dissolve pension funds in the country.

The legal and regulatory environment in Lesotho further provides for both deposit-taking MFIs as well as credit-only MFIs. However, during the period under review, there were 97 licensed Credit-Only MFIs⁵ and no deposit-taking MFIs operating in Lesotho. The six largest MFIs command a larger share of the market. The MFIs industry has grown rapidly over the past five years but currently, it poses no systemic risks. On the other hand, data generated from the Credit Bureau suggest some emergence of high levels of indebtedness in the entire credit market. This is at the back of some prominence of aggressive lending and lack of proper credit worthiness assessment. The rising level of indebtedness is an early warning sign and may have systemic

implications due to the growing interconnectedness among industries in the financial system.

3.2 Cross linkages in the Financial Sector

The following sections highlight the level of Lesotho's financial sector interconnectedness among the sub-sectors of the financial system, as well as with the Government of Lesotho. The level of interconnectedness in the financial sector and linkages thereof are very important for macroprudential surveillance and financial stability. A shock in one sector can have spillover effects on other financial institutions or the rest of the financial system through these linkages. Therefore, it is important that the CBL monitor vulnerabilities emanating from the inter-linkages among the financial institutions and ensure that it takes prompt corrective actions to prevent or remedy contagion risk within the financial system.

3.2.1 Linkages between banks

The linkages between domestic banks are predominantly in a form of placements for purposes of payments and settlements instead of interbank loans. Similarly, cross-border linkages are predominantly placements with parent banks. Furthermore, banks hold deposits of/lend to other non-bank financial corporations. Risks associated with placements with banks from abroad exposes domestic banks to exchange rate risks (except in the case of SA due to the loti's peg to the South African rand). Moreover, integration among global banks increases the likelihood of contagion risk amongst banks and the real economy.

⁴ The Herfindal-Hirschman index (HHI) is a measure of market concentration which, unlike other methods, takes into account the relative size and number of institutions in the industry. It can assume values from zero (a situation close to perfect competition) to 10000 (a situation that reflects monopolistic behaviour). There are three HHI thresholds that determine the market structure of an industry: (1) less than 1000 suggests a competitive industry, (2) 1000 to 1800 indicates a moderately concentrated industry, and (3) a value greater than 1800 depicts a highly concentrated industry.

⁵ Tier II MFIs and 30 Tier III MFIs.

FINANCIAL STABILITY DEVELOPMENTS AND TRENDS

3.2.2 Linkages between financial institutions and Government

Financial sector development is an important determinant of economic growth. Sound and efficient financial systems channel capital to its most productive use that is beneficial for

sustaining development. Besides linkages between various sub-sectors of the financial system, linkages between the financial sector and the government can be a critical source of systemic risk. The Government of Lesotho's debt held by the financial sector primarily consists of Treasury securities⁶. Table 2 shows outstanding Treasury securities held by the financial sector.

Table 2 Financial Sector Exposure to Lesotho's Sovereign Debt, in Thousands of Maloti							
Period	2015	2016	2017	2018	2019	2020	ΔYoY
Total Financial Sector Exposure	979.5	1 021.3	1 251.6	1 932.6	3 118.9	3 344.4	7.2 pct
% of Total Government Debt	80.4	76.1	74.4	78.6	88.4	87.7	-0.7 pp
T-Bill Holders' Amounts Outstanding	425.9	423.3	511.6	644.4	647.7	654.9	1.1 pct
% of Total, of which	43.5	41.5	40.9	33.3	20.8	19.6	-1.2 pp
Commercial Banks	40.4	38.7	38.2	32.1	20.5	20.6	0.1 pp
Insurance Companies	3.1	2.8	2.7	1.2	0.3	0.2	-0.1 pp
Non-Bank Financial Corporations	0.0	0.0	0.0	0.0	0.0	0.2	0.2 pp
Bond Holders' Amounts Outstanding	553.6	597.9	740.0	1 288.2	2 471.2	2 689.5	8.8 pct
% of Total, of which	56.5	58.5	59.1	66.7	79.2	80.4	1.2 pp
Commercial Banks	47.7	45.6	41.9	40.7	77.6	75.6	-2.0 pp
Insurance Companies	8.8	12.9	17.2	26.0	35.3	33.9	-1.4 pp
Non-Bank Financial Corporations	0.0	0.0	0.0	0.0	14.9	29.7	14.7 pp
<i>Source: Central Bank of Lesotho</i>							

⁶ Treasury Bonds and Bills.



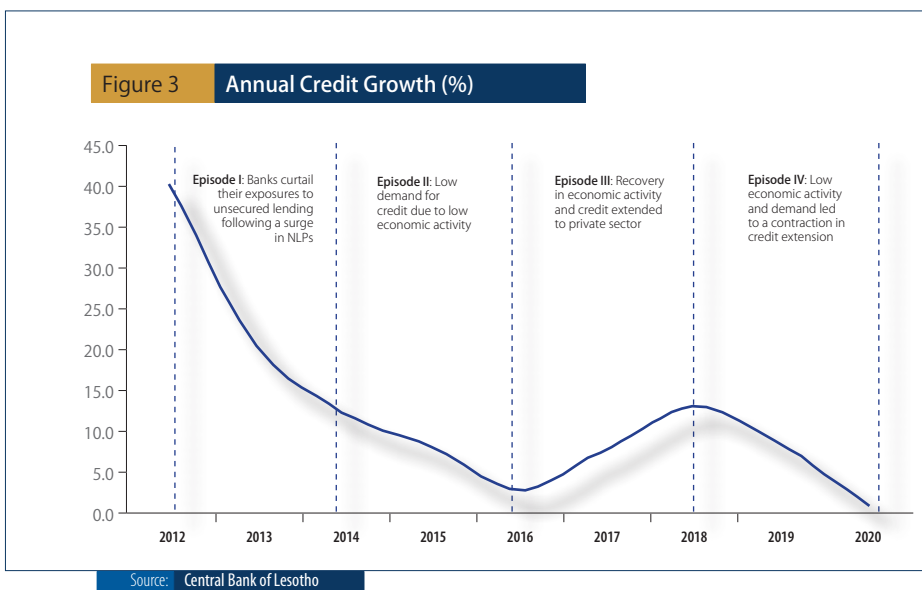
4. BANKING SECTOR

The favourable trends seen in the banking sector in the past years changed significantly in 2020. The sector is exposed to risks emanating from the challenging covid-19-induced economic environment and credit concentration. While the banking sector continued to be adequately capitalised, profitability declined noticeably. Liquidity levels improved in the review period, although the quality of assets declined marginally and there was a notable increase in exposure to foreign exchange. Nevertheless, the stress-test results demonstrate that the current capitalisation, liquidity, and profitability levels guarantee a high degree of resilience to the assumed shocks.

4.1 Credit Developments

Credit extension increased in 2020 relative to 2019, and as shown in Figure 3, the growth rate has slowed down significantly since 2018. Year-on-year, credit grew by 0.7 percent to M7.46 billion. Despite the slight improvement, low global economic activity due to the covid-19 pandemic and dwindling demand, trade tensions, and increasing protectionism policies continue to weigh on credit extended to the key sectors of the economy, most of which export their output.

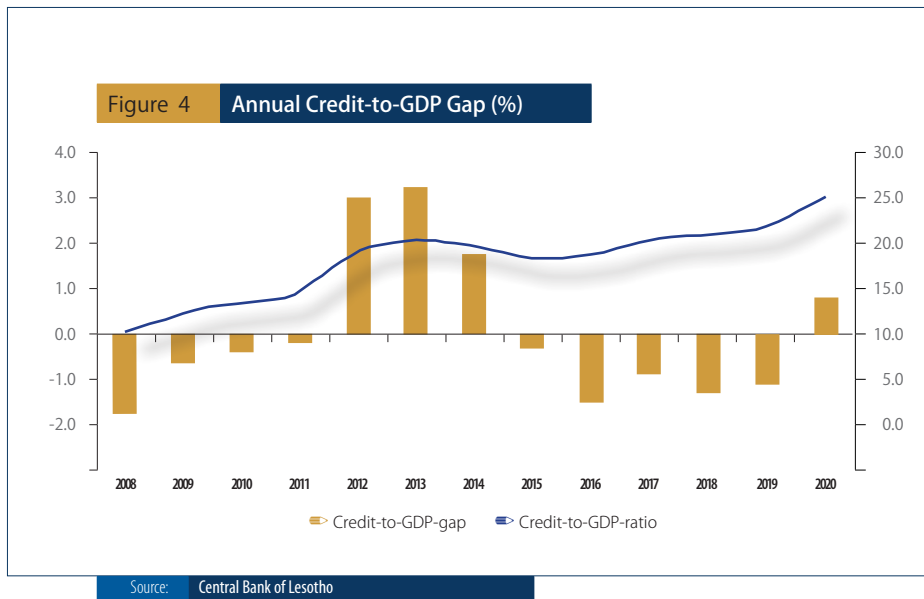
Figure 4 shows the evolution of the annual credit-to-GDP gap. The credit-to-GDP gap⁷ is regarded as a useful early warning indicator (EWI) of banking crises or severe distress. A large positive gap is an indication that the private sector borrows at a level that is perhaps not justified by the current output-producing capacity of the economy while a negative gap theoretically implies that there is scope for additional safe borrowing for consumption or investment purposes. The credit-to-GDP gap in Lesotho has been positive but narrowing since 2013, turning negative in 2015 and turning positive again in 2020 (see Figure 4). This shows that, over time, the credit-to-GDP ratio remained below its long-term trend - an indication of the reduced likelihood of a crisis. However, a positive credit-to-GDP gap registered in 2020, may signal increasing vulnerabilities in the credit market.



Credit extension increased in 2020 relative to 2019. However, the credit growth rate has slowed down significantly since 2018.

⁷ The credit-to-GDP gap is defined as the deviation of the credit-to-GDP ratio from its long-run trend.

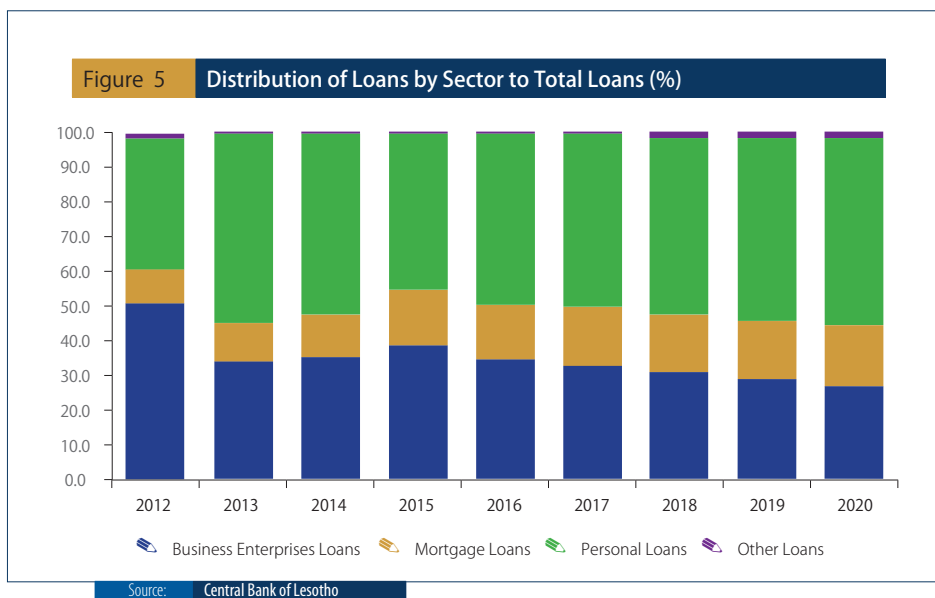
BANKING SECTOR



The credit-to-GDP gap is regarded as a useful early warning indicator (EWI) of banking crises or severe distress.

Figure 5 shows the distribution of credit by economic sectors. Credit to households, consisting of personal loans and mortgage, constituted 70.8 percent of the banks' loan book during 2020. Out of the 70.8 percent, personal loans constituted 53.4 percent. This shows the extent to which the banking sector is exposed to

the household sector. On an annual basis, personal loans grew by 2.9 percent to M4.0 billion while mortgage loans increased by 7.9 percent to M1.3 billion. However, credit to business enterprises dropped by 7.2 percent to M 2.0 billion.



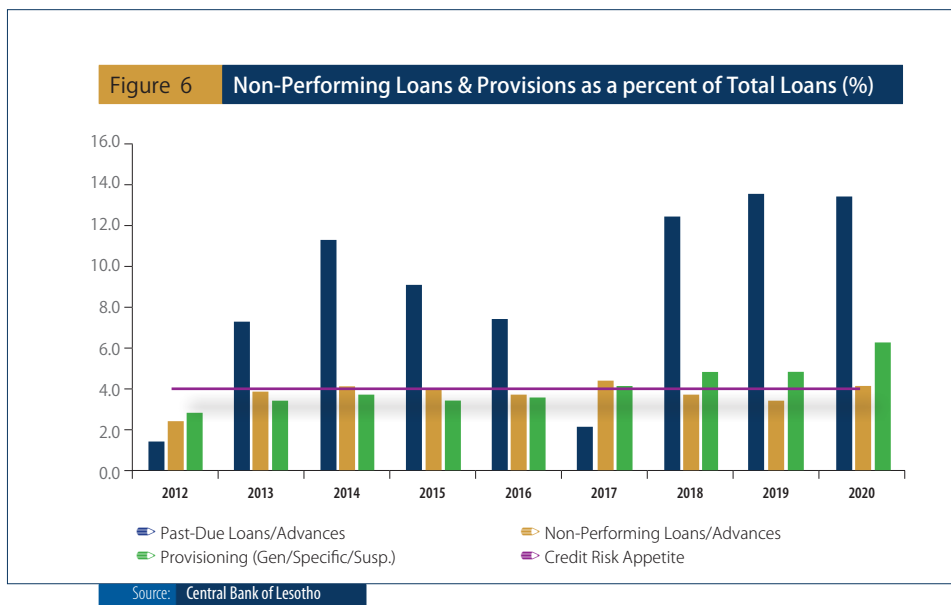
Credit to households, consisting of personal loans and mortgage, remains the largest share of the banks' loan book during 2020.

BANKING SECTOR



Credit risk remains moderate during the review period but the concentration in certain loan types and exposures to single or group of borrowers remain a concern. The ratio of NPLs to total loans increased from 3.3 percent in December 2019 to 4.2 percent in December 2020. The elevated past-due loans (Figure 6) remains the main downside risk to the NPLs' outlook. Past-due loans increased by 31.3 percent to M960.0 million while total NPLs decreased by 28.2 percent to 313.5 million in 2020. Consequently, provisioning levels grew by 35.3 percent to M469.1 million in December 2020.

Sectoral analysis of NPLs revealed that the mortgage component of the banks' loan portfolio realised the highest growth in NPLs during the review period while personal loans' NPLs declined significantly as shown in Figure 7. The growth in NPLs in the mortgage loans is attributed to the arrears in payments from clients that were no longer working⁸ and could not service their loans and low economic activity.

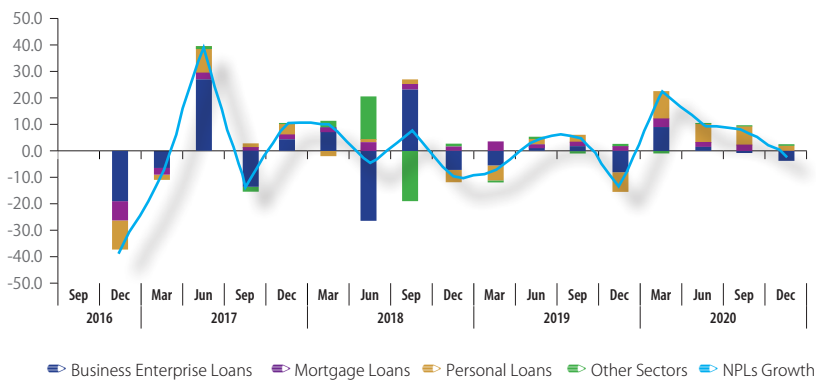


Credit risk rose moderately during 2020.

⁸ No longer working as a result of resignations, retrenchments and employment contract expirations.

BANKING SECTOR

Figure 7 Growth in NPLs (%)



Source: Central Bank of Lesotho

The mortgage loans portfolio realised the highest growth in NPLs during the review period.

4.2 Liquidity Developments and Funding Structure

Capital is arguably the most important safety buffer for banks since it provides the resources to recover from substantial losses of any nature and gives depositors dealing with the bank confidence in its safety. However, the proximate cause of bank failures is usually a liquidity problem that makes it impossible to survive a classic “bank run” or a modern equivalent, such as an inability to access the debt markets for new funding. It is entirely possible for a bank to be solvent - have the economic value of a bank’s assets more than sufficient to cover all of its claims - and

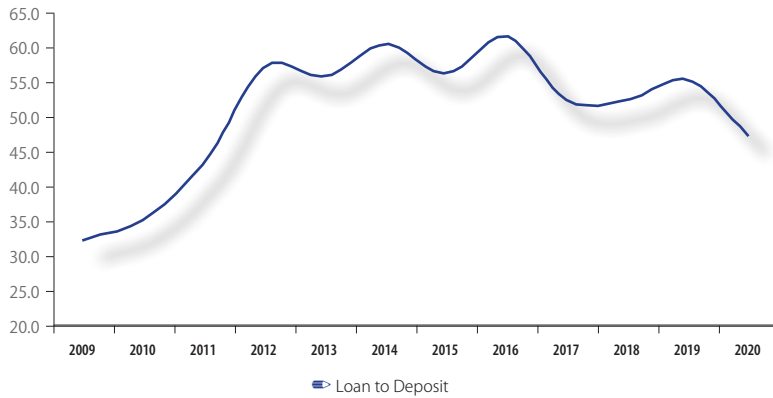
yet go bust because its assets are illiquid and its liabilities have short-term maturities.

The Loan to deposits ratio, shown in Figure 8, is an important indicator used to determine the financial institutions’ short-term viability. A lending institution that accepts deposits must have a certain level of liquidity to maintain its normal daily operations. The ratio declined by 7.8 percentage points (pps) to 47.5 percent in 2020. This shows that the banking industry lends out about half on every loti held as deposits and holds the rest for immediate liquidity needs.

BANKING SECTOR



Figure 8 Loan to Deposit Ratio (%)



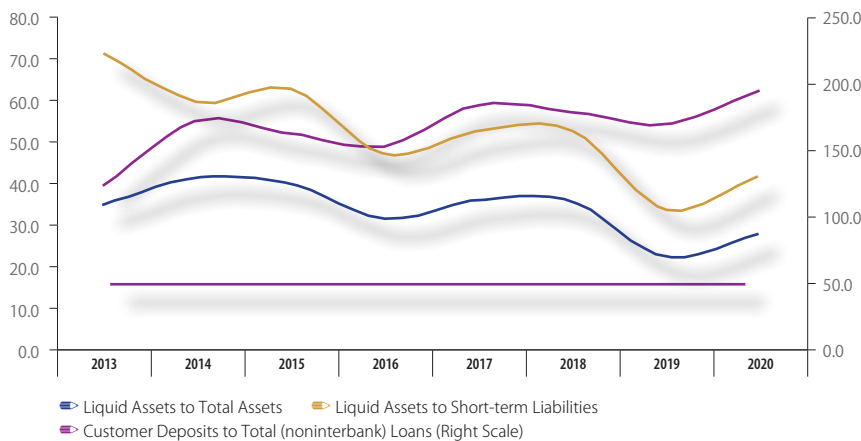
Source: Central Bank of Lesotho

Banks lent out about half of every loti they held in deposits during the review period.

The ratio of liquid assets to short-term liabilities increased from 34.0 percent in 2019 to 41.9 percent in 2020 (see Figure 9). Liquid assets (cash and cash items and transferable deposits) increased significantly in the review period, primarily due to a 48.4 percent increase in transferable deposits with the CBL, local banks, and non-residents.

The ratio of liquid assets to total assets shows, on an on-going basis, the extent to which liquid assets can support the asset base. In the year ending in December 2020, the ratio decreased by 5.6 pps from 22.6 percent that was observed in 2019. This shows that banks invested over one-fifth of their funds in liquid assets. The ratio of customer deposits to total (non-interbank) loans is another measure of banks' liquidity quality. It compares

Figure 9 Liquidity Ratios (%)



Source: Central Bank of Lesotho

The banking sector liquidity position improved during the year under review.

BANKING SECTOR

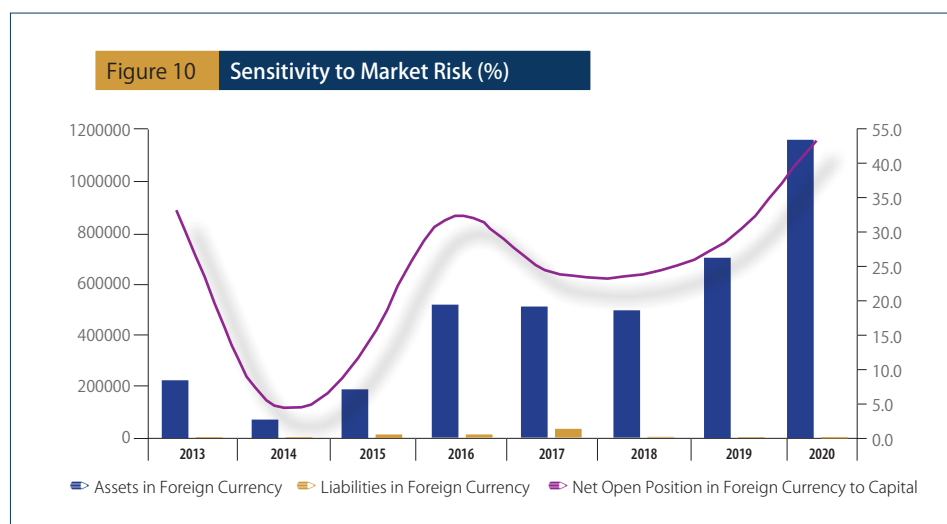
the stable deposit base with gross loans excluding interbank activity⁹. For the year ending in December 2020, the ratio was 195.1 percent reflecting an increase of 24.4 pps from the rate observed in 2019. The ratio increased due to a 27.0 percent growth in customer deposits relative to a measly 0.74 percent increase in total gross loans during the review period.

4.3 Market Risk

Market risk encompasses the risk of financial loss resulting from movements in market prices such as interest and exchange rates. In this report market risk is assessed based on one FSI, the net open position in foreign exchange to capital, due to the

unavailability of required data to assess interest rates exposure. Banks with a short open position in a foreign currency get exposed to exchange rate risk in an instance where the foreign currency appreciates, while those with a long open position get exposed in a case where foreign currency depreciates.

During the review period, the banks maintained a long position in foreign currency assets as a result of an increase in foreign currency denominated assets. Consequently, the net open position in foreign exchange to capital ratio increased from 28.3 percent in 2019 to 42.2 percent in 2020 as shown in Figure 10. This exposed banks a bit to revaluation risk in an instance where the loti appreciates against foreign currencies but would benefit the banks when the loti depreciates.



The banking sector's sensitivity to exchange rate movements continues to rise.

4.4 Capital Adequacy

Capital adequacy ratios (CAR)¹⁰ measure the bank's health and soundness in relation to the risk of insolvency. Minimum CAR serves to protect depositors and promote the stability and efficiency of the financial system¹¹. The purpose of having a minimum CAR is to ensure that banks can absorb a reasonable amount of losses before becoming insolvent and before depositors' funds are lost. The higher the capital adequacy ratio a bank has, the greater the level of unexpected losses it can absorb.

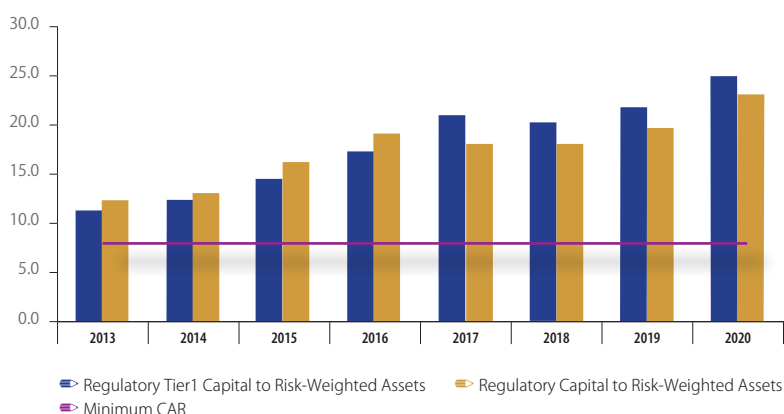
⁹ IMF (2006) Financial Soundness Indicators, Compilation Guide

¹⁰ Currently, the minimum requirement for CAR is eight percent.

¹¹ <http://www.rbnz.govt.nz/finstab/banking/regulation/0091769.html>.



Figure 11 Capital Adequacy Ratios (%)



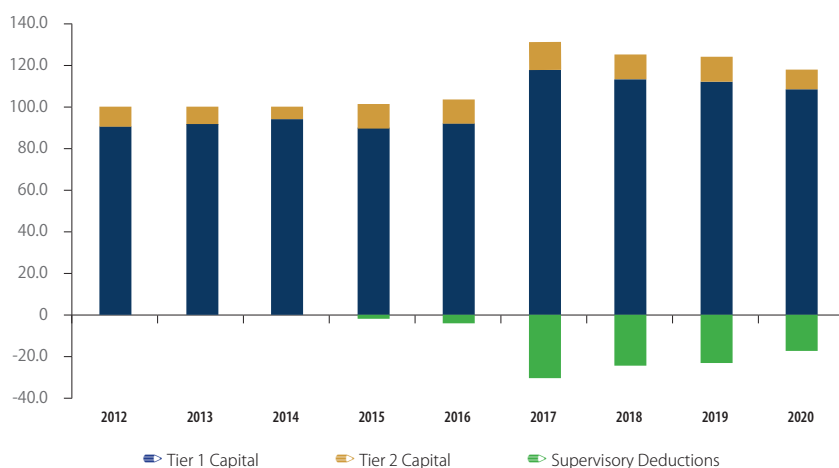
Source: Central Bank of Lesotho

The banking sector in Lesotho maintained CAR above the minimum requirement during 2020.

The banking sector in Lesotho maintained CAR above the minimum requirement during 2020 as shown in Figure 11. The ratio of total regulatory capital to risk-weighted assets stood at 23.0 percent, higher than the 19.4 percent observed in the same period in the previous year. Similarly, the ratio of tier-1 capital to risk-weighted assets increased slightly from 21.7 percent in

2019 to 24.9 percent in 2020. The banking industry continued to maintain core capital buffers higher than the prudential minimum requirement, which is a positive sign in regards to the resilience of the sector. Figure 12 shows the breakdown of total regulatory capital as at December 2020.

Figure 12 Composition of Total Regulatory Capital (%)



Source: Central Bank of Lesotho

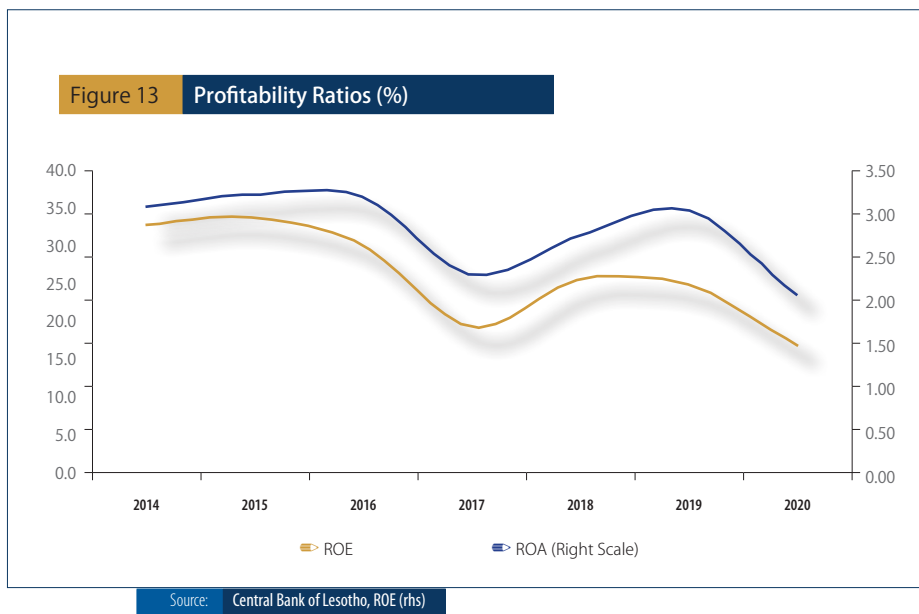
The banking industry continued to maintain core capital buffers higher than the prudential minimum requirement, which is a positive sign in regards to the resilience of the sector.

BANKING SECTOR

4.5 Earnings and Profitability

Profitability ratios assess the ability of a company to generate earnings, profits, and cash flows relative to the amount of money invested. The industry remained profitable during the year 2020. However, profitability declined significantly due to the negative impact of covid-19 pandemic on economic activity. During the review period, ROA declined by 1.0 pps to 2.0 percent as illustrated in Figure 13. Likewise, ROE declined by 7.7 pps to 17.1 percent.

The ratio of net interest margin to gross income decreased marginally in 2020, recording 56.1 percent relative to 58.5 percent recorded in 2019. At this level, the ratio shows that over half of the banks' income came from their core business, which is intermediation. In contrast, the ratio of non-interest expense to gross income increased from 58.0 percent in 2019 to 65.6 percent in 2020 as a result of a 7.6 pps increase in administration expenses relative to income during the review period. The ratio indicates that over half of the income generated during the year went into administrative expenses as opposed to expenses on income-earning assets ▣



The banking sector's profitability deteriorated during the year under review due to the negative impact of Covid-19 on economic activity.

OTHER FINANCIAL CORPORATION'S FINANCIAL PERFORMANCE

5. OTHER FINANCIAL CORPORATION'S FINANCIAL PERFORMANCE

The overall financial performance of the OFCs remained robust despite the challenging economic environment brought by Covid-19. The insurance sector continued to be resilient and financially sound with minimal systemic threats. The insurance sector remained profitable and liquid although its contribution to the overall economy remains low relative to regional peers. In addition, the insurance industry is highly concentrated in both the long-term and short-term categories. The HHIs for the period ending in December 2020 were 6 843 and 4 333 for the long-term and the short-term categories, respectively.

The total volume of business in terms of the gross premium written for the short-term insurance sector amounted to M88.4 million, a growth of 1.2 percent from December 2019. The asset base for the short-term insurance sector grew by 10.1 percent from M526.2 million in December 2019. The combined ratio for the period ending in December 2020 was 105.1 percent, which was a decline from 142.0 percent recorded in December 2019.

This shows that the sector's operational efficiency improved in the review period.

The long-term insurance sector gross written premiums increased by 12.9 percent to M467.3 million during the period under review. The sector registered profits of M68.6 million, a decline of 10.5 percent from December 2019. The sector's balance sheet grew by 1.9 percent and reached M7.3 billion for the period ending in December 2020. The operational performance for the sector remained efficient as reflected by the combined ratio of 80.6 percent.

The asset base of the MFI sub-sector as at September 2020 stood at M977.2million. This was a 6.1 percent increase from September 2019. Moreover, non-current assets of the MFIs for the period ending in September 2020 stood at M880.1 million, an increase of 10.5 percent from September 2019, while non-current liabilities were M499.7 million as at September 2020. The sector realised profits of 73.3 million for the period ending in September 2020. The industry had a return on assets of 7.6 percent for the period ending in September 2020 while the return on equity was 21.7 percent for the same period ▣

FINANCIAL MARKETS INFRASTRUCTURE

6. FINANCIAL MARKETS INFRASTRUCTURE

Financial market infrastructures (FMIs) – such as payment systems, settlement systems, central counterparties, central securities depositories, and trade repositories – deliver services that are vital to the smooth functioning of the financial system. The services provided by FMIs enable payments for goods and services to be made, allow securities to be held and sold, and facilitate risk management.

CBL, among other functions, is also mandated to provide efficient, reliable and safe payment and settlement systems. In line with this mandate, the Payment Systems Act 2014, Section 2(a) empowers the CBL to oversee, inspect and monitor the national payment systems in Lesotho. This mandate is not only achieved by ensuring that the payment system in Lesotho complies with the domestic legal and regulatory framework but also with other international standards and best practices in the payment system sphere¹².

6.1 Systemically Important Payment Systems

The systemically important systems (SIPS) in Lesotho include Lesotho Wire (LSW) and Centralised Securities Depository (CSD) operated by the CBL, Lesotho Automated Clearing House (LACH) operated by Payments Association of Lesotho (PAL). The failure of these systems could pose significant negative repercussions for financial stability, monetary policy implementation, and financial inclusion, among others. Safe and efficient systems are fundamental to money being an effective means of payment and to the smooth functioning of financial markets. A well designed and managed system helps to maintain financial stability by preventing or containing financial crises and help to reduce the cost and uncertainty of settlements, which could otherwise act as an impediment to economic activity¹³.

LSW (real time gross settlements (RGTS)) is the most critical payment system because it processes and settles large values and time-critical payments between system participants and also has linkages with other payment systems such as LACH and CSD. Therefore, its failure could have a systemic impact; with negative repercussions for financial stability within the country. Moreover, this system must meet high safety¹⁴ and efficiency standards to manage and/or mitigate all risks arising from its operations.

There are many ways through which risks may manifest in large-value payment systems such as LSW. These include (a) system unavailability (downtimes), (b) the degree of utilization and (c) inability of system participants to settle their obligations. Therefore, close monitoring of these key aspects in LSW is crucial as they represent the main operational and financial risks that could adversely affect LSW and potentially culminate in a systemic crisis. The fourth quarter of 2020 system utilisation data indicate that the LSW transaction volumes had increased by 1.7 percent while the value of transactions processed increased by 2.5 percent in comparison to the fourth quarter of 2019. The transaction density was higher in 2020 compared to 2019, by averages of M2.4 million and M2.0million per transaction, respectively.

As a large-value payment system, LSW must be available to all the participants at all times during the business day to process and settle interbank transactions. Any system availability rate below 98 percent is not acceptable as it has the potential to undermine the smooth functioning of the financial sector in the economy. In 2020, the system remained available to participants for about 98.0 percent of the time, right on the tolerable system availability and relatively the same as the previous year. The system downtime incidents were on account of intermittent disruptions on the internet and/or server connection. However, such disruptions were resolved within a reasonable time. Therefore, overall a substantial number of large-value and time-

¹² These include the CPSS-IOSCO Principles for Financial Market Infrastructures (PFMI's) and the CPSS-BIS Central Bank Oversight of Payment and Settlement Systems.

¹³ CBL Payment System Oversight Policy Framework.

¹⁴ Among other safety threats, which continue to escalate globally, is cyber-crime. Therefore, there is a need to continue to improve security measures and to launch cyber-crime awareness campaign to help people protect themselves this type of crime. In addition, cyber security law is of paramount importance to protect the financial system.



critical payments could be processed and settled despite the experienced disruptions.

6.2 Mobile Money

The rapid proliferation of mobile money services can be considered a triumph in closing the financial inclusion gap, with money in circulation in 2020 at M327.3 million. This aggregated trust account balance shows the amount of money held in trust

account balances for each loti of mobile money in circulation as a prudential measure. It also acts as a proxy for the size of the market observed over time, which grew by 5.3 percent in 2020, down by 3.1 pps from 2019. An important feature of the mobile money market to note is that growth rates have fallen significantly since mobile money services were introduced in the 2012, where annual growth rates above 1000 percent were not uncommon. This indicates that the market has entered its maturity phase and much lower growth rates can be expected in the future ▣

FINANCIAL SYSTEM RESILIENCE

7. FINANCIAL SYSTEM RESILIENCE

The Central Bank Act of 2000 gives the CBL the mandate and powers to promote and safeguard the stability and soundness of the financial system in Lesotho. The Bank uses stress-testing¹⁵, among other tools, to achieve its objective of promoting the resilience of the domestic financial system and mitigating vulnerabilities arising from financial and economic shocks. In 2020, the CBL ran two stress-tests to determine the resilience of the banking system in Lesotho to adverse and plausible credit, interest-rate, and liquidity shocks¹⁶. The tests covered all four commercial banks. The results covered in this report highlight the June and December 2020 stress-test results and their implications to the banking industry and Lesotho's economy as a whole. The stress-tests results demonstrate that the banking sector is highly resilient and could withstand shocks of the nature assumed in the stress-test.

The level of NPLs is usually used as an indicator of inherent credit risk in bank's loan portfolio.

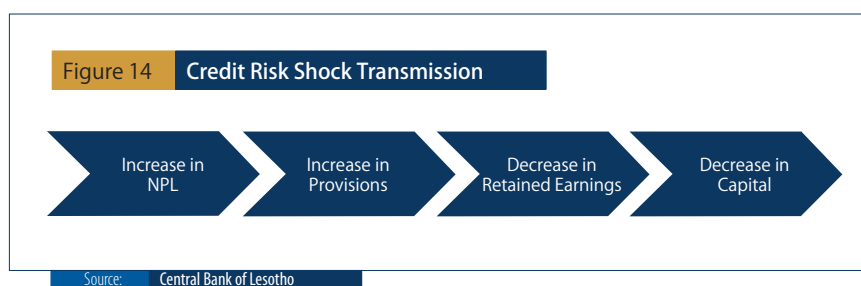
¹⁵ The Bank uses a simple sensitivity test model which is static and does not perform any form of forecasting. A static model assesses the impact of a particular shock or a group of shocks at a certain point in time. The stress-testing approach applied is a top-down one. This implies that CBL collected necessary data and conducted stress-testing based on the information received.

¹⁶ Shocks are defined as exceptional but plausible idiosyncratic and/or system-wide adverse economic events. They are classified in different levels of severity ranging from low to severe, and are used to stress various risk-factors to determine their resilience. The calibration of shocks is made on the basis of both historical and hypothetical approaches. The historical approach uses past-crises information to formulate shocks and scenarios while the hypothetical approach is used in the absence of such information.

7.1 Stress-test Key Assumptions and Shocks

7.1.1 Credit Risk Shocks

Credit risk is defined as the potential that a bank borrower, or counterparty, will fail to meet its payment obligations as stipulated in the contractual terms agreed with the bank. The level of non-performing loans (NPLs) is normally used as an indicator of credit risk inherent in a bank's loan portfolio. A non-performing loan is the sum of borrowed money for which the debtor has not made his or her scheduled payments for at least 90 days¹⁷. Banks normally set aside funds to cover for potential losses on loans in the form of loan-loss provisions. Consequently, since loan-loss provisions are an expense to a bank, they erode the capital levels of the institution by reducing retained earnings as well as reduce the value of the risk-weighted assets (RWA). The credit risk shock transmission channel is summarised in Figure 14.



7.1.2 Liquidity Risk

Liquidity risk is the risk that a bank will not be able to meet its current and future cash-flow and collateral needs, both expected and unexpected, without materially affecting its daily operations or overall financial condition. Liquidity stress-tests are used to assess banks' resilience against maturity mismatches between short-term assets and liabilities or in a case where banks experience unexpected adverse events such as a bank run. CBL runs stress-tests that entail the latter. The bank-run type of shock can be transmitted within the banking sector as indicated in Figure 15.

¹⁷ Financial Institutions (Loan portfolio classification) Regulations 2016.



Figure 15 Liquidity Risk Shock Transmission



Source: Central Bank of Lesotho

Liquidity risk is the risk that a bank will not be able to meet its obligations without materially affecting its daily operations or overall financial condition.

7.1.3 Interest Rate Risk Shocks

Interest rate risk can have both a direct and indirect impact on the banks' balance sheets. Direct interest rate risk is the risk incurred by a bank when its interest rate sensitive assets and liabilities maturities are not matched. In contrast, a bank is exposed to indirect interest rate risk through the impact of interest rate changes on the borrower's creditworthiness and ability to repay. Direct interest rate calculates the changes in interest income and interest expenses resulting from the gap between the flow of interest on the holdings of assets and liabilities in each bucket. The gap in each time bucket provides a relative magnitude of the impact of the shock on the net interest income (NII) given a change in interest rate. Interest income is the most important source of revenue for banks and an indicator of profitability. The test run by CBL assumed shocks in the form of an equal change in all rates (parallel yield curve shift). The shocks are calibrated using historical changes in policy rates. Figure 16 shows the transmission of interest rate shocks.

Figure 16 Interest Rate Risk Shock Transmission Channel



Source: Central Bank of Lesotho

Interest rate risk is a risk to income and capital of a bank brought about by movements in market interest rates.

7.1.4 Foreign Exchange Rate Risk

Foreign exchange risk is the risk that a bank's balance sheet may fluctuate because of changes in the value of a local currency relative to the currency with which the bank's assets are denominated in as shown in Figure 17. For instance, if a bank has foreign-currency (FX) denominated assets and liabilities, its balance sheet will be prone to fluctuations in currency markets. The larger an exposure the bank has to FX-denominated assets and liabilities, the more sensitive its balance sheet will be to swings in currency markets. Foreign exchange stress-test scenarios assumed shocks of 20, 25, and 30 percent depreciation of local currency for low, moderate, and severe scenarios, respectively.

FINANCIAL SYSTEM RESILIENCE

Figure 17 Foreign Exchange Risk Shock Transmission Channel



Source: Central Bank of Lesotho

Foreign exchange risk is the risk that a bank's balance sheet may fluctuate because of changes in the value of a local currency relative to the currency with which the bank's assets are denominated in.

7.2 Stress-test Results

7.2.1 Credit Risk

Credit risk stress-test results revealed that all banks would have been sufficiently capitalised to absorb losses as a result of the assumed sector-wide increase in NPLs in both the June and

December 2020 tests. As illustrated in Table 3, for Group I shocks, all banks' CAR would have remained well above the eight percent minimum requirement and stayed solvent. Therefore, based on the assumptions made and the types of shocks assumed, the credit risk related to an increase in NPLs can be regarded as low because all banks would have had adequate capital to absorb losses induced by high NPLs.

Table 3 Credit Risk Stress Test Results					
Risks	Number of banks below 8.0% CAR	Assets share of banks < 8.0% CAR	Number of Insolvent Banks	Capital Deficiency Relative to CAR	Capital Deficiency Relative to Minimum Capital
June 2020					
Group I: System level credit risk					
Shock I: NPLs increase by 60%	0	0	0	0	0
Shock II: NPLs increase by 120%	0	0	0	0	0
Shock III: NPLs increase by 180%	0	0	0	0	0
Group II: Concentration Risk					
Shock I: Largest 1 Borrower Defaults	0	0	0	0	0
Shock II: Top 3 Borrowers Default	1	25.9	0	54 815	0
Shock III: Top 5 Borrowers Default	3	39.6	1	137 853	0
December 2020					
Group I: System level credit risk					
Shock I: NPLs increase by 60%	0	0	0	0	0
Shock II: NPLs increase by 120%	0	0	0	0	0
Shock III: NPLs increase by 180%	0	0	0	0	0
Group II: Concentration Risk					
Shock I: Largest 1 Borrower Defaults	0	0	0	0	0
Shock II: Top 3 Borrowers Default	0	0	0	28 491	0
Shock III: Top 5 Borrowers Default	3	36.6	0	110 156	1 738

Source: Central Bank of Lesotho

FINANCIAL SYSTEM RESILIENCE



Concentration risk in banks' loan books was stress-tested to assess the resilience of banks to their large exposures. In Group II shocks where the top-three and top-five borrowers default, respectively, up to two banks failed the tests conducted in June and December 2020. This shows that their capital would not have been sufficient to absorb the losses incurred as a result of the assumed shocks and would have fallen below the eight percent CAR threshold. Moreover, they would have required recapitalisation to meet the regulatory unimpaired capital requirement. Concentration risk associated with large exposure can be regarded as high since some banks would not have had adequate capital to cover the losses. However, this could be mitigated by ensuring that collateral pledged is adequate and of good quality to cover the losses.

Table 4 shows the test results regarding the banking industry exposure to two economic sectors, namely the household and business enterprises sectors. Firstly, mortgage and personal loan portfolios are stress-tested by assuming a 30 percent and 45 percent increase in NPLs, respectively. A shock of this magnitude would have had a minimal impact on the mortgage loan portfolio and all banks would have remained with post-shock CAR above the minimum requirement and therefore would

have needed no recapitalisation in both June and December 2020. For the personal loans portfolio, one bank failed the test in June 2020, while two banks failed the test in December 2020. Moreover, recapitalisation of M76.1 million and M132.7 million relative to CAR would have been needed for both periods, respectively. Second, business lines which constitute over half of the loans to the business sector were stress-tested. These are manufacturing, construction, and mining & quarrying. If the scenario envisaged for the construction industry were to materialise, three banks with a combined assets market share of 92.9 percent would have breached both the regulatory and unimpaired capital requirements in June 2020, prompting a combined recapitalisation of about M805.3 million. In addition, one bank would have become insolvent. Likewise, in December 2020, three banks with a combined assets market share of 90.9 percent would have breached both the regulatory and unimpaired capital requirements, prompting a combined recapitalisation of about M534.2 million. Similarly, one bank would have been insolvent. However, in the scenario involving a surge in NPLs of the mining and quarrying together with manufacturing industries, none of the banks would have required recapitalization in the two periods under review.

FINANCIAL SYSTEM RESILIENCE

Table 4 Sectoral Credit Risk Stress-Test Results					
Risks	Number of banks below 8.0% CAR	Assets share of banks < 8.0% CAR	Number of Insolvent Banks	Capital Deficiency Relative to CAR	Capital Deficiency Relative to Minimum Capital
June 2020					
Group III: Sectoral level credit risk (20 percent increase in NPLs)					
Household Sector					
Mortgages	0	0	0	0	0
Personal loans	1	52.5	0	76 106	0
Business Sector					
Manufacturing	0	0	0	0	0
Construction	3	92.2	1	765 541	39 740
Mining & quarrying	0	0	0	0	0
December 2020					
Group III: Sectoral level credit risk (20 percent increase in NPLs)					
Household Sector					
Mortgages	0	0	0	0	0
Personal loans	2	63.4	0	132 715	0
Business Sector					
Manufacturing	0	0	0	0	0
Construction	3	90.9	1	481 412	52 792
Mining & quarrying	0	0	0	23 133	0
<i>Source: Central Bank of Lesotho</i>					

7.2.2 Liquidity Risk

The results for the bank-run Scenario I show that in both June and December 2020 stress tests, all banks would have remained liquid after five days of continuous withdrawals of deposits. This shows that the amount and quality of liquidity the banks held would have been enough to absorb a shock of the nature assumed in this test. In the same way, in Scenario II, following an

initial liquidation by all banks, two banks would have needed a second round of liquidation on day three and four respectively. Therefore, liquidity risk could also be regarded as minimal since banks would have sustained a bank-run type of event for a period of five days under the scenario I and II, allowing the banks and CBL a window of five days to one week to work on a solution that would restore confidence in the industry.

FINANCIAL SYSTEM RESILIENCE



Table 5	Daily Withdrawals							
	June 2020				December 2020			
	Scenario I		Scenario II		Scenario I		Scenario II	
	Daily Withdrawals (%)	# of illiquid Banks (out of 4)	Daily Withdrawals (%)	# of illiquid Banks (out of 4)	Daily Withdrawals (%)	# of illiquid Banks (out of 4)	Daily Withdrawals (%)	# of illiquid Banks (out of 4)
1 st day	5	0	5	0	5	0	5	0
2 nd day	5	0	10	0	5	0	10	0
3 rd day	5	0	15	0	5	0	15	0
4 th day	10	0	20	0	10	0	20	0
5 th day	10	0	25	0	10	0	25	0

Source: Central Bank of Lesotho

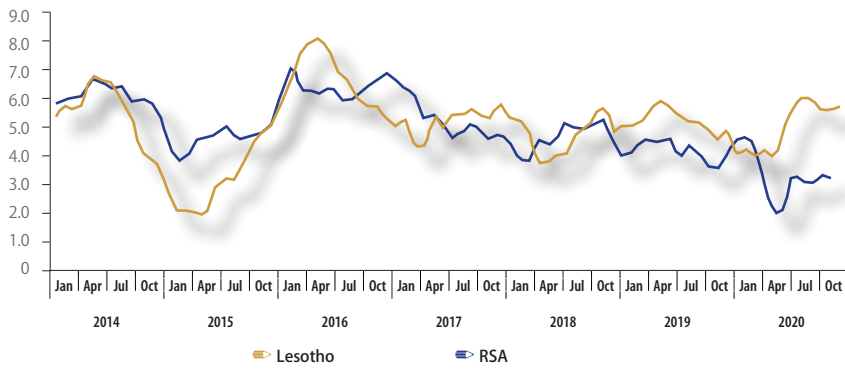
Moreover, the large depositors' bank run stress-test results revealed that if the largest depositor of each bank had simultaneously withdrawn their deposits, none of the four banks would have failed to meet the minimum liquid asset requirement of 25 percent¹⁸ in June 2020 and December 2020. Furthermore, the results show that if the top-three depositors were to withdraw their funds, none of the banks would have failed to meet the same requirement in both June and December 2020.

In the extreme case scenario, where the top-five depositors-run was assumed, one bank failed the test in June 2020 while none failed in December 2020. As the results show, liquidity position appears to have improved in December 2020. On the positive side, the results showed a high level of resilience since none of the banks would have ended up with exhausted liquidity even in the severe scenario involving the top-five depositors' run □

¹⁸ Minimum liquid assets requirements (prudential hurdle rate) as per Financial Institutions (Liquidity Requirements) Regulations 2000.

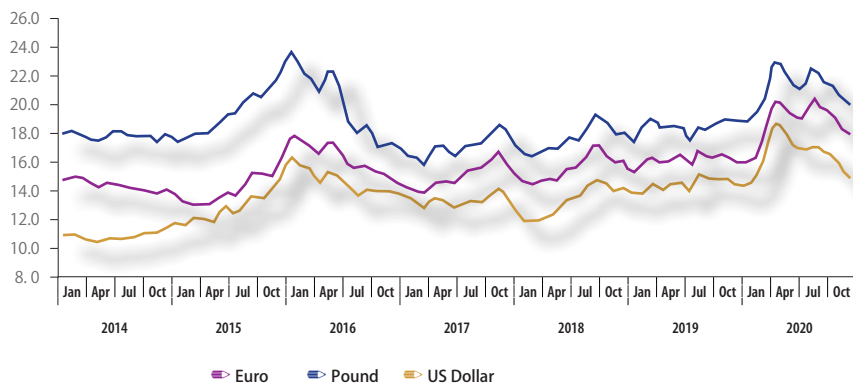
APPENDICES

Appendix 1A Lesotho and RSA Inflation (%)



Source: Central Bank of Lesotho

Appendix 1B Loti Exchange Rate to the Euro, Pound & US Dollar

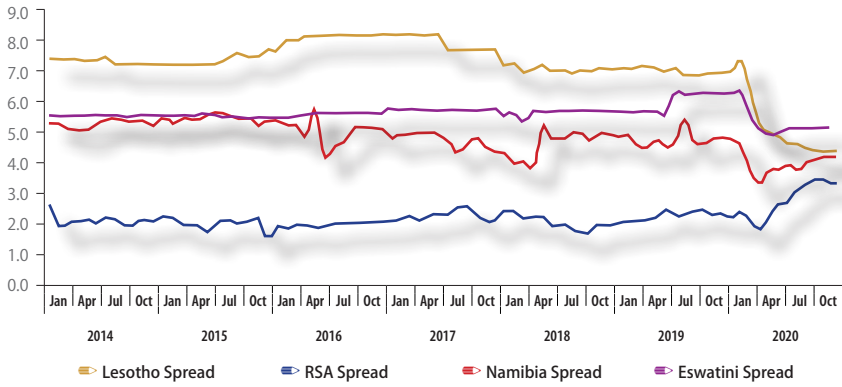


Source: Central Bank of Lesotho

APPENDICES

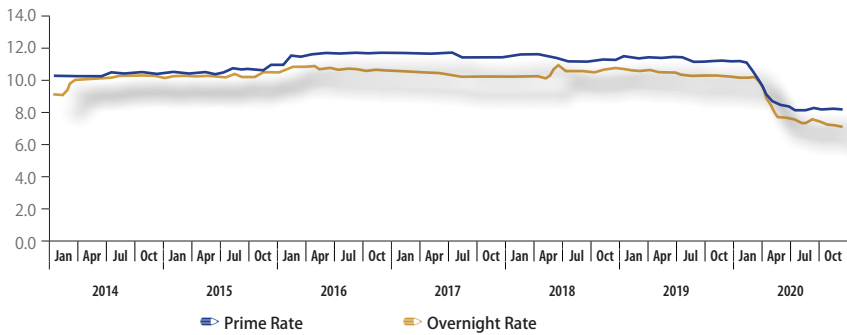


Appendix 1C Intermediation Spread (%)



Source: Central Bank of Lesotho

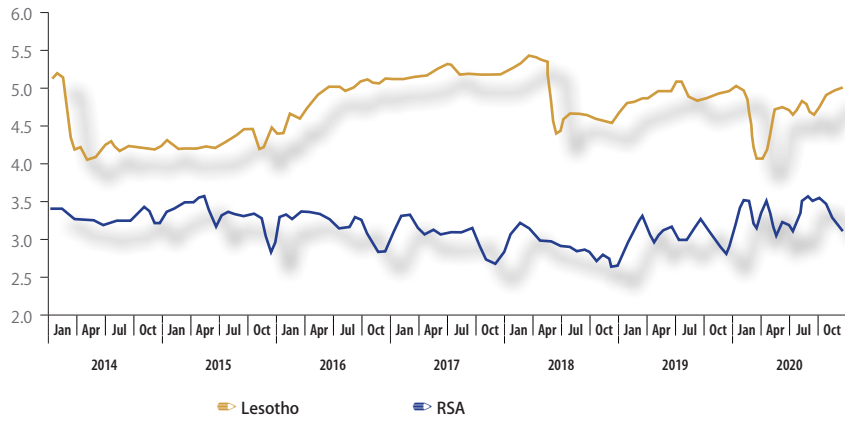
Appendix 1D Money Market Spread (%)



Source: Central Bank of Lesotho

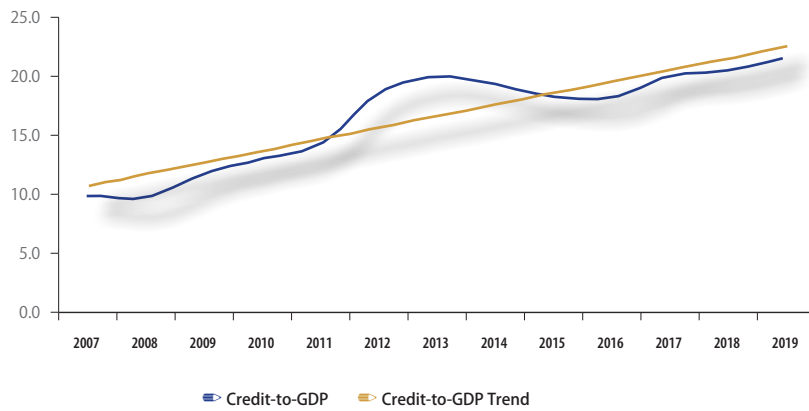
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Appendix 1E Lesotho and RSA Risk Premium (%)



Source: Central Bank of Lesotho

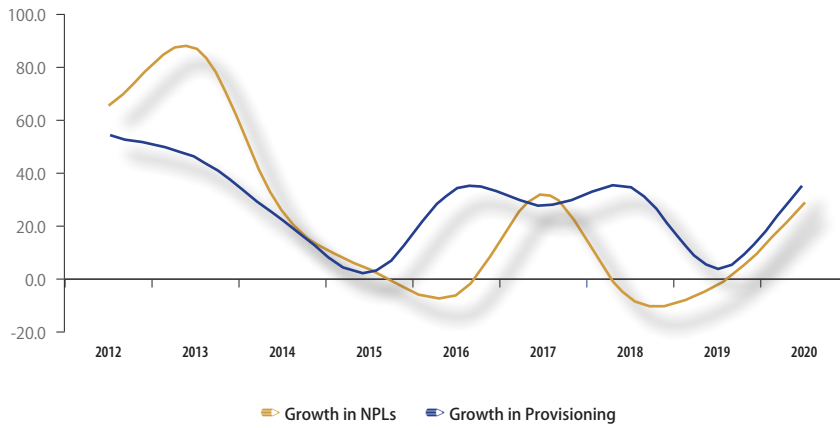
Appendix 1F Credit-to-GDP Ratio and its Trend (%)



Source: Central Bank of Lesotho

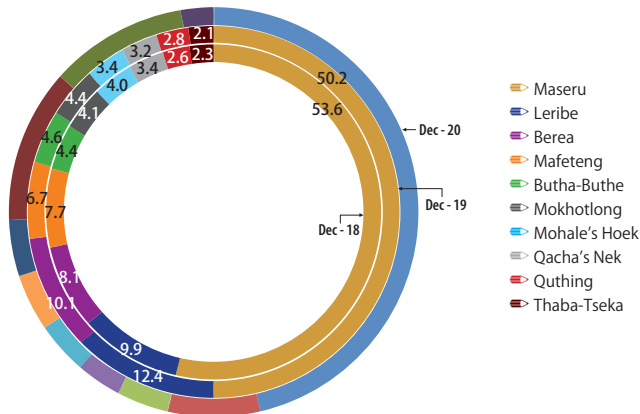


Appendix 1G Growth in NPLs and Provisions (%)



Source: Central Bank of Lesotho

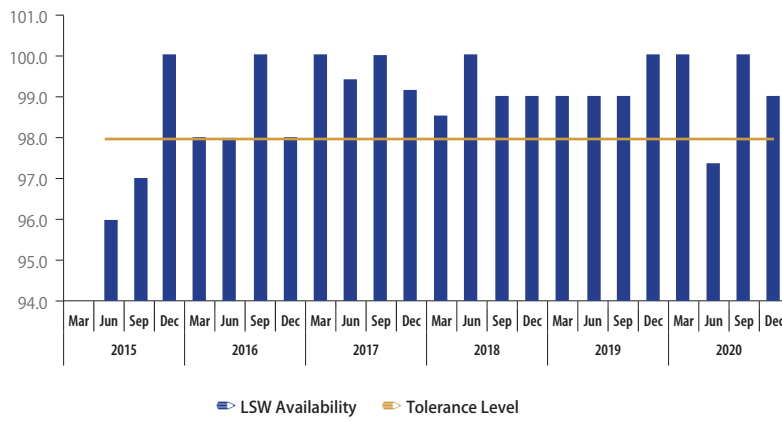
Appendix 1H Mobile Money Agents (% per district)



Source: Central Bank of Lesotho

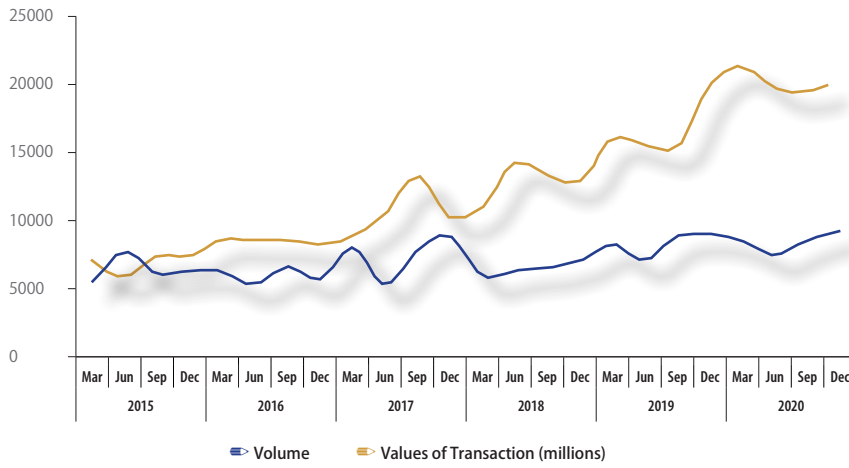
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Appendix 1I LSW Availability (%)



Source: Central Bank of Lesotho

Appendix 1J LSW Transactions and Values



Source: Central Bank of Lesotho

APPENDICES



Appendix II Assumptions and Shocks			
Index	Description	Shock	Description
1. General Credit Risk			
Shock 1.1	Uniform NPL increase	60%	Indicates an increase in NPLs of 60 percent across the credit spectrum.
Shock 1.2	Uniform NPL increase	120%	Indicates an increase in NPLs of 120 percent across the credit spectrum.
Shock 1.3	Uniform NPL increase	180%	Indicates an increase in NPLs of 180 percent across the credit spectrum.
2. Sectoral Credit Risk			
Shock 2.1	Mortgages	20%	Indicates the percentage increase in NPLs across the Mortgages sector.
Shock 2.2	Resident household (personal loans)	20%	Indicates percentage increase in NPLs across the Resident household (personal loans) sector.
Shock 2.3	Non-bank (Non-depository) financial institutions	20%	Indicates the percentage increase in NPLs across the Non-bank (Non-depository) financial institutions sector.
3. Credit risk Exposure by Lines of Business			
Shock 2.4	Manufacturing	20%	Indicates the percentage increase in NPLs across the Manufacturing sector.
Shock 2.5	Construction	20%	Indicates the percentage increase in NPLs across the construction sector.
Shock 2.6	Mining and Quarrying	20%	Indicates the percentage increase in NPLs across the Mining and Quarrying sector.
Shock 2.7	Community, Social and Personal services	20%	Indicates the percentage increase in NPLs across the Community, Social and Personal services sector.
Shock 2.8	Real Estate and Business Services	20%	Indicates the percentage increase in NPLs across the Real Estate and Business Services sector.
4. Concentration Risk			
Shock 3.1	Largest Borrower Defaults	1	Indicates a default of the largest borrower.
Shock 3.2	Top Three Borrowers Default	3	Indicates a default of the largest three borrowers.
Shock 3.3	Top Five Borrowers Default	5	Indicates a default of the largest five borrowers.
Detail 1	Assumed provisioning rate	20%	To calculate provisioning expense for large borrower default.
5. Reverse Stress Testing			
Shock 4.1	Reverse Testing - Deterioration of performing loans	7.9%	Deterioration of performing loans which causes capital to go below 8 percent.
6. Interest Rate Risk			
Shock 5.1	Interest shock	150 bps	Indicates an increase in market-wide interest rates of 150 basis points.
Shock 5.2	Interest shock	200 bps	Indicates an increase in market-wide interest rates of 200 basis points.
Shock 5.3	Interest shock	250 bps	Indicates an increase in market-wide interest rates of 250 basis points.
Shock 5.4	Interest shock	-150 bps	Indicates a decrease in market-wide interest rates of -150 basis points.
Shock 5.5	Interest shock	-200 bps	Indicates a decrease in market-wide interest rates of -200 basis points.
Shock 5.6	Interest shock	-250 bps	Indicates a decrease in market-wide interest rates of -250 basis points.
7. Foreign-Exchange Risk			
Shock 6.1	Depreciation of LSL	20%	Indicates a depreciation of the LSL of 20 percent.
Shock 6.2	Depreciation of LSL	25%	Indicates a depreciation of the LSL of 25 percent.
Shock 6.3	Depreciation of LSL	30%	Indicates a depreciation of the LSL of 30 percent.
Shock 7.1	Standard FX Loans Default	20%	Indicates percentage increase in NPS of 20 percent due to FX changes.
Detail 1	Assumed provision rate	50%	Indicates percentage increase in NPS of 50 percent due to FX changes.
<i>Source: Central Bank of Lesotho</i>			

APPENDICES

Appendix II Assumptions and Shocks (continued)			
Index	Description	Shock	Description
8. Multi-Factor Risk Scenarios			
Shock 8.1	Aggregate NPLs Increase	60%	Indicates simultaneous increase in NPLs of 60 percent, a depreciation of the LSL by 20 percent, and an increase in market-wide interest rates of 150 basis points.
	Depreciation of LSL	20%	
	Interest rate shock	150 bps	
Shock 8.2	Aggregate NPLs Increase	120%	Indicates simultaneous increase in NPLs of 120 percent, a depreciation of the LSL by 25 percent, and an increase in market-wide interest rates of 200 basis points.
	Depreciation of LSL	25%	
	Interest rate shock	200 bps	
Shock 8.3	Aggregate NPLs Increase	180%	Indicates simultaneous increase in NPLs of 180 percent, a depreciation of the LSL by 30 percent, and an increase in market-wide interest rates of 250 basis points.
	Depreciation of LSL	30%	
	Interest rate shock	250 bps	
9. General Liquidity Risk			
Shock 9.1	Withdrawal of deposits: 1st day by	5%	An outflow of deposits is assumed. Liquidity is generated through the fire sale of assets. Haircuts are assumed for all assets. Liquid assets generate the most liquidity, while non-liquid assets are assumed to generate not more than 1 percent liquidity after fire sale. It is also assumed that after 5 days, there is a cooling-off period to allow banks and the central bank to restore confidence.
	Withdrawal of deposits: 2nd day by	10%	
	Withdrawal of deposits: 3rd day by	15%	
	Withdrawal of deposits: 4th day by	20%	
	Withdrawal of deposits: 5th day by	25%	
Detail 1	Fire sale volume assumption: liquid assets	80%	The assumption is that 80 percent liquidity can be generated through a fire sale.
Detail 2	Fire sale pricing haircut: liquid assets	75%	The assumption is that 75 percent liquidity can be generated through a fire sale.
Detail 3	Fire sale volume assumption: non-liquid assets	1%	The assumption is that 1 percent liquidity can be generated through a fire sale.
Detail 4	Fire sale pricing haircut: non-liquid assets	100%	
10. Liquidity Concentration Risk – large-depositor bank run			
Shock 9.2	Withdrawal of deposits by large depositor	1	This affects liquidity ratios. Withdrawals are deducted from liquid assets, short term assets and total assets before the new ratio is calculated.
	Withdrawal of deposits by large depositors	3	
	Withdrawal of deposits by large depositors	5	
Detail 5	Assumed liquidity ratio hurdle rate	25%	The minimum liquidity ratio rate.
<i>Source: Central Bank of Lesotho</i>			



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