



2022 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 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 Central Bank of Lesotho (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 financial institutions; and providing efficient, reliable and safe payment and settlement systems.

This Financial Stability Report is a tool used by the 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 assessing 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 June. 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 current economic environment, which is characterised by a combination of high inflation, low growth, and much tight global financial conditions, has been challenging for financial stability and may exacerbate pre-existing financial vulnerabilities or give rise to new ones.** Since the last FSR, financial stability vulnerabilities emanating from different sectors of the economy remained unchanged except for the household sector. The household sector vulnerabilities increased due to persistently high inflationary pressures, high interest rates, and low employment at the back of weak economic activity.
 - 2. Economic activity has been mixed throughout the review period. However, overall growth had been poor and the likelihood of a global recession in 2023 is manifesting.** The deceleration in global growth in the first half of the year was mainly influenced by the uncertainty brought about by the Russian invasion of Ukraine. Despite some gains made mid-year, global economic activity woes are expected to persist well into 2023, with growth forecasts reduced significantly by major international authorities. The gloomy sentiment largely stems from ongoing geopolitical tensions, high inflation, tightening financial conditions, heightened commodity prices, and dwindling global demand.
 - 3. Economic activity in South Africa (SA) remains sluggish and this was exacerbated by intensifying shortages in electricity production, high inflation and policy rates, and the unstable political landscape.** The power-generating crisis in SA is the major factor weighing negatively on economic activity. Key economic sectors such as manufacturing, mining, and farming are the sectors worst hit by the rolling blackouts, and contraction in these sectors is expected to contribute negatively to GDP. Moreover, commodity prices are expected to decline further due to the Black Sea agreement
- and this will adversely contribute to the decline in export earnings and ultimately economic growth. Another factor that is likely to weigh on growth is the growing debt the government assumed from the state-owned enterprises and thus, increasing the fiscal risk.
- 4. The external and fiscal positions are expected to decline further and contribute to weak economic activity in the domestic economy.** Growth remained subdued in the review period. This was primarily on account of the Ukraine war-induced supply-side disruptions and subdued demand in Lesotho's trading partners. 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 rise in global geo-political tensions. 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 banking sector in the past years deteriorated further in 2022.** The sector is exposed to risks emanating from Covid-19 and its lingering effects on non-performing loans (NPLs), high and persistent inflation and policy rates, and concentration in the credit book. However, the banking sector continued to be adequately capitalised, with positive profitability levels and improved asset quality. There has also been a noticeable deterioration in liquidity since the beginning of 2020 relative to historical levels. Despite the risks observed, the stress-test results demonstrate that the current capitalisation, liquidity, and profitability levels guarantee a high degree of resilience.

¹ The initiative specifically allows for commercial food and fertilizer (including ammonia) exports from three key Ukrainian ports in the Black Sea – Odesa, Chornomorsk, Yuzhny/Pivdennyi as the war in Ukraine had caused partial closure of the ports and export of grain and foodstuffs commodities resulted in spiralling food prices globally.

EXECUTIVE SUMMARY



6. **The overall financial performance of OFCs remained robust during the review period despite the challenging economic environment.** The insurance sector remained resilient, and financially sound and expanded its asset base. In addition, the sector realised improvements in profitability. Likewise, the Credit-only MFIs sector maintained a healthy credit portfolio and its asset base continued to grow. However, the sector is characterised by high liquidity risk as almost all of its assets are in a form of loans.

7. **The payment system and financial market infrastructures operated effectively and efficiently during 2022 and continued to anchor financial stability.** The systemically important payment systems maintained high system availability. Nonetheless, the transaction density in 2022 was lower relative to the previous year and has been on a downward trend since the year 2020. This indicates that the amount of money processed through the national payment systems per transaction has been declining, indicating weak economic activity. 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 current economic environment, which is characterised by a combination of high inflation, low growth, and tight global financial conditions, has been challenging for financial stability and may exacerbate pre-existing financial vulnerabilities or give rise to new ones.

Since the last FSR, financial stability vulnerabilities emanating from different sectors of the economy remained unchanged except for the household sector as shown in Figure 1. The household sector vulnerabilities increased due to persistently

high inflationary pressures, high policy rates, and low employment at the back of weak economic activity, which has made it difficult for households to service their debt obligations. The Russia-Ukraine conflict continued to exert pressure on food and energy prices. Despite the government's subsidy initiative, production and aggregate demand remained weak, and have negatively affected the household sector's balance sheet. These factors have led to a rise in unemployment rates and poverty levels, putting more pressure on households and their ability to service their financial obligations. In addition, high-interest rates have increased the cost of borrowing, and reduced consumer expenditure and investment.



The household sector vulnerabilities increased due to persistently high inflationary pressures, high policy rates, and low employment at the back of weak economic activity.

MACRO-FINANCIAL ENVIRONMENT



2. MACRO-FINANCIAL ENVIRONMENT

2.1 International Developments

Persistent inflationary pressures and faster-than-anticipated monetary policy tightening, the Russia-Ukraine conflict, the Covid-19 resurgence in China, and weak global growth were the main sources of risk for financial stability in 2022. Inflation has been stubbornly high because of restricted supply value chains due to the Russia-Ukraine conflict, which has destabilised the transportation of goods through the Black Sea and resulted in escalating food and energy prices. Consequently, central banks across the globe have embarked on steep tightening of policy rates in an attempt to curb high inflation. The rise in policy rates is anticipated to weigh negatively on global economic activity by not only diminishing consumers' disposable income but also discouraging credit extension as high interest rates lead to increased cost of borrowing.

The global economic activity was muted in the first half of 2022 during the onset of the Russian invasion of Ukraine but the knock-on effects have rippled throughout the global economy for the rest of the year. Nonetheless, economic activity rebounded in the third quarter of 2022, with most economies registering solid economic growth. The growth was boosted by the anticipation that inflation had reached its peak and this would imply a slower pace of monetary policy tightening which bode well for economic activity. Moreover, there was increased fiscal support which boosted economic activity and eased supply bottlenecks thus reducing the costs of inputs. However, during the last quarter of the year, economic activity softened for most advanced economies (AEs) and emerging market and developing economies (EMDEs). This was due to Covid-19 outbreaks in China, which led to renewed containment measures such as lockdowns.

On the other hand, significant downside risks to economic activity persist. They include the recurring Covid-19 outbreaks, intensifying inflationary pressures and the ongoing monetary policy tightening, albeit at a slower pace. In addition, the Russia-Ukraine conflict is anticipated to continue into 2023 and there lies a risk that the Black Sea grain initiative might not

be extended, which could result in a surge in food prices. The Russia-Ukraine conflict has also resulted in renewed geopolitical tensions beyond the borders of both Russia and Ukraine and is anticipated to exacerbate already fragile relations between the United States (US) and China. Moreover, the majority of EMDEs are facing debt distress as a result of relatively still higher policy rates in AEs and a comparatively stronger US dollar. Subsequently, given limited policy space in EMDEs to support activity if needed, these downside risks increase the possibility of a recession in these economies.

In South Africa (SA), economic activity declined significantly relative to the previous year. The persistent power shortages, faltering global demand coupled with high inflation, tightening monetary policy, and the unstable political landscape are expected to weigh negatively on economic growth. Consequently, the South African Reserve Bank (SARB) has markedly downgraded its growth forecast over the next three years citing the power-generating crisis in SA as a major contributing factor. Key economic sectors such as manufacturing, mining, and farming are the worst hit sectors by the rolling blackouts, and contraction in these sectors is expected to drag on economic activity. In addition, commodity prices are expected to decline further, and this will weigh negatively on exports and ultimately on economic growth. Another factor that is likely to weigh on growth is the ballooning debt from state-owned enterprises which will likely increase fiscal risk.

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. The 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.

MACRO-FINANCIAL ENVIRONMENT

Intensifying inflationary pressures leave developing economies like Lesotho vulnerable to tightening monetary policy in AEs.

Continuous monetary policy tightening in AEs could result in sustained periods of large portfolio outflows and trigger significant currency depreciations and growing budget deficit. With the government being the main source of business for the private sector, further pressure on the fiscus may cause the government to postpone projects offered to the private sector while at the same time, delaying payments for the services rendered by the private sector. This will result in an increase in NPLs, which will ultimately hurt the banking sector's balance sheets.

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

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 the loti is mostly affected by changes in capital flows to EMDEs and global risk perception through the rand-loti peg. The appreciation of the currency

against major international currencies reduces Lesotho's export competitiveness while the depreciation of the loti increases input costs since raw materials are sourced from international markets. Coupled with weak global demand, these dynamics can have an adverse impact on the trade balance.

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. Moreover, the Southern African Customs Union (SACU) revenue pool largely depends on the performance of the South African economy. The decline in SACU revenue share for Lesotho will have a negative impact on the budget since it is a significant source of revenue for fiscal operations.

Table I Selected Economic Indicators (%)									
	GDP Growth			Interest Rates			Inflation		
	△ pps			△ pps			△ pps		
	2021	2022	y/y	2021	2022	y/y	2021	2022	y/y
Advanced Economies									
US	5.50	1.00	(4.50)	0.25	4.50	4.25	7.00	6.50	(0.50)
UK	6.50	0.40	(6.10)	0.25	3.50	3.25	5.40	10.50	5.10
Euro Area	4.60	1.90	(2.70)	0.25	2.50	2.25	5.00	9.20	4.20
Japan	0.80	0.60	(0.20)	(0.10)	(0.10)	0.10	0.80	4.00	3.20
Emerging Market Economies									
Brazil	1.60	1.90	0.30	9.25	13.75	4.50	10.06	5.79	(4.27)
Russia	5.00	(2.70)	(7.70)	7.50	(1.00)	8.39	11.90	3.51	3.49
India	5.40	4.40	(1.00)	4.00	6.25	2.25	5.59	5.72	0.13
China	4.00	2.90	(1.10)	3.80	2.75	(1.05)	1.50	1.80	0.30
SA	1.70	0.90	(0.80)	3.75	7.00	3.25	5.90	7.20	1.30

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



2.2 Domestic Developments

Economic activity remained subdued and is estimated to have contracted in the review period. The elevated inflationary pressures coupled with high policy rates and disruptions in supply chains continued to weigh down on the overall economic activity. These factors are also painting a gloomy outlook for future economic growth prospects. The Lesotho Highlands Water Project (LHWP) is expected to keep fixed investment elevated in the medium term. However, strong demand for capital imports will see net exports continue to drag growth.

The fiscal position has worsened owing to low government revenues and increasing government expenditure. The fiscal deficit widened further, driven mainly by the decrease in government revenues amid increases in government expenditure. Furthermore, lower demand for the country's

export led to less revenue. The country has also been facing significant structural challenges even before the Covid-19 pandemic and has been dependent on revenues from Lesotho Highlands Water Project (LHWP), textile industry, and SACU for the past years. The pandemic exacerbated the country's weak macroeconomic performance and budgetary constraints, leading to limited capacity to respond to shocks.

The macro-financial environment continued to be affected by the lingering effects of Covid-19, high inflation, and interest rates. The loti continued to depreciate against major currencies and, inflation remained persistently high in the review period. The country's sluggish growth has been attributed to poor performance in every sector of the economy particularly in the manufacturing sector as the result of the pandemic and low global demand.

FINANCIAL STABILITY DEVELOPMENTS AND TRENDS

3. FINANCIAL STABILITY DEVELOPMENTS AND TRENDS

3.1 The Structure of the Financial System

The financial sector is dominated by the banking sector, which consists of three subsidiaries of South African banks and one local bank. The banking sector remains the main provider of financial services and products in the country. The three foreign-owned banks control about 90.0 percent of the total banking industry's assets, revenue, and deposits. The insurance sector (made up of ten insurers) is the second largest in terms of asset base. Other financial institutions that operate in Lesotho under the regulation and supervision of the CBL are microfinance institutions (MFIs-132), Asset Managers (2), Insurance Brokers (49), Foreign Exchange Bureaus also working as Money Transfer Institutions (MTIs - 2), Credit Bureau (1), Stockbrokers (6), Mobile Money Issuers (5), Pension Funds (7) and Pension Fund Administrators (4). Figure 2 shows the players and their relative size in Lesotho's financial system.

The banking industry's total assets constituted 68.4 percent of the total financial sector assets² and about 55.1 percent of the gross domestic product (GDP) as at December 2022. The Insurance industry commanded 29.8 percent of the total financial system assets and 22.4 percent of the GDP. The share of other non-bank financial institutions³, including MFIs, to total financial system assets, was 31.6 percent, while total financial system assets to GDP stood at 80.5 percent. The financial markets in Lesotho comprise mainly 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 markets are still shallow, concentrated, and have limited investment options. The CBL is the sole regulator of all the financial institutions outlined above.

The banking sector is composed of four commercial banks, with 50 branches across the country. The sector is characterised by limited competitiveness and is highly concentrated with a Herfindal-Hirschman index⁴ (HHI) of 3 720. As at December 2022, the total banking industry assets were M19.8 billion. Relative to the previous year, the banking industry's total assets declined by 8.4 percent.

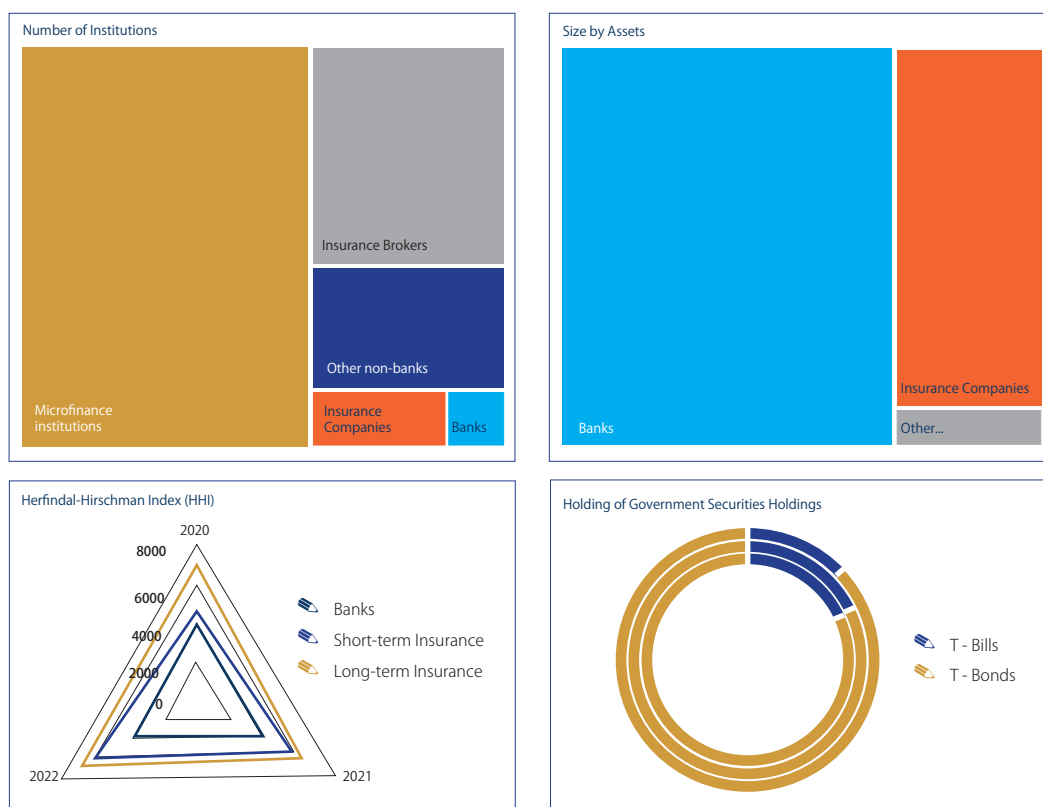
² Total financial system assets data is as at 30 September 2021 due to a one quarter lag reporting for MFS's.

³ Inclusive of the insurance sector.

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.

FINANCIAL STABILITY DEVELOPMENTS AND TRENDS

Figure 2 Financial System Structure



Source: Central Bank of Lesotho

Likewise, the insurance sector is highly concentrated in both the long-term and short-term categories. The HHI for the long-term and short-term categories stood at 6 824 and 5 964, respectively. The legal and regulatory environment in Lesotho further provides for both deposit-taking MFIs as well as credit-only MFIs. However, there were no deposit-taking MFIs operating in

Lesotho during the period under review. As at the third quarter of 2022, the four largest MFIs command a larger share of the market. The sector experienced growth in credit extension, hence an increase in the asset base. The insurance industry's assets base increased by 11.8 percent from the previous year to M9.4 billion while the MFIs experienced a decline of 9.5 percent.

FINANCIAL STABILITY DEVELOPMENTS AND TRENDS

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 (GoL). The level of interconnectedness in the financial sector and linkages are very important for macro-prudential surveillance and financial stability. A shock in one sector can have spillover effects on other sectors or the rest of the financial system through these linkages. Therefore, it is important that the CBL monitors vulnerabilities emanating from the inter-linkages among the financial institutions and ensures 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. Cross-border linkages, on the other hand, are predominantly placements and investments with

banks in SA and outside SA. Furthermore, banks hold deposits of/ lend to other non-bank financial corporations. Risks associated with placements with banks from abroad expose domestic banks to exchange rate risks (except in the case of SA due to the loti's peg to the South African rand).

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 which 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 GoL's debt held by the financial sector primarily consists of Treasury securities⁵. The exposure of the financial sector to total government debt has been declining marginally since 2019 to the current period but accounts for over 80 percent of total government domestic debt. Table 2 shows outstanding Treasury securities held by the financial sector.

Period	2017	2018	2019	2020	2021	2022	ΔYoY
Total Financial Sector Exposure	1 251.6	1 932.6	3 118.9	3 344.4	3 687.0	4 420.6	19.9 pct
% of Total Government Debt	74.4	78.6	88.4	87.7	86.8	86.3	-0.4 pp
T-Bill Holders' Amounts Outstanding	511.6	644.4	647.7	654.9	709.1	668.7	-5.7 pct
% of Total, of which	40.9	33.3	20.8	19.6	19.2	15.1	-4.1 pp
Commercial Banks	38.2	32.1	20.5	19.2	19.2	14.9	-4.2 pp
Insurance Companies	2.7	1.2	0.3	0.2	0.0	0.0	0.0pp
Non-Bank Financial Corporations	0.0	0.0	0.0	0.2	0.0	0.2	0.2 pp
Bond Holders' Amounts Outstanding	740.0	1 288.2	2 471.2	2 689.5	2 978.0	3 751.9	26.0 pct
% of Total, of which	59.1	66.7	79.3	80.4	80.8	84.8	4.1 pp
Commercial Banks	41.9	40.7	48.1	43.7	45.4	45.1	-0.3pp
Insurance Companies	17.2	26.0	21.9	19.6	21.4	24.7	3.3 pp
Non-Bank Financial Corporations	0.0	0.0	9.3	17.1	13.9	15.0	1.1 pp

Source: Central Bank of Lesotho

⁵ Treasury Bonds and Bills.

BANKING SECTOR



4. BANKING SECTOR

The favourable trends seen in the banking sector in the past years deteriorated further in 2022. The sector remain exposed to risks emanating from Covid-19 and its lingering effects on non-performing loans (NPLs), high and persistent inflation and policy rates. While the banking sector continued to be adequately capitalised, profitable and with improved asset quality, liquidity

position deteriorated relative to historical levels. In addition, the sector remains exposed to credit concentration, wholesale funding, and government debt overtime. These risks are structural and inherent in small and underdeveloped financial systems. Nevertheless, stress-test results demonstrate that the current capitalisation, liquidity, and profitability levels guarantee a high degree of resilience to shocks.

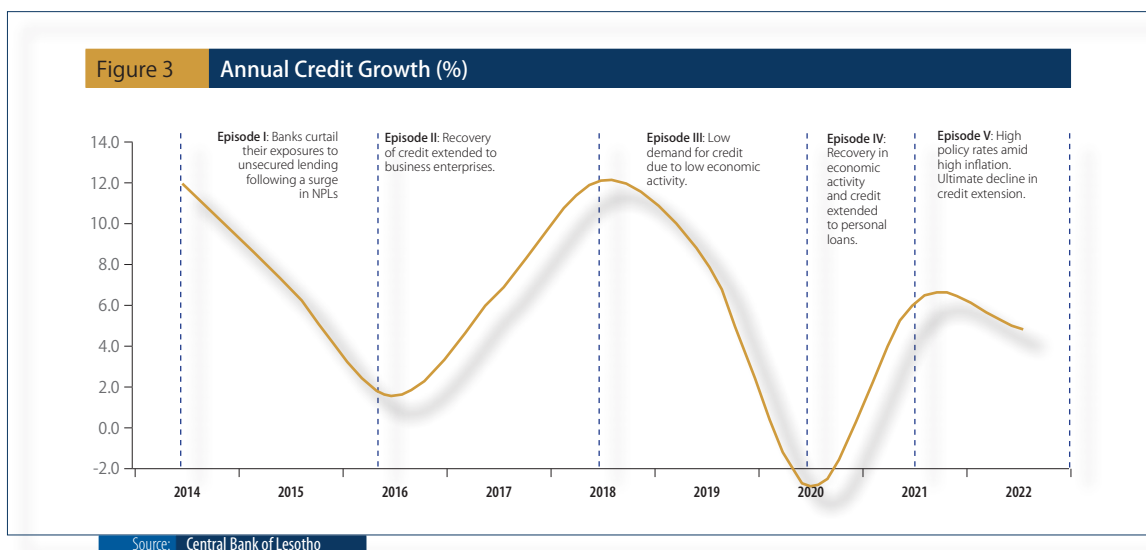
Bank Health Index	2016	2017	2018	2019	2020	2021	2022
Overall Industry Health	-0.3	-0.3	0.2	0.1	-0.2	0.1	0.2
Capital Adequacy	-0.1	-0.7	-0.5	0.2	1.0	-0.5	0.2
Asset Quality	0.6	0.9	-0.1	-0.8	-0.1	-1.2	-1.7
Earnings	-0.2	-1.4	0.2	1.0	-1.2	-0.6	0.7
Liquidity	-1.7	1.0	-0.9	-1.4	0.0	1.3	-1.5
Leverage	0.4	-0.6	0.4	-0.4	1.1	0.2	1.6
Sensitivity to Market Risk	1.9	1.1	0.1	0.4	-2.2	0.9	-0.9

Source: Central Bank of Lesotho

4.1 Credit Developments

Credit extension decreased in 2022 relative to 2021 as shown in Figure 3. Between 2020 and 2021, credit extension increased due to the recovery in economic activity as the economy reopened from the first hard-lockdown that was effected in March 2020. Between 2021 and 2022, credit extended continue to grow as the vaccine rollout took effect in Lesotho and less severe lockdowns. However, in 2022, high policy rates and

inflation (brought about by the war in Ukraine and its knock-on effects globally) led to the ultimate decline in credit extension. In the review period, the war between Russia and Ukraine, led to high inflationary pressures due to the rise in food and energy prices as the war squeezed the recovering supply value chains from the Covid-19 pandemic. In response to high inflation, monetary authorities tightened policy rates, thereby reducing credit extension to the rest of the economy. Year-on-year, credit declined by 2.3 pps to M8.41 billion.

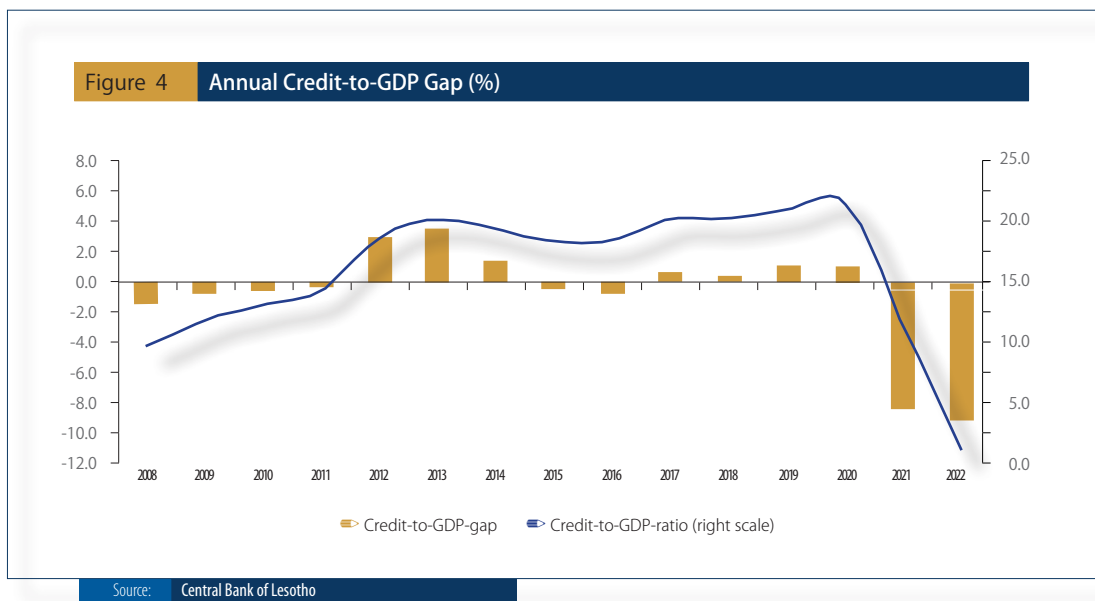


BANKING SECTOR

Figure 4 shows the evolution of the annual credit-to-GDP gap. The credit-to-GDP gap⁶ is regarded as an 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 2016. The gap turned positive again between 2017 and 2020, from whence it turned sharply negative (see Figure 4). This shows that, over time, the credit-to-GDP ratio has mostly been positive and remained almost at par with its long-term trend although it has fallen significantly between 2021 and 2022. This

is an indication of more room for sustainable extension of credit to the economy with a low probability of overheating.

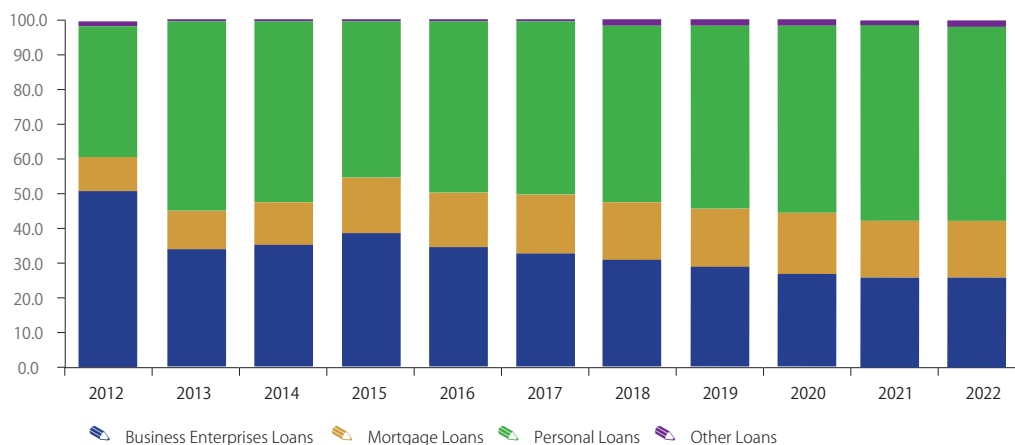
Figure 5 shows the distribution of credit by economic sectors. Credit to households, consisting of personal loans and mortgages, and credit to business enterprises made up 71.7 percent and 26.3 percent of the banks' loan book during 2022, respectively. Out of the 71.7 percent loans to households, personal loans constituted 53.6 percent. This shows the extent to which the banking sector is exposed to the sector. On an annual basis, personal loans grew by 3.3 percent to M4.5 billion while mortgage loans increased by 8.5 percent to M1.5 billion. On the other hand, credit to business enterprises grew by 6.6 percent to M2.2 billion.



⁶ The credit-to-GDP gap is defined as the deviation of the credit-to-GDP ratio from its long-run trend.



Figure 5 Distribution of Loans by Sector to Total Loans (%)



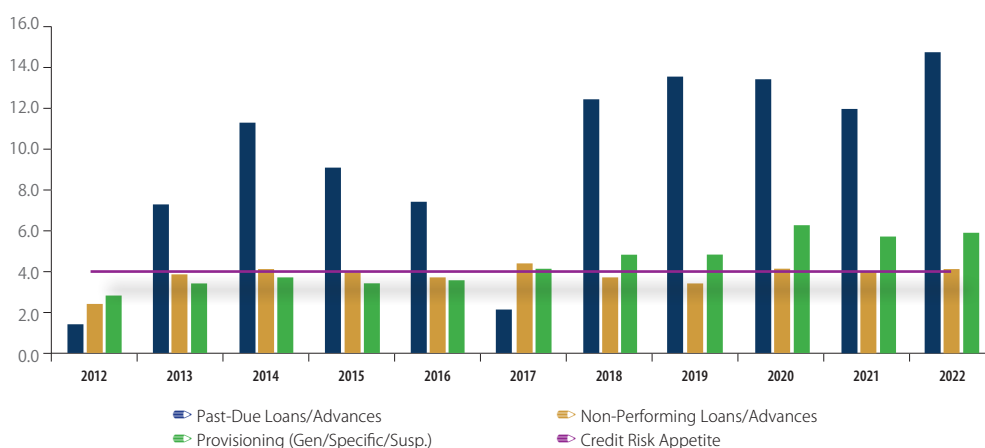
Source: Central Bank of Lesotho

Personal loans constitute more than half of credit extended to households.

Credit risk remains moderate during the review period but concentration in certain loan types and exposures to single or group of borrowers remains a concern. The ratio of NPLs to total loans increased from 4.1 percent in December 2021 to 4.3 percent in December 2022. Furthermore, past-due loans increased by

29.7 percent to M1.2 billion and total NPLs increased by 12.5 percent to M362.8 million in 2022. Consequently, provisioning levels increased by 9.1 percent to M497.6 million. The increase in past-due loans, however, (Figure 6) remains the main downside risk to the NPLs' outlook.

Figure 6 Non-Performing Loans & Provisions as a percent of Total Loans (%)



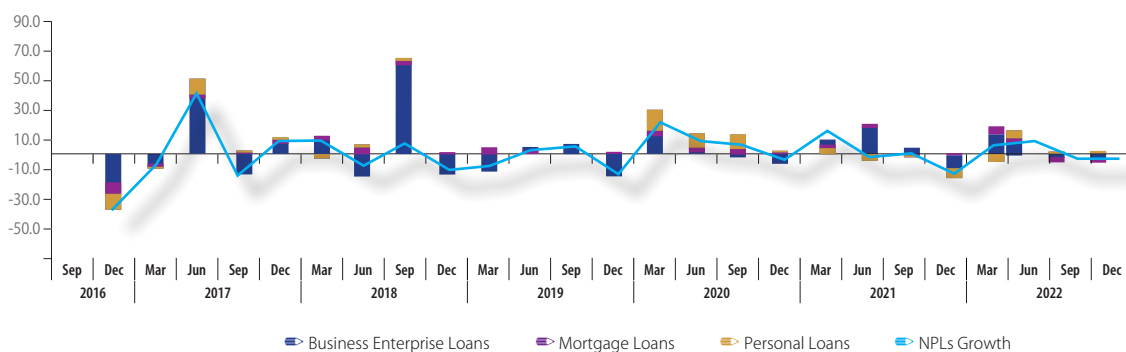
Source: Central Bank of Lesotho

Asset quality remained relatively unchanged during the review period.

Sectoral analysis of NPLs revealed that the business enterprises component of the banks' loan portfolio continues to realise the highest growth in NPLs during the review period followed by the personal loans category as shown in Figure 7. The mortgage loan portfolio, on the other hand, realised a decrease in NPLs.

BANKING SECTOR

Figure 7 Growth in NPLs (%)



Source: Central Bank of Lesotho

4.2 Liquidity Developments and Funding Structure

Capital is arguably the most important safety buffer for banks since it provides the resources for banks to recover from substantial losses of any nature and gives depositors confidence in banks' 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. A bank can be solvent - have the economic value of a bank's assets more than sufficient

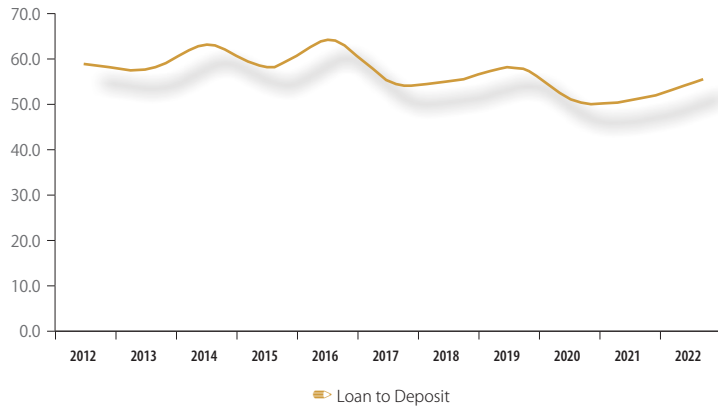
to cover all of its claims - and yet go bust because its assets are illiquid and its liabilities have short-term maturities.

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 increased by 4.2 pps to 55.5 percent in 2022. This means that the banking industry lends out about 56 lisente on every loti held as deposits and keeps the rest for immediate liquidity needs.

BANKING SECTOR



Figure 8 Loan to Deposit Ratio (%)

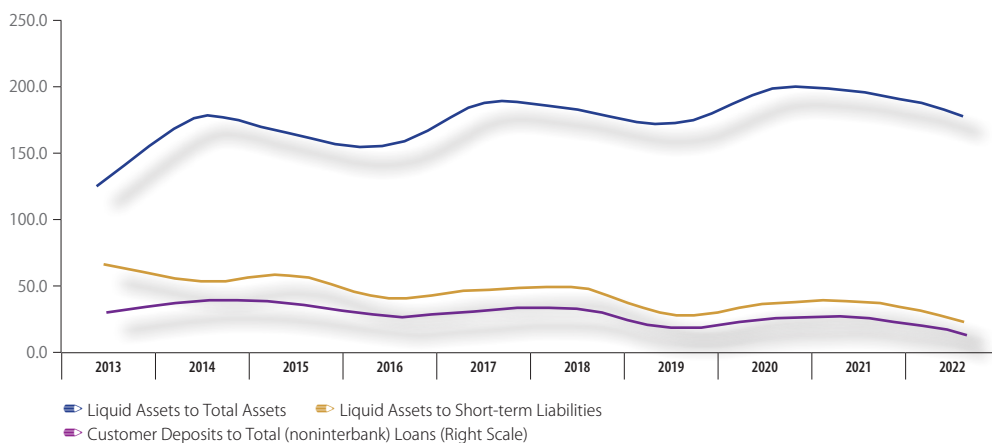


Source: Central Bank of Lesotho

The banking industry lends out about 56 lisente on every loti held as deposits and keeps the rest for immediate liquidity needs.

The ratio of liquid assets to short-term liabilities decreased from 43.2 percent in 2021 to 29.1 percent in 2022 (see Figure 9). Liquid assets decreased significantly by 47.6 percent in the review period mainly due to a fall in transferable deposits with both resident and non-resident banks.

Figure 9 Liquidity Ratios (%)



Source: Central Bank of Lesotho

BANKING SECTOR

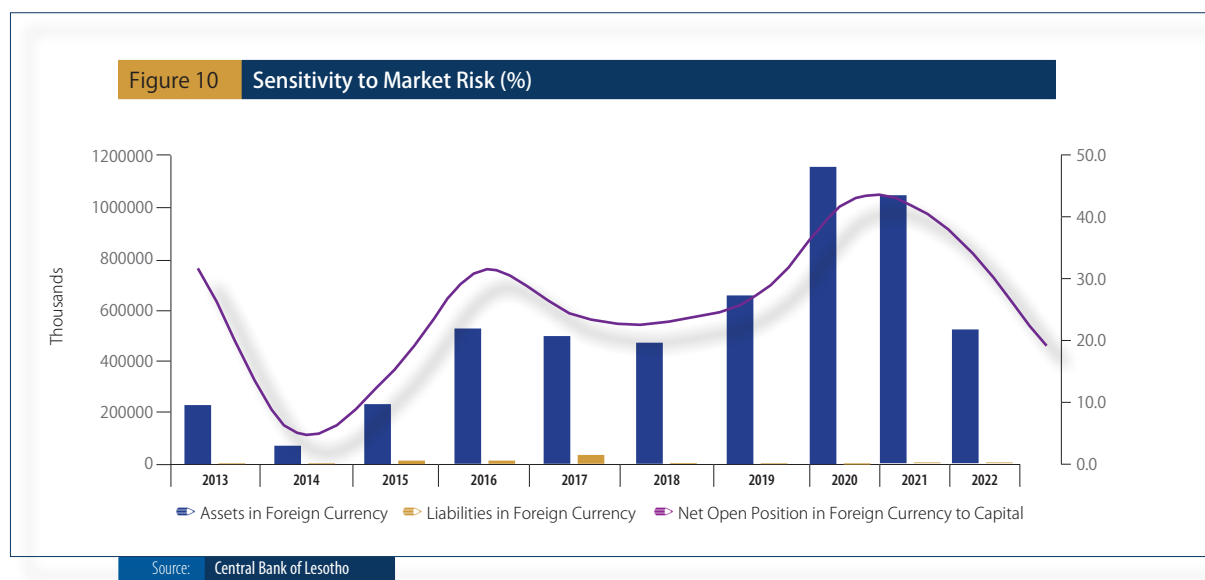
The ratio of liquid assets to total assets shows, on an ongoing basis, the extent to which liquid assets can support the asset base. In 2022, the ratio decreased by 10.5 pps from 29.7 percent which was observed in 2021. The ratio of customer deposits to total (non-interbank) loans is another measure of banks' liquidity quality and it compares the stable deposit base with gross loans excluding interbank activity⁷. In 2022, the ratio was 177.4 percent reflecting a decline of 15.5 pps from the rate observed in 2021. The main driver in the reduction observed in the ratio was an overall decline in customer deposits in the review period relative to a growing share of loans extended. Nonetheless, as far as the stability of funding is concerned, the ratio is deemed relatively satisfactory by industry standards with deposits being almost twice the amount of loans.

The level of capital relative to the net open position has increased in the review period, which indicates that the banks' exposure to revaluation risk has decreased.

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 limited amount of data required 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 the foreign currency depreciates.

During the review period, the banks maintained a long position in foreign currency assets despite the decrease in foreign currency-denominated assets. Consequently, the ratio of a net open position in foreign exchange to capital decreased from 38.4 percent in 2021 to 19.6 percent in 2022 as shown in Figure 10. The level of capital relative to the net open position has increased in the review period, which indicates that the banks' exposure to revaluation risk has decreased.



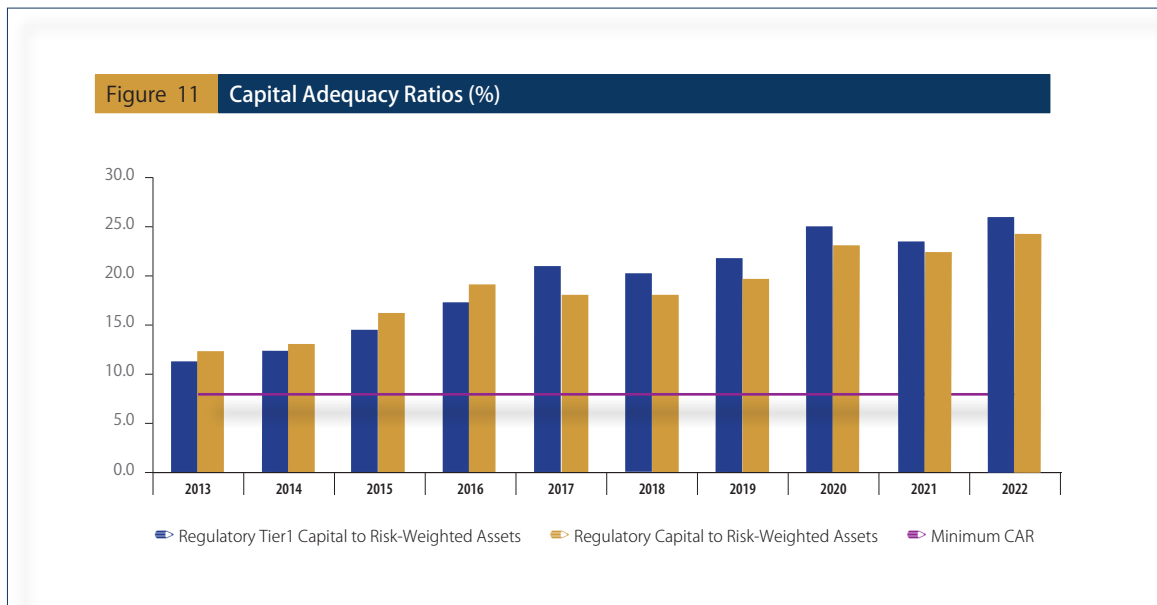
⁷ IMF (2006) Financial Soundness Indicators, Compilation Guide.



4.4 Capital Adequacy

Capital adequacy ratios (CAR)⁸ measure banks' health and soundness relative to insolvency risk. Minimum CAR serves to protect depositors and promote the stability and efficiency

of the banking system⁹. It is also used to ensure that banks can absorb a reasonable amount of losses before becoming insolvent and before depositors' funds are lost. The higher the CAR a bank has, the greater the level of unexpected losses it can absorb.

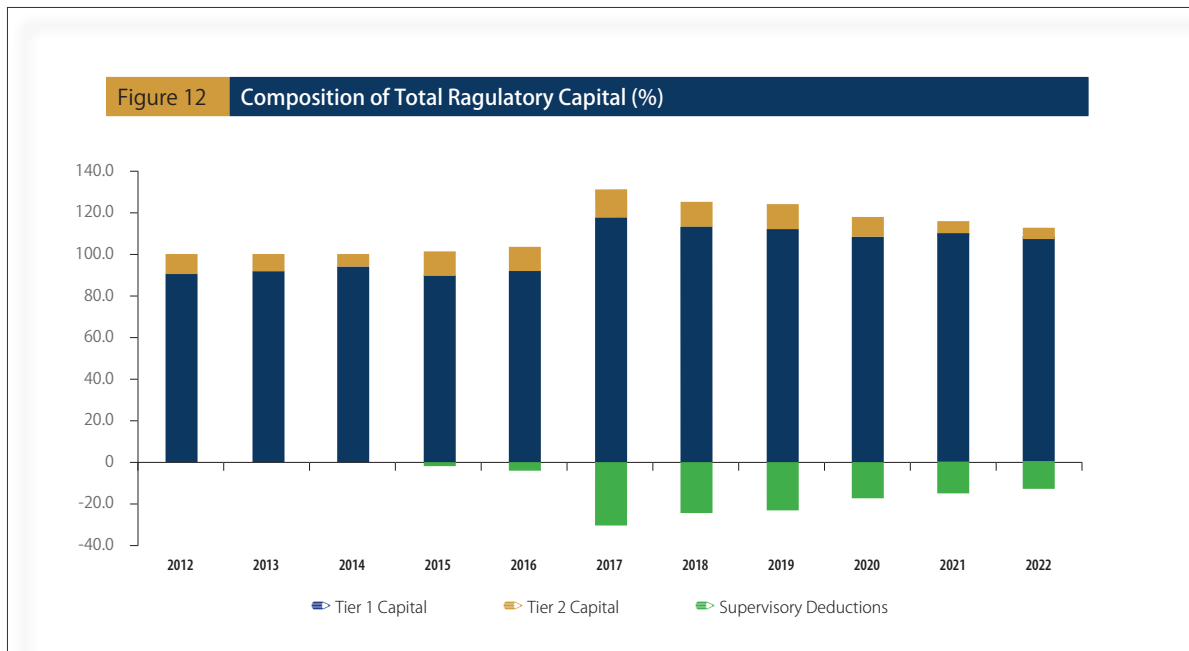


The banking sector in Lesotho maintained CAR above the eight percent minimum prudential requirement in 2022 as shown in Figure 11. The ratio of total regulatory capital to risk-weighted assets stood at 24.0 percent, 1.6 pps higher than the level observed in 2021. Similarly, the ratio of tier-1 capital to risk-weighted assets increased slightly from 24.4 percent in 2021 to 25.6 percent in 2022. The banking industry continued to maintain core capital buffers higher than the prudential minimum requirement, which is a positive sign of the resilience of the sector. Figure 12 shows the breakdown of total regulatory capital as of 2022.

⁸ Currently, the minimum requirement for CAR is eight percent.

⁹ <http://www.rbnz.govt.nz/finstab/banking/regulation/0091769.html>

BANKING SECTOR

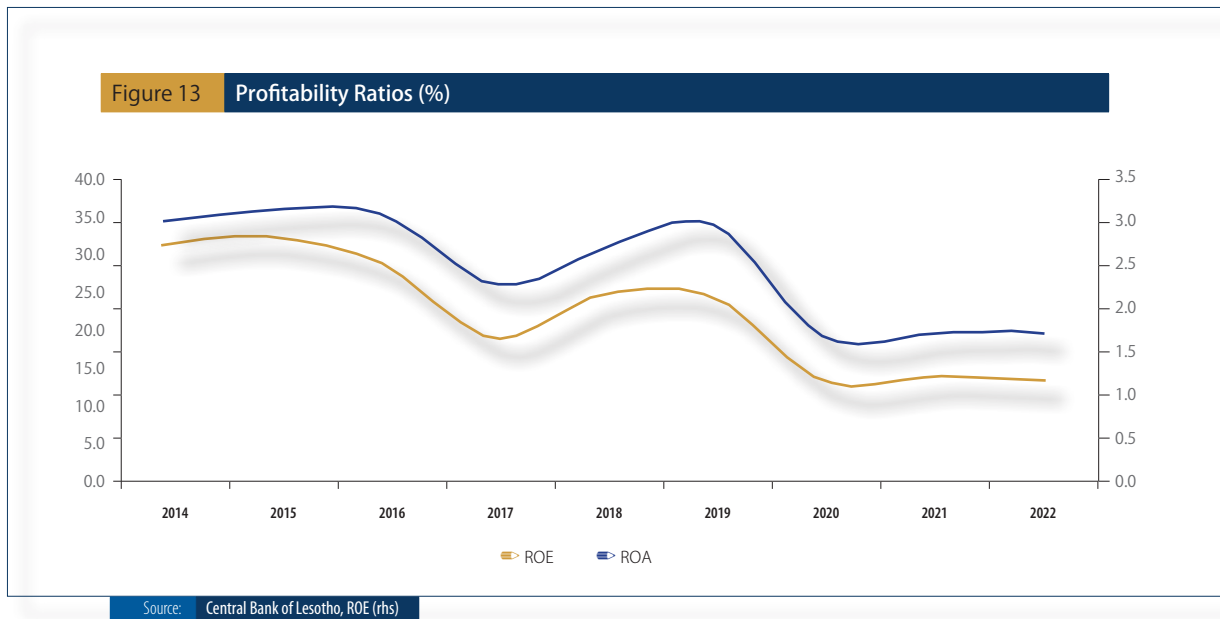


4.5 Earnings and Profitability

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 review period. The profitability has been recovering from the impact of Covid-19, which weighed heavily on economic activity.

During the review period, ROA remained relatively constant at 1.7 percent as illustrated in Figure 13. However, ROE declined by 0.3 pps to 13.4 percent. The industry profitability remained relatively unchanged from the 2021 ratio even though there was a slight increase in interest income, commission income, and proceeds from equity investments and thus, overall annualised net income.

BANKING SECTOR



Net interest margin is a measure of the difference between the interest income generated by banks and the amount of interest paid out to their lenders, relative to the assets. The ratio of net interest margin to gross income increased in 2022, recording 56.3 percent relative to 52.0 percent recorded in 2021. At this level, the ratio of interest margin to gross income shows that over half of the banks' income came from their core business, which is intermediation. Likewise, the ratio of non-interest expense to gross income increased from 68.5 percent in 2021 to 69.2 percent in 2022 as a result of a decline in noninterest expenses. 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

OTHER FINANCIAL CORPORATION'S FINANCIAL PERFORMANCE

5. OTHER FINANCIAL CORPORATION'S FINANCIAL PERFORMANCE

5.1 Insurance Sector

The structure and the composition of the insurance sector in 2022 remained the same as in the previous year. The sector consists of ten (10) insurers, with six (6) long-term (LT) insurers and four (4) short-term (ST) insurers. Furthermore, the sector had 49 insurance brokers at the end of December 2022. The LT insurance industry had most of its net written premiums from the life cover (65.7%), followed by the endowment (22.1%) and credit life (7.7%). On the other hand, the ST insurance business

consists largely of motor and property insurance products with a combined share of 74.8 percent of total ST insurance net written premiums.

Overall, both LT and ST insurance industries remain sound and stable during the review period. The LT insurance experienced an increase in total assets of 4.6 percent from December 2021 to M8.6 billion in December 2022. The growth in assets was driven by increases in the investments made by the sector. The ST insurance industry also experienced an increase in total assets of 10.7 percent in the review period. In addition, the industry experienced an increase of 16.6 percent in assets from December 2021.

Table 4 Insurance Industry Selected Ratios					
	Dec 19	Dec 20	Dec 21	Dec 22	%ΔY/Y
Short-term insurance					
Claims	59.6	31.2	77.9	39.8	(48.9)
Expense	82.4	73.9	77.8	76.5	(1.7)
Combined	142.0	105.1	155.7	116.3	(25.3)
Investment Returns	1.7	2.0	3.1	2.2	(29.0)
Net Investment Income	14.2	12.0	18.6	14.6	(21.5)
Underwriting Expense	79.2	58.3	96.5	62.6	(35.1)
Long-term insurance					
Claims	52.8	56.4	71.5	60.1	(15.9)
Expense	25.0	24.2	22.1	34.4	55.7
Combined	77.8	80.6	93.6	94.5	1.0
Investment Returns	2.2	1.4	1.7	2.0	17.6
Net Investment Income	28.7	16.9	26.0	33.1	27.3
Underwriting Expense	71.8	71.4	87.3	72.7	(16.7)

Source: Central Bank of Lesotho

Investment Mix: LT insurance and ST insurance

The LT insurance held 50.9 percent of its investment assets in non-money market investment funds while 4.4 percent of the investment assets were held in money markets at the end of December 2022. A sizeable proportion of the industry's investment assets were held in various asset classes such as government securities, non-governmental securities, investment property, and investment in subsidiaries and

OTHER FINANCIAL CORPORATION'S FINANCIAL PERFORMANCE

affiliates. The ST insurance held 45.3 percent of its investment assets in money market funds while non-money market funds constituted 16.8 percent of the investment assets. Similarly, as in the case of LT insurance, the other ST asset classes included government securities, investment property, and investment in subsidiaries and affiliates.

Investment performance and profitability

The LT insurance remained profitable with investment ratios improving in the review period. The investment return (return on investment – ROI) and the net investment income ratios increased as compared to December 2021. The ST insurance experienced declines in investment ratios on an annual basis as shown in Table 4. The industry saw an increase in gross written premiums from the previous year by 38.1 percent. Conversely, the industry saw a decline in net written premiums due to reinsurance which increased by 71.4 percent from December 2021 to M122.9 million in December 2022.

5.2 Microfinance Institutions (MFIs)

In terms of size, the MFI sector is relatively small compared to the banking sector and the insurance sector. As at end of September

2022, MFIs constituted 3.8 percent of the total financial sector assets. This was a 7.3 percent decrease from the previous year. The number of institutions increased by 12.8 percent from December 2021 to 132 institutions in the review period.

The MFIs asset base decreased by 9.5 percent to M1.2 billion relative to the previous reporting period. The sector's loans repayable within one year increased by 11.2 percent from the previous year to M118.2 million while loans repayable beyond one year declined by 7.7 percent to M962 million. Overall, total loans increased by 8.5 percent to M1.1 billion in the review period.

The asset mix of the MFIs sector remained broadly unchanged from the previous year. The loans constituted the majority of the assets of MFIs with a share of 92.6 percent. Furthermore, total loans offered by the sector declined by 9.5 percent. In addition, the placements in banks constituted 3.8 percent at the end of the review period. Other asset categories of MFIs include accounts receivables (0.6%) and net intangible assets (0.2%).

The MFIs industry remained profitable during the review period. However, profit after tax declined by 36.9 from the previous year. Nonetheless, the sector was able to generate income from the assets it owned and the equity it held.

Indicators	2018	2019	2020	2021	2022 ¹⁰
Assets	797 047	949 153	1 046 612	1 288 067	1 166 116
Total Loans	739 717	875 288	1 012 840	1 148 469	1 080 380
Loans payable > 1 year	667 647	792 401	917 959	1 042 196	962 202
Loans payable < 1 year	72 070	82 887	94 881	106 273	118 178
Net profit/loss	79 048	66 566	98 482	71 372	45 056
ROA	9.9	7.5	10.0	6.2	5.1
ROE	33.7	22.8	28.1	18.0	14.6

Source: Central Bank of Lesotho

¹⁰ Data as at September 2022.

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 and the domestic economy. 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.

The CBL 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 sphere¹¹.

6.1 Systemically Important Payment Systems

The systemically important systems (SIPS) in Lesotho include Lesotho Wire (LSW) and Centralised Securities Depository (CSD) and Lesotho Automated Clearing House (LACH) operated by the CBL. 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 supports financial stability by preventing or containing financial crises and reduces the cost and uncertainty of settlements, which could otherwise impede economic activity¹².

LSW (real-time gross settlements system (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 safety¹³ 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) protracted system unavailability (downtimes), (b) the degree of utilization, and (c) the inability of system participants to settle their obligations (which could lead to credit events). 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. In 2022, LSW transaction volumes increased by 6.0 percent while the value of transactions processed decreased by 16.5 percent in comparison to December 2021. A lower transaction density was recorded in 2022 in comparison to 2021, with averages of M1.54 million and M1.96 million 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 2022, the system remained available to participants over 98.0 percent of the time and above the tolerable system availability similar to the previous year. The system downtime incidents were on account of intermittent disruptions on the internet and/or server connections. However, such disruptions were resolved within a reasonable time. Therefore, overall, a substantial number of large-value and time-critical payments were processed and settled despite the experienced disruptions.

¹¹ These include the CPSS-IOSCO Principles for Financial Market Infrastructures (PFMI's) and the CPSS-BIS Central Bank Oversight of Payment and Settlement Systems.

¹² CBL Payment System Oversight Policy Framework.

¹³ 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.



6.2 Mobile Money

The rapid proliferation of mobile money services can be considered a triumph for financial inclusion, with money in circulation in 2022 at M532.9 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. The trust account balances grew by 23.4 percent in 2022 which was lower than the growth rate observed in 2021. An important feature of the mobile money market to note is that growth rates have fallen significantly since mobile money services were introduced in 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 may 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-testing¹⁴, 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 2022, 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 shocks¹⁵. The tests covered all four commercial banks. The results covered in this report highlight June and December 2022 stress-test results and their implications for the banking industry and Lesotho's economy as a whole. The stress-test results demonstrated that the banking sector is highly resilient and could withstand shocks of the nature assumed in the stress-test.

The level of non-performing loans (NPLs) is normally used as an indicator of credit risk inherent in a bank's loan portfolio.

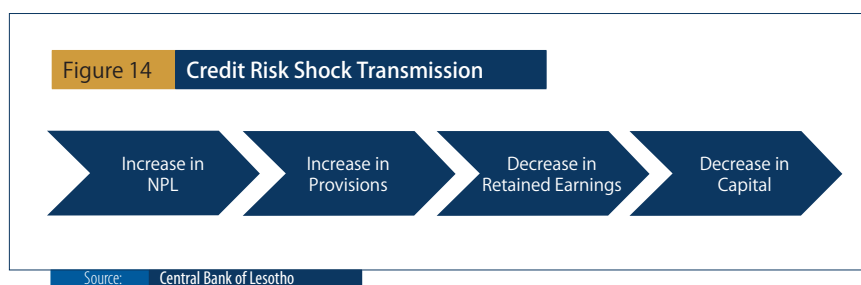
¹⁴ The Bank uses a simple sensitivity test model which is static and does not perform any form of forecasting. A static model assesses the impact of a particular shock or a group of shocks at a certain point in time. The stress-testing approach applied is a top-down one. This implies that CBL collected necessary data and conducted stress-testing based on the information received.

¹⁵ 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 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 days¹⁶. Banks normally set aside funds to cover 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 decreasing retained earnings as well as reducing 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.

¹⁶ 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 current and future cash flow and collateral needs, both expected and unexpected, without materially affecting its daily operations or overall financial condition.

7.1.3 Interest Rate Risk Shocks

Interest rate risk have can have both a direct and indirect impact on the bank’s 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 the 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 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.

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 June and

December 2022. As illustrated in Table 6, for Group I shocks, all banks' CAR would have remained well above the eight percent minimum capital 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 6 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 2022					
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	15.1	0	50 142	945
Shock III: Top 5 Borrowers Default	1	15.1	0	84 463	35 266
December 2022					
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	16	0	75 137	15 541
Shock III: Top 5 Borrowers Default	1	16	0	130 136	70 540

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, none of the banks failed the test in the low scenario¹⁷. However, one bank failed the test in both the moderate and severe scenarios where the top three and top five creditors would have defaulted both in June and December 2022. This shows that its 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 and the minimum unimpaired capital. Nonetheless, none of the banks would have gone insolvent under the assumed shocks. Therefore, the concentration risk associated with large exposure can be regarded as high since one bank would not have had adequate capital to cover the losses. However, this risk could be mitigated by ensuring that the collateral pledged is adequate and of good quality to cover the losses.

Table 7 shows the test results regarding the banking industry's exposure to two economic sectors, namely the household and business enterprises sectors. First, mortgage and personal loan portfolios (household sector) were stressed 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 the banks would not have needed recapitalisation in both June and December 2022. For the personal loans portfolio, one bank failed the test in both June and December 2022 and

would have required a recapitalisation of M228.9 million and M290.4 million relative to CAR in both periods, respectively.

Second, business lines which constitute over half of the loans to the business sector were stress-tested. Manufacturing, construction, as well as mining, and quarrying sectors, were each subjected to 185, 790, and 280 percent increases in NPLs shocks¹⁸, respectively. If the scenario envisaged for the construction industry were to materialise, two banks with a combined assets market share of 35.4 percent would have breached both the regulatory and unimpaired capital requirements in June 2022, prompting a combined recapitalisation of about M462.7 million. In addition, one bank would have become insolvent. Likewise, in December 2022, two banks with a combined assets market share of 34.6 percent would have breached both the regulatory and unimpaired capital requirements, prompting a combined recapitalisation of about M402.9 million. However, unlike in June 2022, both banks would have gone insolvent. In addition, in the scenario involving a surge in NPLs of the mining and quarrying sectors, a bank with assets market share of 54.7 percent failed the test. For the presumed shock, the bank would have breached the CAR in June 2022, prompting a recapitalisation of about M73.4 million. However, in December 2022, none of the banks failed the test in the scenario envisaged for mining and quarrying. Finally, in the scenario involving a surge in NPLs of the manufacturing industry, all banks passed the test and would have remained with post-shock capital levels above the prudential CAR requirements.

¹⁷ Largest borrower default.

¹⁸ See Appendix 9.

FINANCIAL SYSTEM RESILIENCE

Table 7 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 2022					
Group III: Sectoral level credit risk (20 percent increase in NPLs)					
Household Sector					
Mortgages	0	0	0	0	0
Personal loans	1	54.7	0	228 290	0
Business Sector					
Manufacturing	0	0	0	0	0
Construction	2	35.4	1	296 477	166 237
Mining & quarrying	1	54.7	0	73 378	0
December 2022					
Group III: Sectoral level credit risk (20 percent increase in NPLs)					
Household Sector					
Mortgages	0	0	0	0	0
Personal loans	1	54.8	0	290 371	0
Business Sector					
Manufacturing	0	0	0	0	0
Construction	2	34.6	2	268 681	134 171
Mining & quarrying	0	0	0	0	0
<i>Source: Central Bank of Lesotho</i>					

7.2.2 Liquidity Risk

The results for the first bank-run scenario, show that in both June and December 2022 stress tests, all banks would have remained liquid after five days of continuous withdrawals of deposits. All banks would have had to undertake one round of liquidation, on the first day of the run, and the cash generated would have been enough to meet customer withdrawals for the remainder of the five days. This shows that the amount and quality of liquidity assets the banks hold would have been enough to absorb a shock of the nature assumed in this test. In the same way, in Scenario II, all banks would have sustained the bank-run for five days. However, the run would have necessitated several rounds of liquidation by the fifth day. Nevertheless, all banks would have remained liquid for the assumed duration of the run in this test. In the June stress test, scenario I would have resulted in about M6.68 billion withdrawn from banks' deposits of M14.71 billion causing the banking industry balance sheet to shrink by 33.5 percent. Moreover, M6.27 billion would have been withdrawn against deposits of M15.15 billion that banks were holding as

at December 2022, causing the balance sheet to shrink by 33.6 percent. On the other hand, in scenario II, the June 2022 stress test shows that shocks assumed would have led to withdrawals of M8.30 billion worth of deposits, causing the banking industry balance sheet to shrink by 52.2 percent. Similarly, M10.2 billion out of M15.15 billion worth of deposits held by banks would have been withdrawn as at December 2022 causing the banking industry balance sheet to shrink by 53.0 percent. These results are largely similar, implying that the resilience of the banking system has not changed much in 2022 based on the results of both test periods.

Therefore, liquidity risk could also be regarded as minimal since banks would have sustained a bank-run type event for a period of five days under both scenarios, allowing the banks and the CBL a window of five days to one week to work on a solution that would restore confidence in the industry. It is, however, worth noting that, the size of the banking industry, measured by total assets, would have emerged considerably smaller from such bank-run scenarios, especially for scenario II.

FINANCIAL SYSTEM RESILIENCE



	Daily Withdrawals							
	June 2022				December 2022			
	Scenario I		Scenario II		Scenario I		Scenario II	
	Daily Withdrawals (%)	No. of illiquid Banks (out of 4)	Daily Withdrawals (%)	No. of illiquid Banks (out of 4)	Daily Withdrawals (%)	No. of illiquid Banks (out of 4)	Daily Withdrawals (%)	No. 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

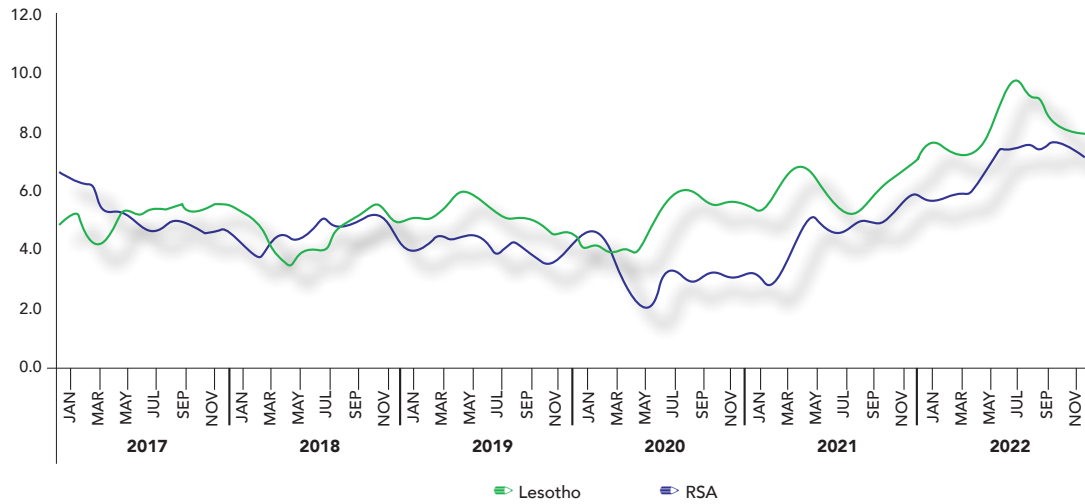
The large depositors' bank-run stress-test results revealed that if the largest depositor(s) of each bank had simultaneously withdrawn their deposits, none of the banks would have exhausted their liquidity. However, one bank would have breached the 25.0 percent minimum liquid assets requirement¹⁹ in the severe scenario where the top five depositors simultaneously withdrew their deposits in June 2022. On the other hand, in December 2022, one bank would have breached

the minimum liquid assets requirements in both the moderate (top three depositors simultaneously withdraw their deposits) and severe scenarios. As the results show, the liquidity position appears to have remained more or less the same in June and December 2022. On the positive side, the results show 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 ▣

¹⁹ Still meet the 25 percent minimum liquid assets requirements (prudential hurdle rate). Financial Institutions (Liquidity Requirements) Regulations 2000.

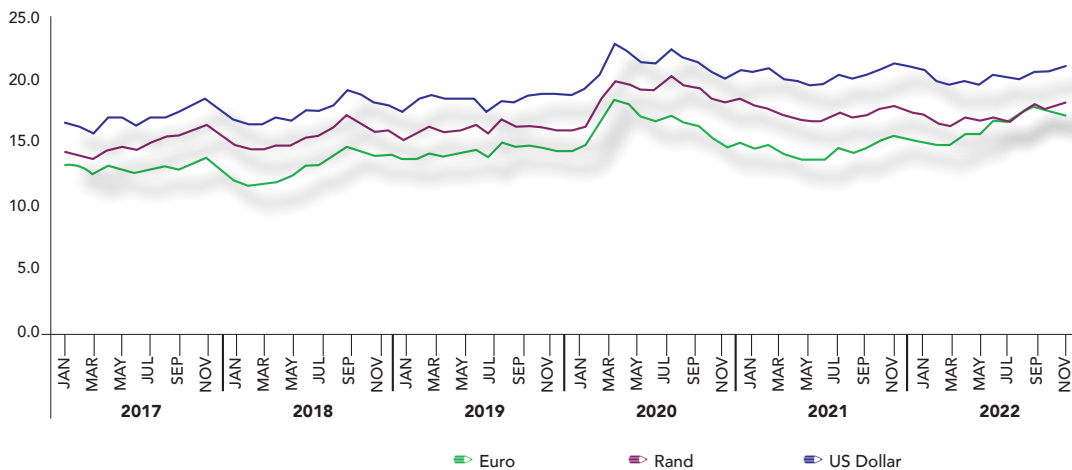
APPENDICES

Appendix 1A Lesotho and RSA Inflation (%)



Source: Central Bank of Lesotho

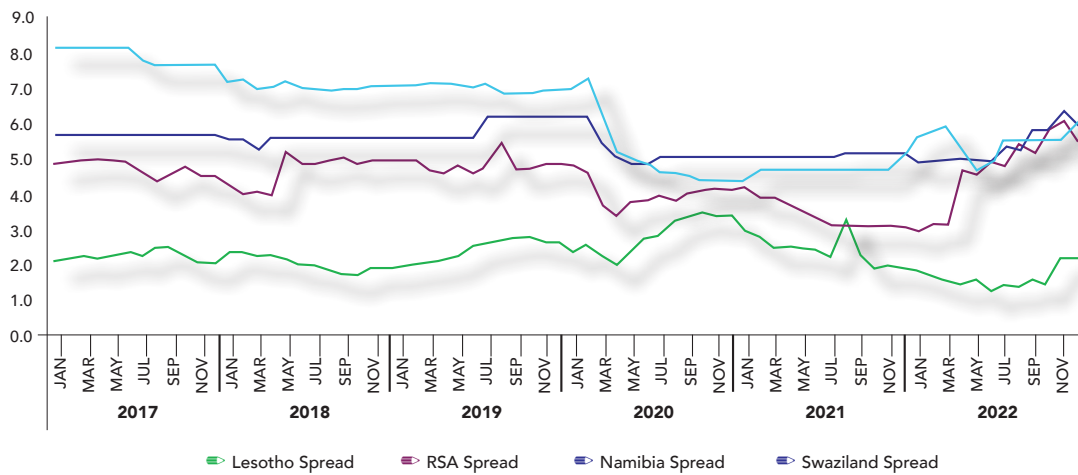
Appendix 1B Loti Exchange Rate to the Euro, Pound & US Dollar



Source: Central Bank of Lesotho

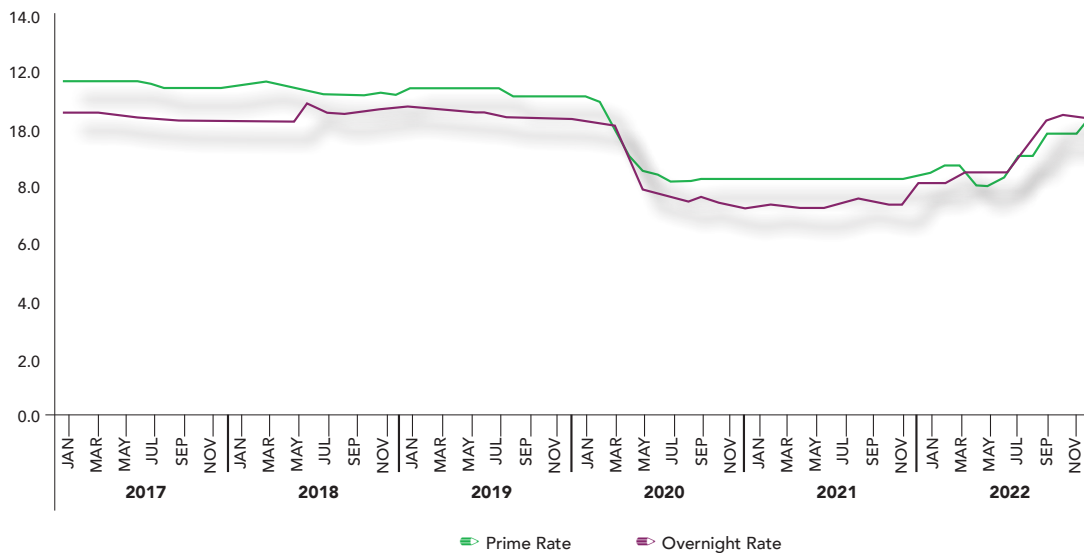


Appendix 1C Intermediation Spread (%)



Source: CBL, BON, CBS

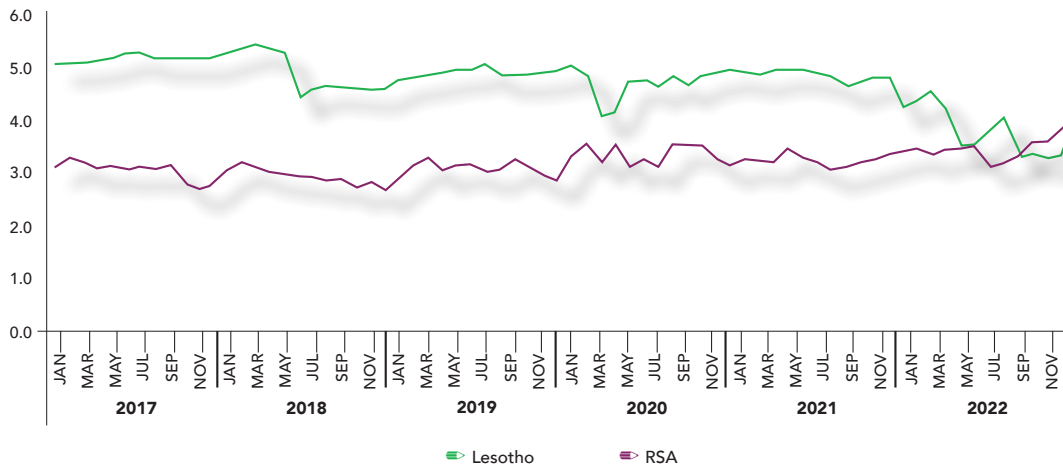
Appendix 1D Money Market Spread (%)



Source: Central Bank of Lesotho

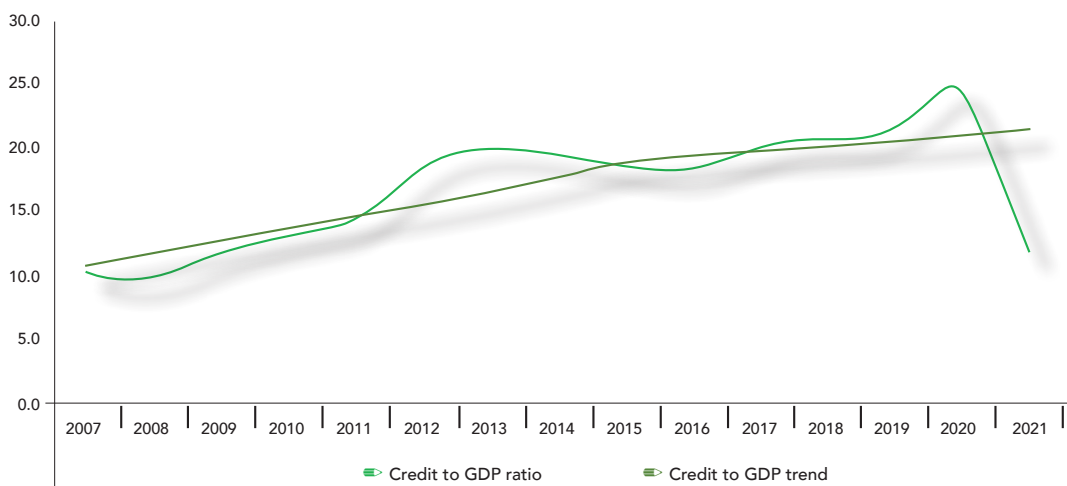
APPENDICES

Appendix 1E Lesotho and RSA Risk Premium (%)



Source: Central Bank of Lesotho

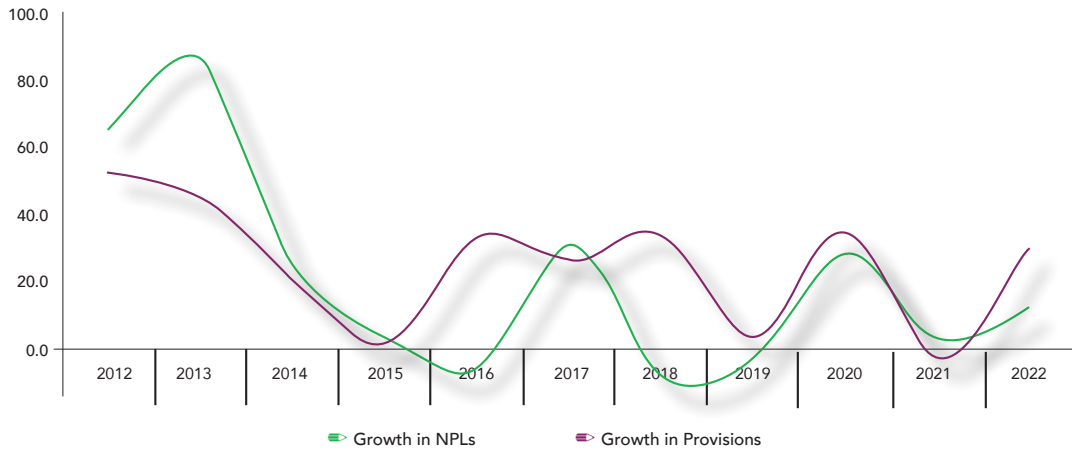
Appendix 1F Credit-to-GDP ratio and its trend



Source: Central Bank of Lesotho



Appendix 1G Growth in NPLs and Provisions



Source: Central Bank of Lesotho

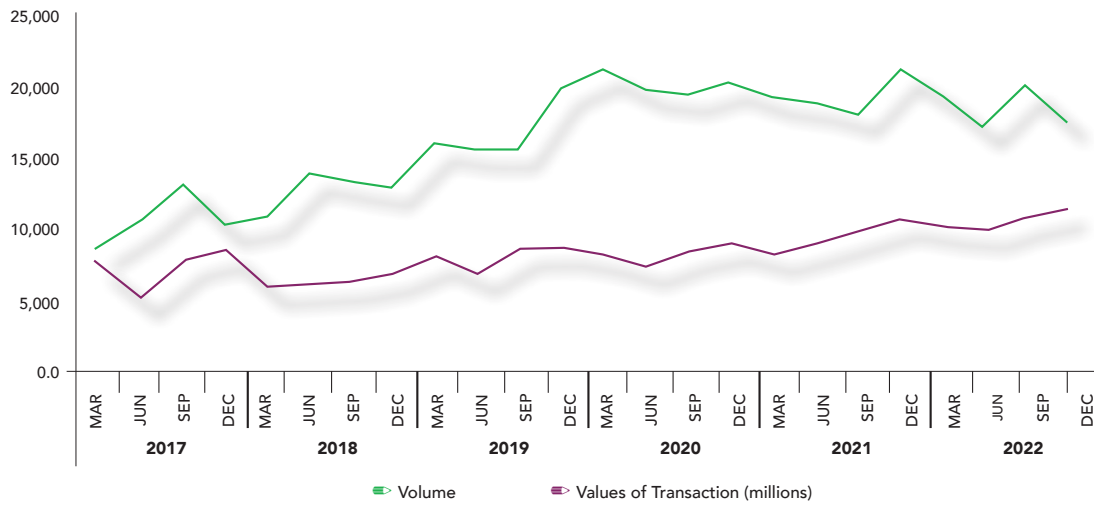
Appendix 1H LSW Availability



Source: Central Bank of Lesotho

APPENDICES

Appendix 11 LSW Transactions and Values



The primary axis is in millions while the secondary axis is in thousands

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 I	Assumed provisioning rate	20%	To calculate provisioning expenses 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 the percentage increase in NPS of 20 percent due to FX changes.
Detail I	Assumed provision rate	50%	Indicates the percentage increase in NPS of 50 percent due to FX changes.
Source: Central Bank of Lesotho			

APPENDICES

Appendix II Assumptions and Shocks (continued)			
Index	Description	Shock	Description
8. Multi-Factor Risk Scenarios			
Shock 8.1	Aggregate NPLs Increase	60%	Indicates a 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 a 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 a 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 a 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.

Source: Central Bank of Lesotho



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Central Bank of Lesotho

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