FINANCIAL STABILITY REPORT

Reserve Bank of Malawi *December 2023*

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TABLE OF CONTENTS

ABBREVIATIONS

BLS	Bank Lending Survey
CRBs	Credit Reference Bureaus
COVID-19	Coronavirus disease
DFS	Digital Financial Services
DSI	Domestic Share Index
DTIs	Deposit-Taking Institutions
EFTs	Electronic Funds Transfers
FSI	Foreign Share Index
FSR	Financial Stability Report
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
IBR	Interbank Rate
MASI	Malawi All Share Index
MFIs	Microfinance Institutions
MITASS	Malawi Interbank Transfer and Settlement System
MPC	Monetary Policy Committee
MSE	Malawi Stock Exchange
NDTIs	Non-Deposit Taking Institutions
NPLs	Non-Performing Loans
RBM	Reserve Bank of Malawi
ROA	Return on Assets
ROE	Return on Equity
RR	Reference Rate
RWA	Risk-Weighted Assets
SACCOs	Savings and Credit Co-operatives
SMEs	Small and Medium Enterprises
SSA	Sub-Saharan Africa
TMC	Total Market Capitalisation
USA	United States of America
WEO	World Economic Outlook

THE RESERVE BANK OF MALAWI FINANCIAL STABILITY MANDATE

Section 4 of the Reserve Bank of Malawi Act of 2018 ('the Act') provides that the primary objectives of the Reserve Bank of Malawi (RBM) are to maintain price and financial stability. Further, in line with section 24 of the Act, one of the primary mandates of the RBM is to ensure the financial system's stability through formulating and implementing macro-prudential policies.

Against this background, the Financial Stability Report (FSR) provides an overall assessment of risks to the financial system and evaluates the system's resilience to these risks to inform policy action. Therefore, the analysis provided in the FSR is one of the tools used by the RBM to fulfil its mandate of safeguarding the financial system's stability.

The RBM considers financial stability as a condition represented by a sound financial system, capable of withstanding shocks to the economy, efficiently allocating savings to investments, facilitating settlement of payments efficiently and adequately managing risks. On the other hand, financial instability is a systemic disruption to the intermediation and payment processes, which often has detrimental consequences for the real economy.

The RBM's Financial Stability Report (FSR) is produced and published bi-annually on the RBM website (www.rbm.mw). It reflects the overall evaluation of the Financial Sector Stability and Development Committee (FSSDC) on risks to the stability of the Malawian financial system. In this edition of the Financial Stability Report, the RBM assesses vulnerabilities and risks in the domestic financial system between July and December 2023, while the forecast period extends to June 2024 and points to measures that can contribute to financial stability.

GOVERNOR'S FOREWORD

In the half year to December 2023, Malawi's financial sector continued to face heightened systemic risk in the context of the challenging global, regional and domestic conditions. Nonetheless, the Malawi financial system remained resilient,

In the October World Economic Outlook (WEO), the IMF estimated a global growth of 3.0 percent and 2.9 percent for 2023 and 2024 respectively, reflecting the long terms effects of the COVID 19 pandemic, the Ukrainian war and increased monetary policy risks.

On the domestic front, macroeconomic imbalances persisted despite concerted stabilization measures. High inflation rates persisted, which together with elevated interest rates, intensified the risks to financial stability; with the second-round effects of Tropical Cyclone Freddy also contributing to inflationary pressure. Headline inflation accelerated to 34.5 percent in December 2023 from 27.3 percent in June 2023, raising further inflation-related risks in the domestic financial sectors. Meanwhile, the Malawi kwacha continued to depreciate in the half year, with the realignment of the local currency in November 2023 furthering inflation pressure, in the wake of foreign exchange shortages. Fiscal pressures also prevailed. These macroeconomic developments reduced disposable incomes for most households and deteriorated the levels of working capital for the corporates. This in turn increased demand for credit, as well as heightened the risk of default in the financial sector.

Looking ahead, pressure on inflation is expected to prevail in the near term, majorly affected by the prices of commodities in the face of the looming effects of El Nino on the agriculture sector. Weather related food production risk constitutes a critical downside risk that will call on government and relevant stakeholders to intervene and mitigate. On the global front, possible easing financial conditions and moderating Brent crude oil prices could ease external and spill over risks to the domestic economy. Nonetheless, developments in the exchange rate, disruption in supply chains and geopolitical tensions could offset the gain on reduced international prices.

Attempting to rebound from the multiple shocks it has experienced since 2020 in the form of cyclones Gombe, Anna, the war in Ukraine and cyclone Freddy, the economy continued to experience slow growth, with GDP growth only picking up to 1.5 percent in 2023 from 1.2 percent in 2022. Growth is however projected to recover to 3.2 percent in 2024 on the back of improvements in the foreign exchange situation. This is on account of the International Monetary Fund's approval of the Extended Credit Facility (ECF) program in December 2023.

Amidst this mixed outlook, the resilience of the domestic financial system will be sustained over the half year to June 2024 forecast period, as players in the financial sector continue deploying relevant risk management strategies to mitigate threats to the financial sector's soundness from anticipated threats.

The following constitute a number of key initiatives and policy implementation actions undertaken in 2023 in order to safeguard the financial system.

1. strengthened the legal and regulatory framework through reviewing of the Financial Services Act 2010, Insurance Act 2010, Banking Act 2010, Microfinance Act, 2010 Securities Act, 2010 and Medical Aid Schemes Bill; and some Directives;
2. facilitated Basel III training for the banking industry to orient the industry to Basel III concepts in preparation for the rollout of Basel III in 2025;
3. conducted stress testing exercise for the banking sector to assess the resilience of the industry to various shocks as at end December 2023;
4. continued to review the Internal Capital Adequacy Assessment Programs (ICAAPs) of banks annually to ensure adequate capital planning and conservation by commercial banks comparative to their risk profiles;
5. established the deposit insurance scheme to enhance the stability of the financial system in the event of bank failures;
6. commenced implementation of an automated market trading surveillance system to improve surveillance of the capital markets; and
7. made significant progress on the implementation of a risk-based supervision framework for insurance companies.

In line with its financial stability mandate, the RBM will continue to monitor potential systemic risks and vulnerabilities and address any threats to stability that might emerge in the near term.

DR. WILSON T. BANDA

GOVERNOR

ASSESSMENT OF FINANCIAL SYSTEM STABILITY

Since the release of the June 2023 issue of the Financial Stability Report (FSR), Malawi's financial system has remained stable despite increased systemic risks arising from adverse global and domestic conditions in the second half of 2023.

Globally, the effects of macroeconomic developments stemming from elevated inflation, tightening of financial conditions, strengthening of the US dollar and increased volatility of the financial markets have spilt over to domestic economies worldwide, thereby increasing the challenges faced by the already weak domestic economies, especially economies in the Sub-Saharan Africa region (SSA) including Malawi. Nonetheless, the risks to global financial stability have moderated amidst increased vulnerabilities, and the balance of risks remained tilted towards the upside of more robust global growth. However, several adverse risks to global growth remain plausible, especially from the build-up of vulnerabilities in commodity prices amid geopolitical and weather shocks.

On the domestic front, macroeconomic risks to financial stability increased in the second half of 2023 compared to the previous half, primarily due to rising inflation and interest rates, local currency depreciation, and foreign exchange shortages. Consequently, the GDP growth rate for 2023 was revised downward to 1.5 percent from the 1.9 percent projection made in June 2023. The downward revision was attributed to the falling performance in agriculture; wholesal and retail; and manufacturing industries.

Risks to financial stability emanating from inflation developments intensified during the period under review, headline inflation increasing to 34.5 percent in December 2023 from 27.3 percent in June 2023, due to an increase in both food and non-food inflation. In response to the rising inflation, the Monetary Policy Committee (MPC) adjusted the Policy rate by 200 basis points to 24.0 percent, while maintaining the Liquidity Reserve Requirement (LRR) ratio on local currency deposits at 5.75 percent in July 2023. The decision was deemed necessary to restore price stability, which is essential for reviving and sustaining economic growth. Resultantly, interest rate risk heightened. Meanwhile, the Reference rate (and thus, the base lending rate) and the overnight Interbank Market Rate (IBR) increased by 260 and 300 basis points to close at 23.60 percent and 23.0 percent, respectively, as of end-December 2023 relative to the end-June 2023 positions. The latter part of the half year to December 2024 also saw a marked realignment of the Malawi.

Gross official reserves and private sector reserves remained low. The GOR stood at US$214.3 million (0.9 months of imports) as at December 2023 compared to US$238.6 million (1.0 months of imports) recorded in June 2023 and US$323.7 million (1.30 months of imports) registered in December 2022.

Despite the weak macroeconomic environment, as enunciated above, the domestic financial sector remained sound and resilient in the second half of 2023 as banks maintained adequate capital, earnings and liquidity despite registering weak asset quality as the industry NPL ratio stood at 6.1

percent above the prudential threshold of 5.0 percent. The Banking Stability Index (BSI)[1] despite marginally decreasing from 0.75 in June 2023, stood at 0.68 indicating a satisfactory level of stability, albeit, the banking industry balance sheet remains skewed towards Securities and Investments. Meanwhile, in the near term, credit risk posed by high interests and inflation environment, as well as sectoral concentration of loans in agriculture and other dominant sectors, remain the key risks that may affect the soundness of the banking sector and, consequently, financial stability.

Institutions in the banking sector remain resilient to critical risks. The Registrar of Financial Institutions conducted a stress testing exercise to assess the banking sector's resilience to shocks as of end December 2023. The stress test results revealed that institutions in the sector were resilient to almost all the risks, including successive default of large borrowers, haircuts on liquid assets, interest rate risk, foreign exchange rate risk and income risk. The sector, however, depicted vulnerabilities to shocks in economic sectorsand the overall combination of shocks.

The Non-Banking Financial Institutions (NBFIs) remained sound and resilient during the period under review, as evidenced by steady growth of assets, strong earnings performance and a well-capitalized sector. Nonetheless, the microfinance sector experienced elevated credit risk due to high non-performing loans and low liquidity in some financial cooperatives (SACCOs[2]), which persisted during the period under review. The general insurance sector showed signs of weak liquidity, largely due to high insurance receivables coupled with the effects of climate shocks. The pension sector continues to record high contribution arrears, and exposure to inherent risks such as market, credit and inflation risks continues to threaten or pose risk to the real growth of the sector. Timely remittance of contributions remained a prime challenge for some employers, while concentration funds/investments in listed equities and government securities persisted in the period under review. Meanwhile, Malawi's capital market was bullish during the six months to December 2023, as seen by the increase in the MASI. The positive performance of the capital market saw returns exceeding money market returns.

The payment system remained sound and resilient with no system-wide downtime to the country's core payment infrastructure, recorded during the period under review. The payment system remained stable and always available to process and settle various interbank payment transactions in the financial system.

The Bank Lending Survey which is informed by perceptions of commercial banks, indicated that demand for credit in the half year to December 2023 increased across all three economic agents (households, small and medium enterprises (SMEs) and large enterprises). The increased credit demand was mainly attributed to financing needs, particularly commodity financing, rising consumption expenditure and working capital requirements.

[1] It is important to note that the Banking Sector Stability Index analysis incorporates mostly the CAMEL elements (CAEL in this case).

[2] Savings and Credit Cooperatives

However, uptake for credit was slow for large enterprises amid a slowdown in business due to the weak macroeconomic environment, weighed down by rising inflation and interest rates and the intermittent availability of foreign exchange and fuel supply in the country.

Regarding credit supply, most banks maintained tight credit standards and conditions for approval of loans and credit lines to economic agents during the second half of 2023, both for short-term and long-term loans. The tightening position points to risk aversion amid a persistently deteriorating macroeconomic environment. Most banks expect to further tighten their credit standards and conditions in the first half of 2024, as they envisage a continued weakening in the macroeconomic environment.

On non-performing loans (NPLs), most banks experienced an increase in NPLs across all three economic agents due to a weak macroeconomic environment characterised by rising inflation and interest rates, which affected borrowers' capacity to service their loan obligations. In the first half of 2024, most banks anticipate an increase in defaults across the economic agents, as informed by commercial banks' expectations of a continued decline in disposable income due to the further weakening of the macroeconomic environment.

Looking ahead, the Reserve Bank of Malawi will continue to closely monitor trends in systemic risk and seek to ensure that the financial system is prepared for and resilient to the wide range of risks in the face of uncertain projections.

1. Introduction

This edition of the financial stability review assesses risks and vulnerabilities that threaten the stability of the Malawi financial system and, in turn, spill over to the real economy. The assessment considers the weaknesses in the financial system interaction or interlinkage and that with the macroeconomic environment that has the potential to trigger systemic risk.

Risks and vulnerabilities affecting the financial system are assessed through developments in the financial institutions, the financial markets and the performance of the financial infrastructure, which may arise in the form of liquidity risk, solvency risk, credit risk, market risk, operational risk, and solvency risk. Conversely, developments arising from the macroeconomic environment that affect the financial system stability arise from either the external (global) economy or the domestic real economy. The materialisation of some or a combination of the above risks can weaken the country's financial system stability, ultimately affecting the economy's performance and the general welfare of the public.

2. Global Financial Stability Trends

2.1 Global Macroeconomic Developments and Financial Stability Risk

Risks to global financial stability remained elevated despite marginally moderating in the second half of 2023. The October 2023 Global Financial Stability Report (GFSR) indicates that the global financial system remains vulnerable to developments in the global economy as global inflation remains high, albeit there is a marginal decline in the period under review. Global headline inflation is expected to fall to 5.8 percent in 2024 and 4.4 percent in 2025, with the 2025 forecast revised. The January 2024 World Economic Outlook (WEO) estimates global economic growth to slightly improve by 0.1 percent to 3.1 percent in 2023 and remain unchanged in 2024 before picking to 3.2 percent in 2025, reflecting restrictive monetary policies, fiscal support withdrawal due to high sovereign debts, and low underlying productivity growth. These monetary and fiscal policy decisions have seen a slowdown in global inflation, contributing to the global economic recovery from the COVID-19 pandemic and the war in Ukraine. Resultantly, risks to the outlook of global financial stability remain heightened, and risk to global growth is skewed to the downside following the build-up of vulnerabilities during the period of prolonged low-interest rates, high liquidity, commodity price spikes amid geopolitical and weather shocks whose effects have become more pronounced as central banks took a tightened monetary stance to control high inflation. The conflict in Gaza and Israel could further escalate into the wider region, causing supply disruption to oil and gas. Similarly, the ongoing war in Ukraine risks generating fresh adverse supply shocks to the global recovery, with pressure on food, energy, and transportation costs. Further, extreme weather shocks, including floods and drought, could, together with the El Nino phenomenon, exacerbate food insecurity and disrupt the global disinflation process.

2.2 Crypto Assets Activities and Financial Stability Risk

Crypto assets pose risks to the financial sector. The decentralized nature of crypto-assets has led to most crypto assets arriving on the financial markets unbacked or poorly backed, which has led to high volatility in prices due to the lack of intrinsic value. Some crypto assets are backed by reserves; however, some have collapsed due to reliance on unreliable reserves or no collateral. Crypto assets pose heightened Anti-Money Laundering (AML) risks due to their decentralized nature. Money laundering and other illicit activities have been estimated in the tens of billions of dollars per year. Meanwhile, in November 2023, the founder of Binance, the world's largest crypto currency exchange, pleaded guilty to money laundering charges right after the founder of FTX, a prominent exchange that crashed, was convicted of fraud and other crimes (New York Times, 2023).

Going forward, it is necessary to establish regulations for crypto assets in order to reduce the risk that high crypto adoption carries in terms of the likelihood of undermining macro-financial stability and regulation.

Anecdotal evidence indicates that the crypto asset market is still in its infancy and relatively small, thereby posing limited risks to financial stability in Malawi. This is on account of relatively low data on the adoption of crypto assets due to their decentralised nature. Nonetheless, some local investors have lost their holdings to scammers who compelled them to invest in crypto-asset markets through fake platforms.

Among the risks associated with Crypto assets is the indication that they can weaken monetary policy effectiveness, particularly in nations with unstable currencies and fragile monetary systems. Additionally, due to their volatile prices, unbacked crypto assets lack reliable backing from a reserve of other financial assets thereby presenting risks to investor protection and financial stability at large (IMF, 2023).

Recently, the Financial Action Task Force (FATF) recommended that the monetary authorities in Malawi conduct a risk assessment and come up with a policy stance on virtual assets to comply with FATF. recommendations. Notably, the policy direction that can be taken consists of one of two choices. These being to either regulate and supervise virtual assets or to ban them as other countries have done..

Meanwhile, some economies have embraced the adoption of a Central Bank Digital Currency (CBDC), which constitutes digital money that a central bank can issue alongside cash.

According to a 2022 survey from the Bank of International Settlements (BIS), 93 percent of central banks are exploring CBDCs, and 58 percent report that they are likely to or might issue a retail CBDC in the short or medium term (Kosse and Mattei, 2023). Indications are that more than 100 countries are exploring retail CBDC issuance. Several central banks have already launched pilots or even issued a CBDC. However, issuing a CBDC in a developing economy with low financial literacy and technology uptake can increase risks to financial stability. This is attributed to the fact that issuing CBDC is formally accepting virtual assets as “real money”, which paves the way for crypto assets and stablecoins to flow into the economy. It is thus likely that, crypto investors and traders would prefer to use foreign crypto assets as these are decentralised, the central bank cannot monitor the related transactions, and Malawi does not have adequate infrastructure to regulate crypto assets (BIS, 2022).

The adoption of a CBDC in Malawi is likely to be challenging due to low financial literacy, technology uptake, and competing payment solutions such as mobile banking, which have been easier for most Malawians. Further, it is important to note that adopting the CBDC would require changing the structures of the supervision and regulation arms of the central banks to consider crypto assets and further changing the monetary policy framework, as crypto assets are likely to affect the money supply in the economy.

2.3 Climate Related Risk to Financial System Stability

Climate-related risks to financial system stability are on the rise. Climate-related risks and their mitigation strategies continue to take centre stage in world forums and re-define the financial system's future regulatory and supervisory frameworks. Accordingly, the January 2024 WEO Update discusses that in addition to coordination on debt resolution and fiscal consolidation, cooperation is required to mitigate the effects of climate change and facilitate the green energy transition, building on recent agreements at the 2023 Conference of the Parties to the UN Framework Convention on Climate Change (COP28). Further investments in climate adaptation activities and infrastructure are also needed to support resilience.

In Malawi, financial stability risks associated with climate-related events, such as increased frequency and intensity of floods and droughts in some parts of the country and unprecedented heatwaves and hailstorms have increased in the past few years. These climatic shocks have translated into low agriculture output, exacerbated food inflation and food insecurity, and have had an adverse transmissional effect on the servicing of credit facilities and an increase in insurance claims. Nonetheless, the financial sector has remained seemingly resilient to climate-related shocks that the country has so far experienced.

Box 1: Commercial Bank's Initiatives/Strategies to Mitigate Climate-Related Risks.

Commercial banks in Malawi are employing a number of strategies and initiatives to mitigate climate related risks as summaried below;

1. Banks in the country have developed Environmental, Social and Governance (ESG) policies and have trained their staff on climate-related risk management in line with international standards such as the United Nations Framework Convention on Climate Change (1994), IFC Performance Standards, and UNEP FI Declarations to access trade lines.
2. Banks have embarked on climate risk assessment for geohazard areas and risk-based assessment when assuming collateral. Further, these Bank are refraining from pursuing projects in areas prone to disaster unless there is an effective climate risk management plan.
3. Banks are reviewing their Business Continuity Plan to ensure that they are in sync with the current climate-related shocks the country has been experiencing.
4. Banks are consistently assessing disaster recovery preparedness through regular simulation exercises.
5. Banks are pursuing a digitalization strategy to minimize their carbon footprint.
6. Banks intend to roll out Green Finance products in the near term.

2.0 Regional Financial Stability Trends

Economic growth in the Sub-Saharan Africa (SSA) region is anticipated to grow at 3.8 percent in 2024 from 3.3 percent in 2023 as the adverse effects of earlier weather shocks subside and supply issues gradually improve. The downward revision for 2024 growth by 0.2 percentage points from the October 2023 WEO projections mainly reflects the impact of a weaker projection for growth for the South African economy because of increasing logistical constraints, including those in the transportation sector, on economic activity in the country. The IMF anticipate that growth in the two largest economies in the region, Nigeria and South Africa, will slightly improve to 3.8 percent and 3.0 percent in 2024 from 3.3 percent and 2.8 percent estimated in 2023, respectively, reflecting lower-than-expected currency pressures; and energy and transportation crises. With high borrowing costs, careful monitoring of financing conditions and readiness to deploy financial stability tools will remain vital for avoiding financial sector strains; as these challenges, in part, have the potential to filter through Malawi's domestic economy as most of the emerging market economies are major trading partners in various aspects.

3.0 Domestic Macro-Financial Stability Trends

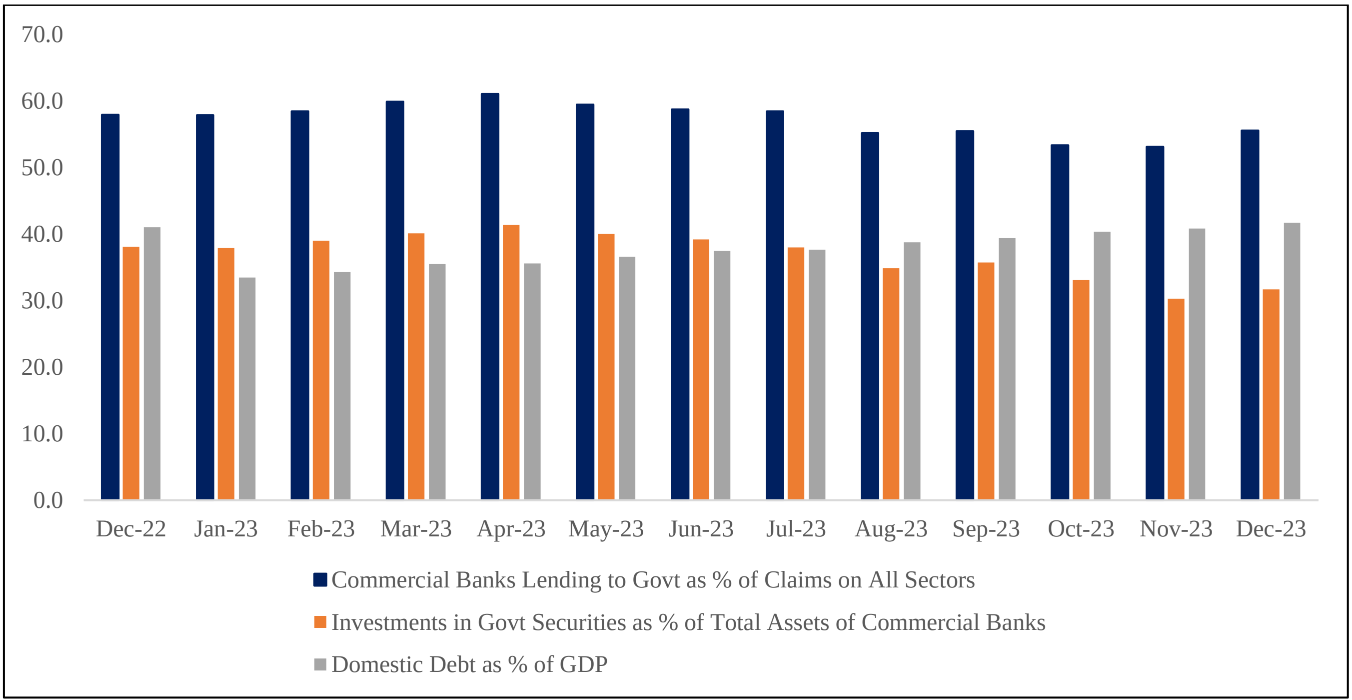
3.1 Sovereign Bank Nexus

The sovereign bank nexus reflects the interconnectedness between the health of the sovereign and the banking system, whereby the stress in one sector may create and amplify stress in another industry. In addition to banking sector solvency and liquidity regulations, which incentivise holding domestic sovereign debt relative to other claims, several other factors explain banks' exposure to sovereign debt.

These include liquidity management, higher interest rates, lower financial sector development concerning access, and the government's moral suasion. The overreliance of governments on domestic banks in emerging market economies for their financing needs and the associated high exposure of banks to sovereign debt increases the likelihood of shock transmission between the two sectors.

The sovereign-bank nexus has intensified in emerging markets as banks' exposure to domestic sovereign debt has increased to all-time highs. With public debt also historically high and with the sovereign credit outlook deteriorating in many emerging markets, it is increasingly likely that a negative shock to the sovereign balance sheet may trigger an adverse feedback loop between sovereigns and banks that could threaten macro-financial stability. Emerging markets thus face complex policy trade-offs amid tighter global financial conditions on the back of monetary policy normalisation in advanced economies and heightened economic and geopolitical uncertainty. Growth prospects are weak in several emerging markets; meanwhile, the policy space to support the economy is limited, and borrowing constraints have tightened as foreign investor interest in local currency sovereign bond markets has waned and yields have risen.

Chart 1: Commercial Bank's Investments in Government



Source: Reserve Bank of Malawi

Given the multifaceted nature of the sovereign-bank nexus, policy action is required on multiple fronts. In Malawi, risks to the sovereign-bank nexus have intensified due to the high public debt, the dwindling foreign currency reserves, persistent high inflation, frequent currency devaluations and high interest rates. Meanwhile. the current macroeconomic shocks have led to contention between monetary policy and financial stability. Safeguarding macroeconomic stability will require coordination between monetary policy and financial stability.

3.2 Financial Stability Indicators

The stability of the financial system is dependent on the performance of the macroeconomic and financial sectors. A number of leading indicators assist to depict the financial stability landscape . Table 1 below details the performance of a select number of financial stability leading indicators in the period under review.

Table 1: Financial Stability Leading Indicators

Indicator	December 2022	June 2023	December 2023
GDP (K 'Billion)	(1.2% growth) 11,849.6	(1.9% growth) 14,594.0	(1.5% growth) 14,579.0
Current Account Deficit	-16.5	-2.8	-16.8
Fiscal Deficit (% of GDP)	-7.5	-4.7	-5.4
Inflation (%) (benchmark of <5%)	25.4	27.3	34.5
Gross Official Reserves ($'million) (3.9 month import cover)	292.0 (1.2 months cover)	306.6 (1.2 months cover)	239.3 (1.0-month cover)
Total Debt to GDP (%)	68.2	61.8	79.2
Exchange Rate (MWK)	1,034.7	1,058.8	1,698
Bureau Indicative Cash Rate (MWK)	1,429.5	1,573.2	1,915.2
Interest Rate (%)	17.3	21.0	23.6
Banking Sector Capital Adequacy Ratio (%)	17.7	19.9	17.1
Banking Sector NPLs (%)	6.3	6.9	6.1
Banking Sector Return on Assets (ROA) (%)	4.1	5.4	5.1
Banking Sector Liquidity Ratio (%)	53.5	55.9	54.7

Source: Reserve Bank of Malawi

The country's real GDP growth is projected at 1.5 percent in 2023, according to the November 2023 Business Interviews Survey; lower than 1.9 percent reported during the June 2023 Business Interviews Survey; but an improvement from the 1.2percent growth estimated in 2022. The downward revision was attributed to the weak performance in agriculture; wholesale and retail, and manufacturing industries. The economic shocks that impacted the economy in 2022, such as foreign exchange shortages, inflation, and fuel shortages, resurfaced in some months in 2023. These shocks affected the procurement and distribution of affordable farm inputs in the 2022/23 farming season, hampering the performance of the agriculture sector. Furthermore, climate-related shocks, such as the tropical cyclone Freddy, contributed to the negative performance of crop production as it swept away crop fields and infrastructure, leaving the country in a humanitarian crisis as it claimed human lives, displaced thousands of people, and damaged infrastructure.

The alignment of the local currency, which saw the Malawi Kwacha devalued by 44.0 percent against the US Dollar in November 2023, increased inflationary pressure in the economy.

In the period between June and December 2023, inflationary pressure heightened as headline inflation accelerated to 35.5 percent in December 2023 from 27.3 percent in June 2023. This is higher than the 25.4 percent recorded in December 2022. The outturn was driven by an acceleration in food inflation, which averaged 39.9 percent in the second half of 2023, compared 33.1 percent in the second half of 2022. Further, gross official reserves (GOR) declined, total debt to GDP increased, and interest rates continued to rise, augmenting financial stability risks arising from macroeconomic fundamentals, as they registered above acceptable thresholds in the case of the first three highlighted indicators. Notably, GOR continue to register below the ac`ceptable 3.9 months of imports and resultantly the exchange rate was reflective of these low reserves.

3.3 External Sector Vulnerability Assessment

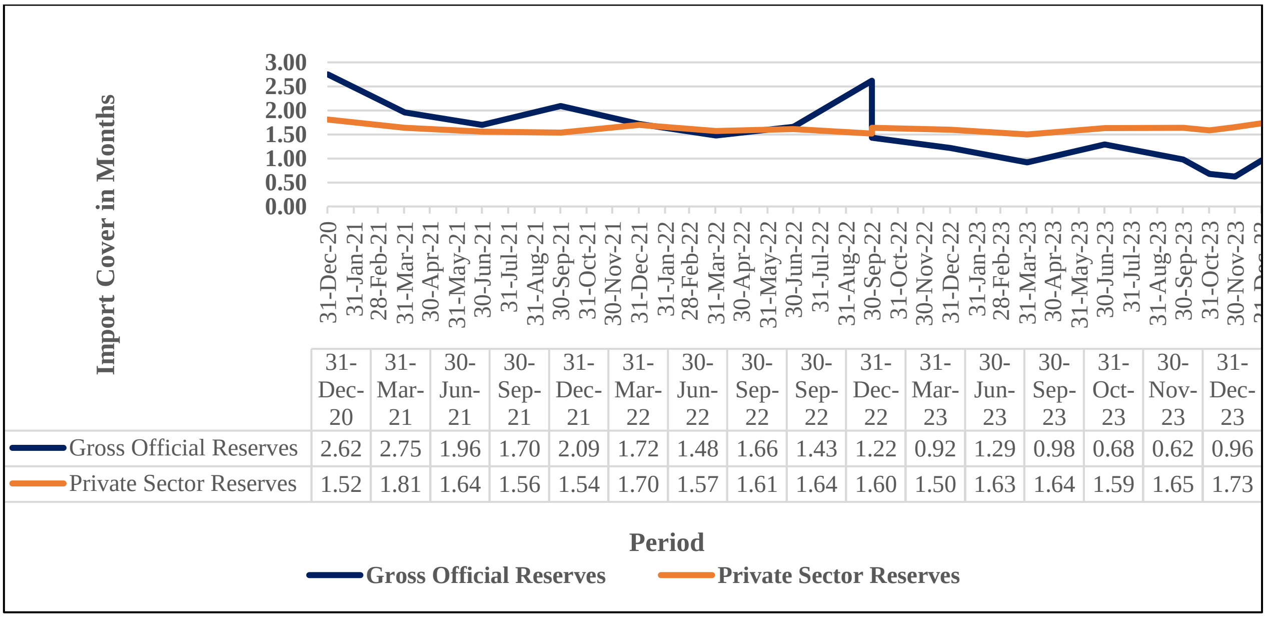
Malawi remains vulnerable to external sector shocks with the trade deficit remaining wide. Financial stability risks and vulnerabilities emanating from the external sector thus remained pronounced in the domestic economy, as evidenced by a narrow export base in the period under review. Preliminary statistics indicate that the merchandise trade balance marginally improved to a deficit of US$495.8 million in December 2023, compared to a shortfall of US$555.0 million recorded in June 2023 and US$532.5 million registered in December 2022. From June to December 2023, the trade deficit narrowed due to a more significant drop in imports than the decline in exports. The aggregate performance from January to December 2023 indicated that the trade balance slightly weakened, from minus US$2.0 billion recorded in December 2022 to minus US$2.1 billion in December 2023. The outturn was mainly explained by an upsurge in imports compared to exports during the year.

External buffers continued to decline, with gross official reserves (GOR) reverting to the declining path into low positions below recommended levels. The development follows the onset of the lean season that necessitated the central bank's support for importing strategic commodities. The development indicates the heightened risk of failing to pay foreign obligations and import bills on time. Private sector reserves remained stable with a slight improvement.

The GOR stood at US$214.3 million (0.9 months of imports) as of December 2023 compared to US$238.6 million (1.0 months of imports) recorded in June 2023 and US$323.7 million (1.30 months of imports) registered in December 2022.

Looking ahead, there is an expectation of improved foreign currency inflows from the IMF and other development partners on the back of the staff-level agreement that the country reached with the Fund in December 2023, indicating that the government is on track to improve external debt sustainability. However, these inflows will likely come on the back of substantial financing requirements, thus, the official reserves are projected to remain low in the near future.

Chart 2: Foreign Exchange Reserves



	31-Dec-20	31-Mar-21	30-Jun-21	30-Sep-21	31-Dec-21	31-Mar-22	30-Jun-22	30-Sep-22	30-Sep-22	31-Dec-22	31-Mar-23	30-Jun-23	30-Sep-23	31-Oct-23	30-Nov-23	31-Dec-23
Gross Official Reserves	2.62	2.75	1.96	1.70	2.09	1.72	1.48	1.66	1.43	1.22	0.92	1.29	0.98	0.68	0.62	0.96
Private Sector Reserves	1.52	1.81	1.64	1.56	1.54	1.70	1.57	1.61	1.64	1.60	1.50	1.63	1.64	1.59	1.65	1.73

Source: Reserve Bank of Malawi

3.4 Malawi's Financial Markets

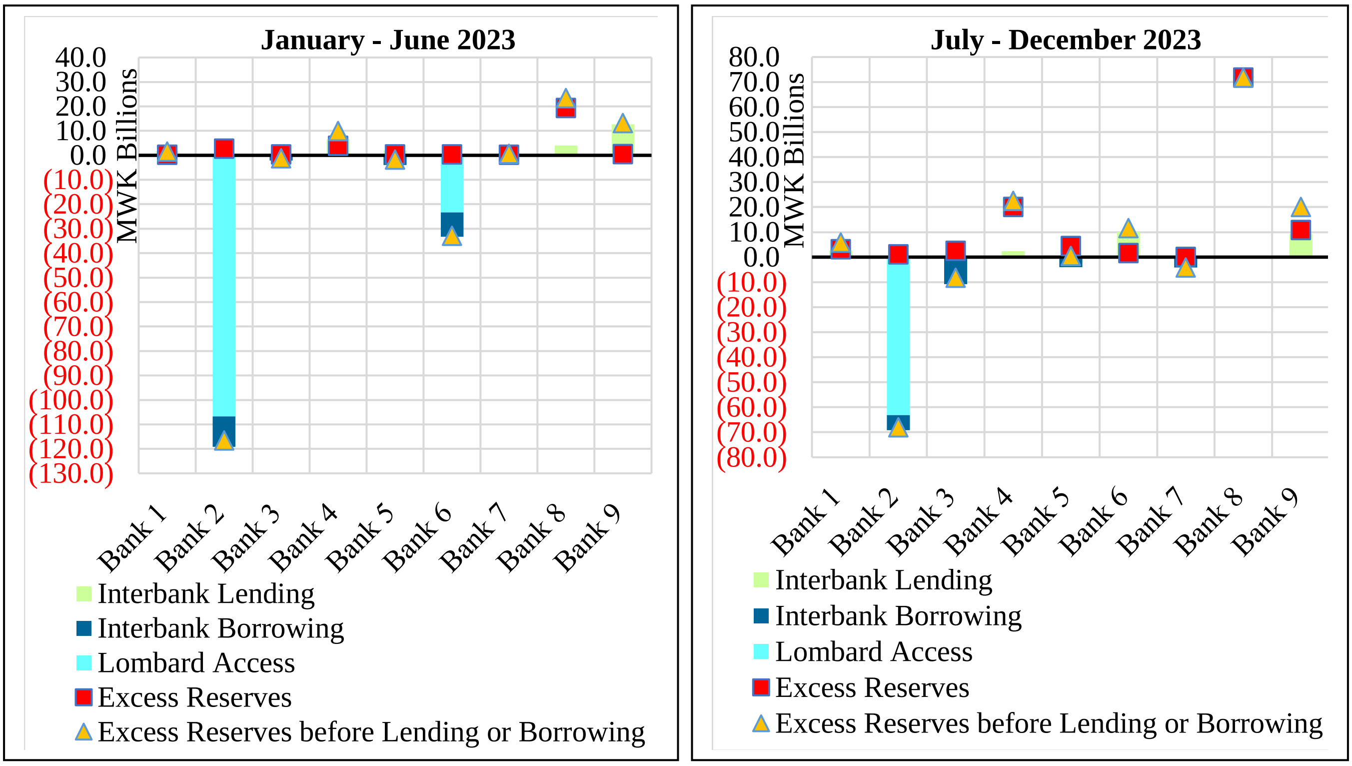
The banking system liquidity conditions loosened further by the end of December 2023 as evidenced by improvement in daily average excess reserves *before borrowing from the central bank* (un-borrowed excess reserves) that averaged K26.2 billion compared to a deficit of K41.2 billion recorded in June 2023 and K13.3 billion recorded in December 2022. Consequently, commercial banks with liquidity shortfalls maintained high borrowing from the interbank market compared to the central bank 'lender of last resort' facilities *(Table 2).* Nevertheless, one financial institution continues to rely on borrowing from the Lombard facility. Notably, in the first half of 2023, the bank accessed an average of K100.0 billion per day against a liquidity reserve requirement of less than K6.0 billion. However, the situation improved in the second half up to December 2023 as the bank reduced its access to K60.0 billion per day *(Chart 3).* Overall, nonetheless, the liquidity risk in the banking system remained manageable, considering that borrowing on the Lombard facility is against high-quality collateral that can quickly be sold for cash.

Table 2: IBR (end period, %) and Banking System Liquidity (Daily Averages, K'bn)

(K'bn)	Q4 2022	Q1 2023	Q2 2023	Q3 2023	Q4 2023
Daily Average Total Reserves	115.8	142.6	176.1	223.2	321.1
Daily Average Required Reserves	88.2	94.1	133.2	195.1	231.1
Daily Average Excess Reserves	27.7	48.5	42.9	28.1	90.0
Daily Average Un-Borrowed Excess Reserves (-) deficit	-13.3	-21.7	-41.2	-85.6	26.2
Daily Average Lombard Facility Access	41.0	70.1	84.1	113.7	63.7
Daily Average Inter-Bank Market Trading	16.1	21.2	28.9	29.0	33.1
Inter-bank Market Rate (End Period, Percentage)	15.00	15.00	20.38	22.79	23.00

Source: Reserve Bank of Malawi

Chart 3: Banking System Liquidity Distribution (Daily Averages, K'bn)

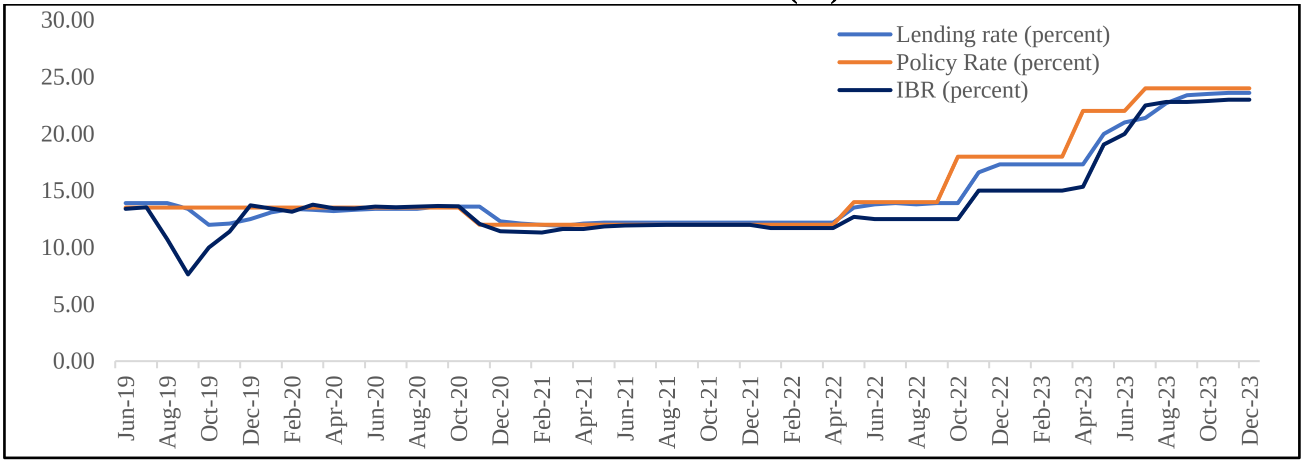


Source: Reserve Bank of Malawi

3.5 The Overnight Interbank Market

Interest rate risk heightened following the upward revision of the policy rate. Interest rate risk increased during the period under review following the upward revision of the policy rate by 200 basis points to 24.0 percent during the July 2023 MPC meeting. Subsequently, the financial system's vulnerability stemming from interest rate developments heightened during the review period as the Reference rate (and thus, the base lending rate) and the overnight Interbank Market Rate (IBR) increased by 260 and 300 basis points to close at 23.60 percent and 23.0 percent, respectively, as of end-December 2023, relative to the end-June 2023 positions *(Chart 4).*

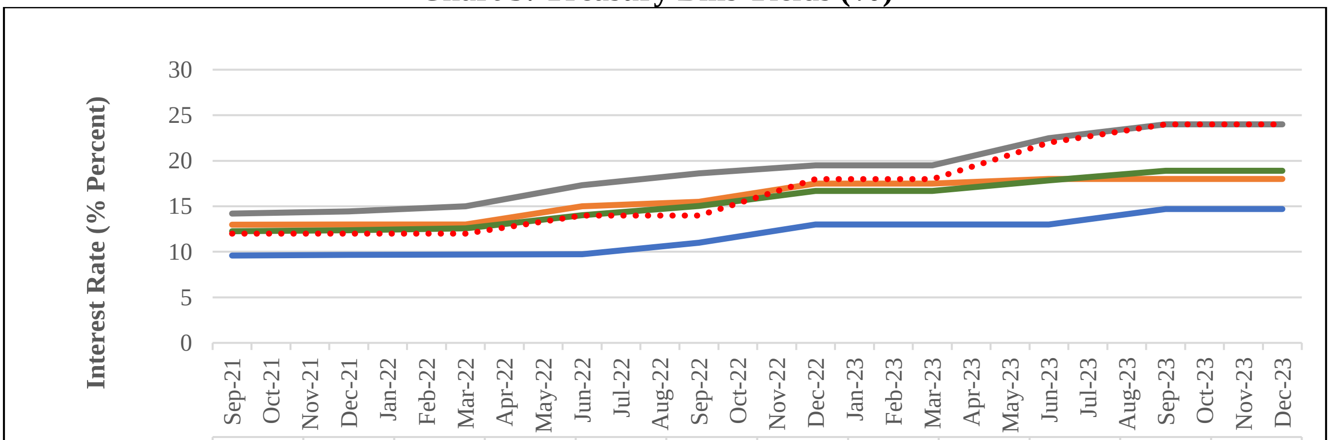
Chart 4: Interest Rates (%)



Source: Reserve Bank of Malawi

Treasury bill yields rose during the period under review reflecting an upward revision of the policy rate. The upward revision of the policy rate during the July 2023 MPC meeting was followed by a rise in Treasury bill yields on the 91-day and 364-day tenors. In particular, the 91-day tenor gained 147 basis points, while the 364-day tenor gained 151 basis points. The 182-day tenor remained unmoved. Consequently, the all-type Treasury bill rate gained 107 basis points to stand at 18.90 percent as at end December 2023 (*Chart 5*). These developments imply that servicing Government short-term domestic debt became relatively costlier, further eroding fiscal space.

Chart 5: Treasury Bills Yields (%)



	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Oct-23	Nov-23	Dec-23
91 Days	9.59	9.67	9.71	9.75	11	13	13	13	14.7	14.7	14.7	14.7
182 Days	12.98	13	13	15	15.49	17.5	17.5	18	18	18	18	18
364 Days	14.2	14.43	15	17.32	18.61	19.5	19.5	22.49	24	24	24	24
All Type	12.26	12.37	12.57	14.02	15.03	16.67	16.67	17.83	18.9	18.9	18.9	18.9
PR	12	12	12	14	14	18	18	22	24	24	24	24

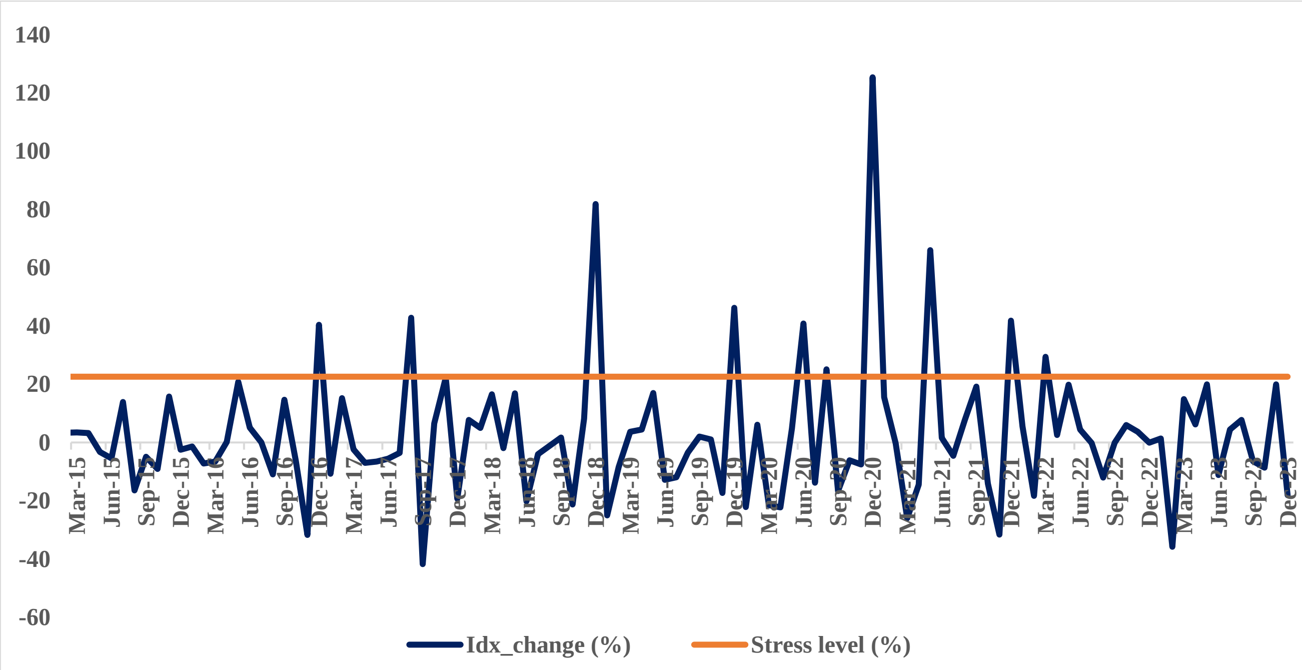
91 Days 182 Days 364 Days All Type PR

Source: Reserve Bank of Malawi

3.6 Financial Stress Index

The financial stress index depicted below in Chart 6 measures the degree of financial stress[3] in the financial markets. The index measures the interaction between money market operations, equity market, external sector and the real estate markets to assess the changes in the financial stress in the financial market. Deviation from the average of the four variables reflects the presence of a shocking event in the financial sector. The index below illustrates the index change (idx_change) and how the index has fluctuated along the stress level. The periods of stress highlighted in the graph below, indicates the impact of shocks emanating from the overnight interbank market rate and depreciation of the exchange rate movement in the respective periods.

Chart 6: Malawi Financial Stress Index



Source: Reserve Bank of Malawi

In the past two years, exchange rate depreciation, shortage of fuel, high interest rates and high inflationary pressures emanating from climate related disasters, geo- political conflicts and other factors have increased stress to the financial sectors hence the high frequency and magnitudes of the spikes in the chart.

[3] Financial Stress refers to periods where financial markets are experiencing high volatility and disruptions in the normal functioning of financial markets.

4.0 The Malawi Financial Sector in Perspective

4.1 The Contribution of the Financial Sector to GDP

The financial services and insurance sector contribution to the gross domestic product (GDP), is projected to grow by 3.6 percent in 2023 from an estimate of 5.4 percent in 2022, and 6.3 percent in 2021 (Table 3). The lower projection is explained by the higher cost of borrowing, which somewhat restrain access to credit hence affecting productivity. Overall, the sector contributed 3.6 percent to real output growth, and estimates indicate that the sector will grow by 6.1 in 2024

Table 3: Real Output Growth by Type of Activity (at 2017 prices)

	2017	2018	2019	2020	2021	2022	2023*	2024*
Agriculture………………………………………...	6.1	0.3	5.9	3.4	3.8	0.9	0.8	1.9
Mining and Quarrying………..	1.6	8.8	7.4	3.1	(3.6)	2.6	3.5	5.8
Manufacturing………………...	2.0	6.8	7.6	4.2	4.1	(1.4)	0.4	4.4
Utilities………………...	2.6	8.4	7.6	4.7	(1.8)	(2.9)	8.0	4.2
Construction ……………………………………….	4.4	7.2	7.8	3.7	2.8	3.1	8.2	5.6
Wholesale and retail…...	5.0	3.3	6.0	(0.1)	3.3	(2.3)	(1.9)	1.4
Transport Storage...	6.0	6.7	8.8	(6.9)	5.7	2.2	3.4	4.5
Accommodation and food service activities…...............	4.2	4.0	3.4	(23.4)	1.7	6.5	8.6	9.9
Information and communication……............................	6.5	9.5	9.3	5.9	6.9	1.5	3.2	6.8
Financial activities….............................	5.5	6.8	5.1	4.8	6.3	5.4	3.6	6.1
Real estate activities………….....................................	4.4	2.9	2.8	3.1	4.5	1.5	2.2	3.7
Public Administration and defence…............................	5.7	6.0	9.5	4.2	3.6	4.9	3.6	4.9
GDP in 2017 constant prices.......................................	**5.2**	**4.4**	**5.4**	**0.8**	**4.6**	**0.9**	**1.5**	**3.2**

Source: *National Statistical Office & Ministry of Economic Planning and Development and Public Sector Reforms * Projections*

4.2 Malawi's Banking Sector

The banking sector remained sound and well capitalized during the period up to December 2023. Total assets in the sector grew by 20.7 percent (K856.2 billion) to K5.0 trillion from June 2023 position. Growth in total assets was primarily attributed to increases in securities and investments by 13.1 percent to K2.3 trillion, gross loans and leases by 17.2 percent to K1.3 trillion, balances with banks abroad by 48.0 percent to K433.9 billion and balances with RBM by 91.7 percent to K277.0 billion. The sector remained well capitalized despite a decline in capital ratios. Core and total capital ratios declined to 17.1 percent and 20.1 percent as at December 2023, from 19.9 percent and 22.8 percent in June 2023, though remained above the regulatory benchmarks of 10.0 percent and 15.0 percent, respectively. The capital ratios declined due to relatively higher growth in risk weighted assets than capital.

In absolute terms, core and total capital increased by 1.7 percent and 3.6 percent to K472.3 billion and K533.1 billion in December 2023, respectively. On the other hand, risk weighted assets grew by 17.7 percent to K2.8 trillion.

Credit risk remained heightened, despite registering an improvement from the June 2023 position. The banking sector NPL ratio improved to 6.1 percent from the 6.9 percent registered in June 2023 which was however still above the tolerable limit of 5.0 percent.

The banking sector remained resilient to external sector shocks. This is mainly attributed to the sector's net long foreign currency position which increased by 74.6 percent to K33.7 billion in December 2023 from K19.3 billion in June 2023. Thus, the depreciation of the Kwacha against the major foreign currencies was likely to result in a net gain and vice versa.

Risks and Vulnerabilities to the Banking Sector: Credit risk persisted as evidenced by high levels of sectoral credit concentration in the six months up to December 2023. The top three economic sectors continued to account for more than 50.0 percent of credit at 66.8 percent of gross loans and leases, thus a downturn in the sectors poses a threat to the stability of banking industry. Further, the industry sustained high levels of NPLs, notably, the NPL ratio remained above the tolerable limit of 5.0 percent at 6.1 percent in December 2023. Climate related risks remain a threat due to the increase in frequency and magnitude of extreme weather and climate change related events over the recent past years, which pose concern to financial stability. The adverse impact of these events on some dominant economic sectors such as the agriculture sector, has potential to increase non-performing loans in such sectors.

Banking sector liquidity risk persisted as marked by asset and liability gaps in the case of high deposit withdraws. The sensitivity analysis indicated that the banking sector would have a significant negative liquidity gaps in the one-month bucket, and one-to-three months bucket mainly because of the banking sector's funding and investment structure.

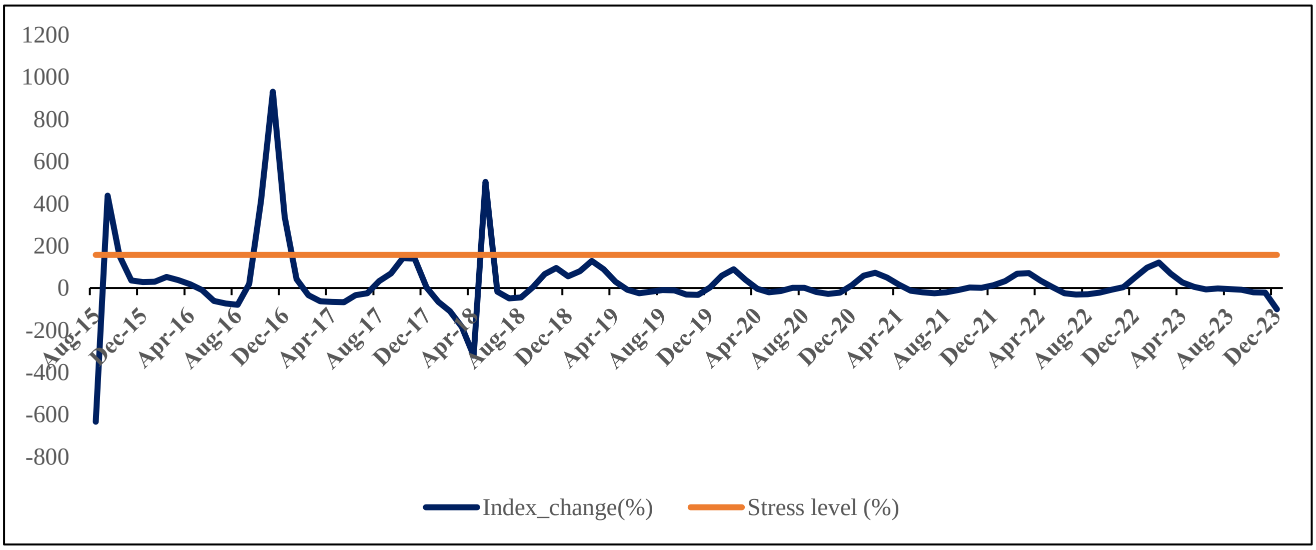
Remedial measures: Mitigation measures include conducting periodic stress testing exercises of the institutions in the banking industry to assess its resilience against shocks and ensuring appropriate action plans are in place to mitigate against any risks that may crystallize. In addition, the Registrar continues to review the Internal Capital Adequacy Assessment Programs (ICAAPs) of banks annually to ensure effective capital planning and conservation by commercial banks, commensurate to their risk profiles.

Furthermore, the Registrar continues to review bank liquidity contingency plans and associated test reports to ensure availability of liquidity from contracted contingent sources during liquidity stress periods. Finally, the Reserve Bank of Malawi and Malawi Government has setup a Deposit Insurance Scheme which became operational effective 1st October 2023 with the ultimate objective of promoting financial stability.

4.3 Financial Resilience Index

The resilience index measures the ability of banks to withstand adverse shocks. The index in chart 8 illustrates the index change and which periods the banking sector was less resilient and above the stress level. In the periods 2016 and 2017, the banking system was less resilient following the increase in NPLs which averaged 15.1 percent and was above the 5.0 percent prudential benchmark. Notably, though, and with reference to the period from June to December 2023, the Malawi banking sector has remained resilient to various shocks that affected the general economy starting with, climate related disasters, high inflation, high interest rate regime, shortage of fuel and persistent energy challenges which is evidenced by the index registering well below the stress level in the period indicating high resilience of the banking sector.

Chart 8: Financial Resilience Index



Source: Reserve Bank of Malawi

4.3 Banking Stability Index

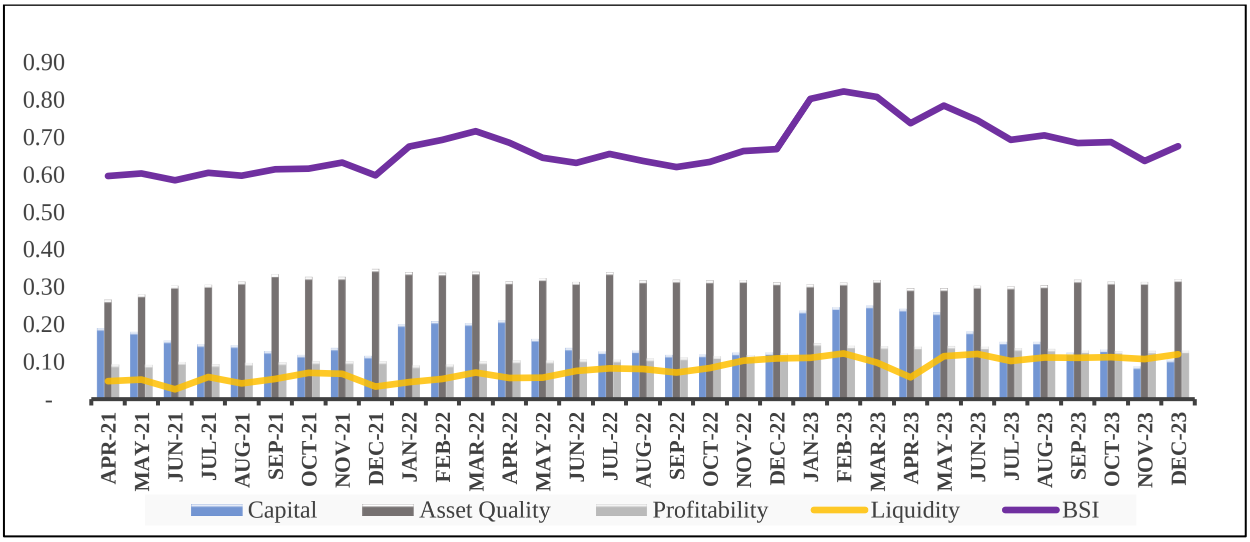
The Banking Stability Index (BSI) measures the stability of the banking system and the causes of the changes in the index. The BSI is similar to and complementary to the resilience index. Whereas, the resilience index measures the ability of banks and other financial entities to withstand shocks, the BSI measures the direction of the stability of the banking system. An upward trend signifies an increase in the stability of the banking system evidenced by the good performance of the prudential indicators. Meanwhile, a downward trend signifies a decline in the stability of the banking system. The Banking Stability Index (BSI) indicated a marginal decline in the stability of the banking sector to 0.68 in December 2023 from 0.75 in June 2023, owing to a decrease in the capital adequacy, liquidity and profitability of the banking system.

Meanwhile, non-Performing Loans (NPLs) remained above the 5.0 percent prudential benchmark despite a marginal improvement to 6.0 percent from 6.9 percent in the period under review. Nonetheless, the industry remained resilient.

4.4 Banking Sector Health

Banking Sector health as depicted by the banking health heat map highlights the soundness of the banking system and individual banks. The heatmap is able to expose specific areas of vulnerability in the banking system. A CAELS[4]-type rating for each institution is used in the development of the heat map. In the period up to December 2023, the banking sector remained resilient to solvency, liquidity and profitability risk. Nevertheless, the sector displayed vulnerabilities to credit risk reflecting concerns in NPLs which remained above the prudential benchmark during the year. Individually, all banks except one bank remained sound and well capitalized.

Chart 9: Banking Stability Index



Source: Reserve Bank of Malawi

5.0 Macro Financial Developments

5.1 Macroeconomic Risks to Financial Stability

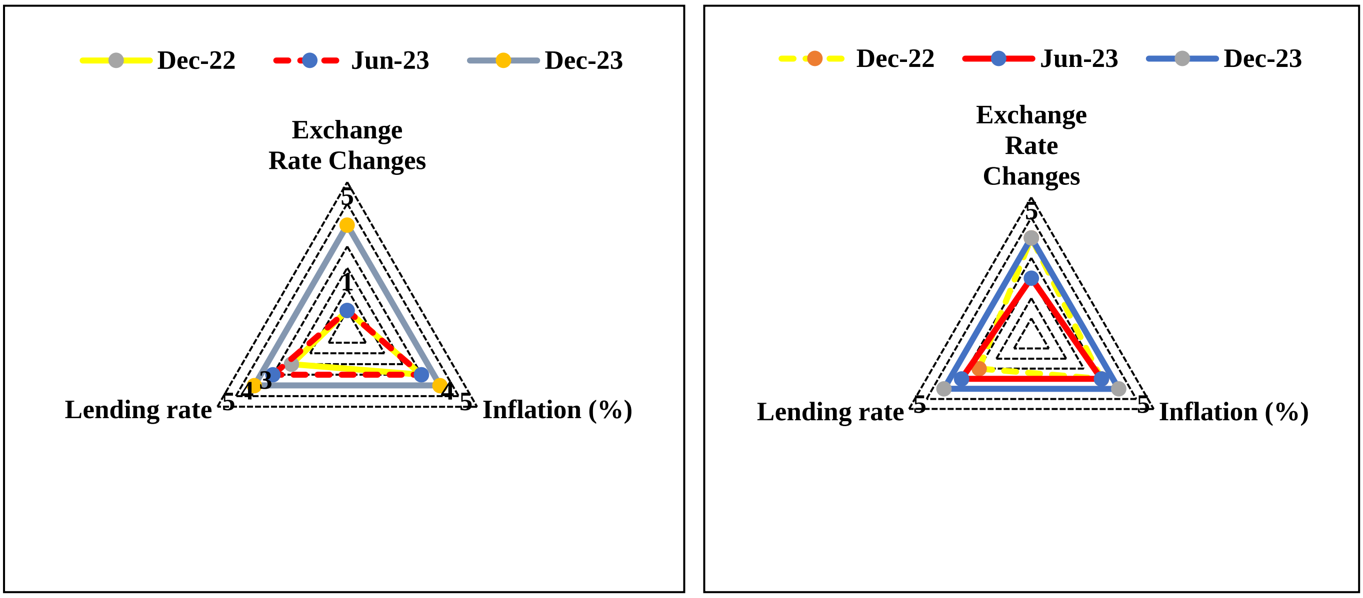
Macroeconomic risks increased in the year: Financial stability risks originating from the macroeconomic environment increased during the period under review(Chart 11). Financial stability risks originating from exchange rate developments remained heightened during the review period as the Kwacha remained under pressure.

[4] Capital adequacy, Asset quality, Earning and Liquidity and Sensitivity

During the review period, the Kwacha lost 60.37 percent (K639.16) in value against the US dollar in the Authorised Dealer Banks (ADBs) Telegraphic Transfer (TT) market and 21.74 percent (K341.98) in the Bureau cash market to close at K1,915.21 per US dollar. The Kwacha also lost value against the British Pound (61.44 percent) and the Euro (62.1 percent). Further, the Kwacha also lost value against the South African Rand (62.58 percent).

Chart 10: Macroeconomic Risks to Financial Stability

11a) Actual Trade Weighted TT rate **11b)** ***Bureau Indicative Rates***



*Away from the centre signifies high risk

Source: Reserve Bank of Malawi

Significantly, macroeconomic risk to financial stability arising from exchange rate developments is seen to heighten further when the exchange rate risk is computed using the bureau indicative cash rate which has depreciated significantly overtime (Chart 11b). The misalignment between the actual trade weighted TT rate and the bureau indicative cash rate has affected the formal market through increased inflationary pressures and increased cases of forex externalization. The inflationary pressures have gained the attention of monetary policy authorities who have increased the policy rate to contain inflation. The increase in the policy rate has increased the stress on the financial system following the increase in attendant interest rates which will likely affect the affordability of loans and increase the default rate in the financial system in the near term.

Meanwhile, the post review period indicates a further increase in macroeconomic risk to financial stability following the devaluation of the exchange rate by 44.0 percent in November 2023 in a bid to align the Authorized Dealer Banks (ADBs) Telegraphic Transfer (TT) market rate to the Bureau Cash rate. The development is expected to contribute to an upward adjustment in prices on the market thereby increasing inflationary pressure in the near term.

5.2 Malawi's Macro-financial Health

The macroeconomic heat map measures risks and vulnerabilities in the macro financial environment. The heat map offers an in-depth view of potential areas of vulnerabilities in the macroeconomy and the sectors which have a high risk of causing a crisis. Overall, the heat map indicates less risk where it is green, more risk where it is red, and amber is when the value is within the threshold.

In the period up to December 2023, the financial sector continued to be buoyant amidst increased vulnerabilities emanating from the macroeconomic environment. Notably, economic strength continued to be weak evidenced by persistent high inflationary pressure and slow economic growth; fiscal resilience continues to be feeble as sovereign debt and expenditure register a significant high; trade balance ratio continued to exhibit heightening external sector vulnerabilities; and financial markets indicated signs of volatility. Meanwhile, the banking system indicated signs of stability following the positive performance of the CAELS in the period under review. However, the asset quality indicator of the banking system remained above the prudential benchmark indicating persistent credit risk in the banking system.

The stability of the banking system is largely attributed to its earnings and profitability line, which is supported by the banking sectors' huge investments in government securities. Banks' investments in government securities have been increasing over time as these investments are considered risk free. Meanwhile, the performance of the indicators of fiscal resilience and external sector resilience show deteriorating signs of the macroeconomic environment. Ideally, the positive performance of the banking industry should have been reflective of a thriving macroeconomy. Thus, the sovereign nexus[5] scenario raises financial stability concerns as the shocks from the fiscal economy could eventually adversely affect the banking system which heavily relies on government for investments.

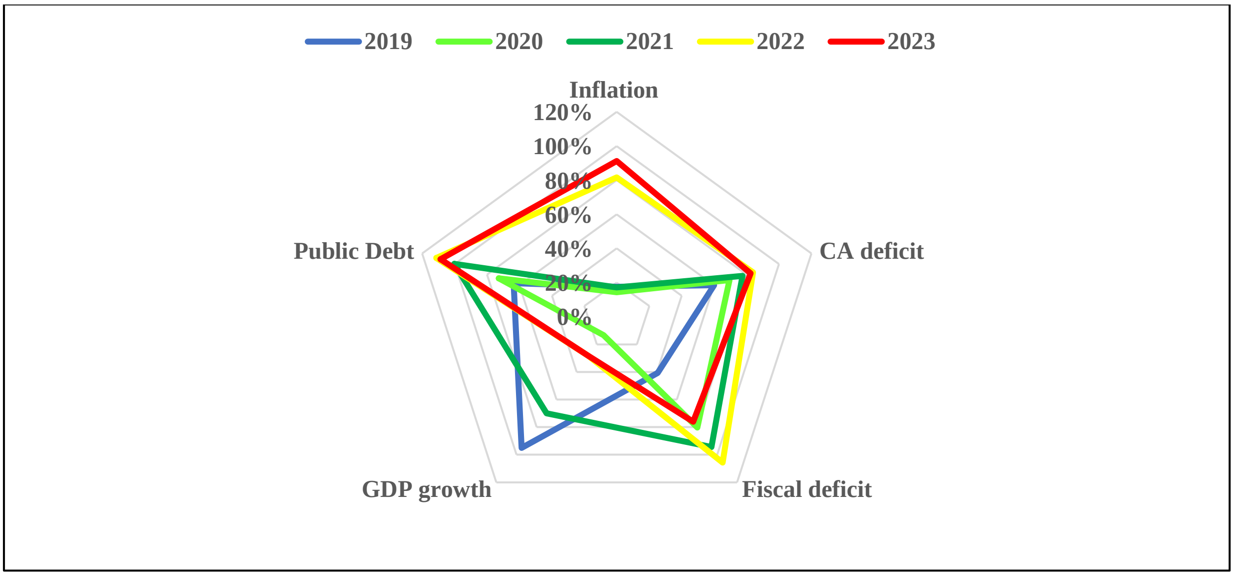
5.3 Malawi Macroeconomic Vulnerabilities

The Malawi economy vulnerabilities map measures and informs vulnerabilities in the macro environment. The map is similar to the macroeconomic risks cobweb, but considers a wider set of the macroeconomic indicators. Specifically, year on year headline inflation stood at 28.8 percent as at end December 2023; public debt rose to 79.2 percent of GDP; GDP growth was revised downwards to 1.5

[5] *The sovereign nexus reflects the interconnectedness between the health of the sovereign and the banking system, whereby stress in one sector may create and amplify stress in the other*

percent; the fiscal deficit stood at minus 5.4 percent; and the current account deficit stood at minus 16.5 percent. Similar to the earlier analyses of the potential areas of vulnerabilities from the macroeconomic sector, the fiscal deficit continues to register as one of the prominent sources of vulnerabilities and risks in Malawi's financial stability assessment, as the widening fiscal deficit has contributed to an increase in public debt on both the domestic and foreign accounts. As at December 2023, total public debt increased to K11.6 trillion in December 2023 from K9.0 trillion in June 2023. Domestic debt stood at K6.0 trillion while foreign debt stood at K5.5 trillion. In the unlikely case of sovereign default, the financial system is bound to experience a severe crisis considering that financial sector exposure to government is currently very high.

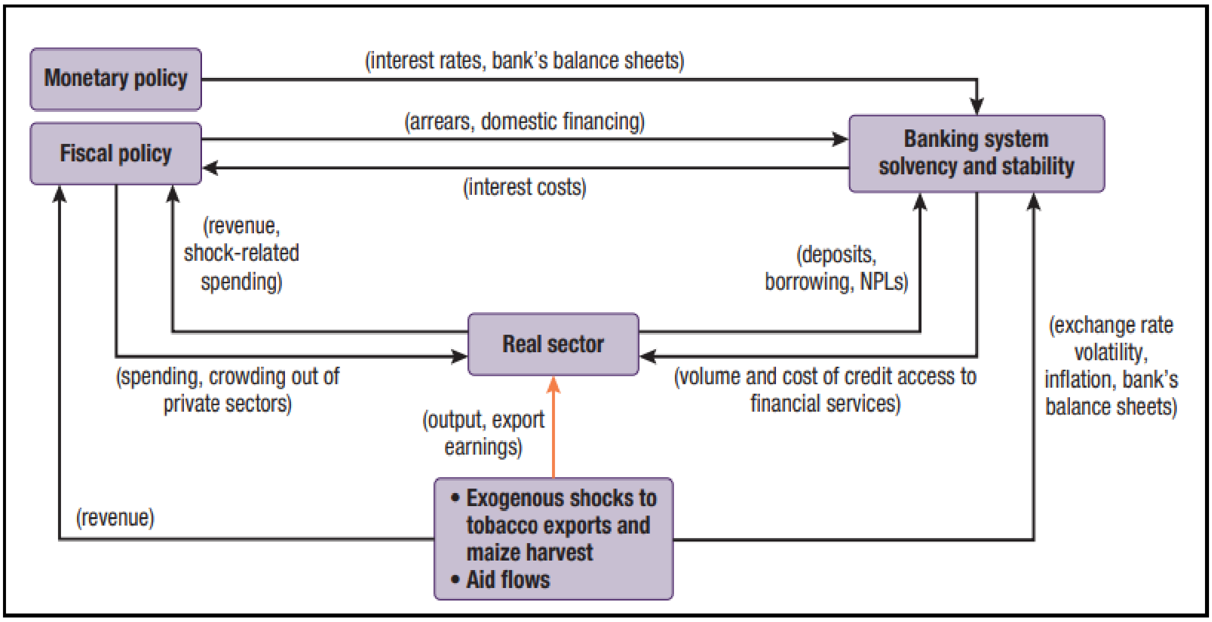
Chart 11: Malawi Economy Vulnerability Map



Source: Reserve Bank of Malawi

Further, the seemingly improved current account deficit is largely attributed to shortage of foreign exchange in the country which has significantly suppressed imports. However, the development has affected productivity of some crucial sectors of the economy thereby affecting general economic growth. This coupled with high inflationary pressure contributes to increased stress on servicing of credit obligations and general management of businesses.

Figure 1: Snapshot of Macro-financial Linkages in Malawi



Source: Dieterick and Williams, 2018

The macro-financial linkages snapshot is intended to highlight interlinkages between the macroeconomic environment and the financial system, as well as the vulnerabilities in the macro-financial system. For instance, Malawi's main export is tobacco and in the agriculture period of 2022/2023, tobacco proceeds amounted to $280.0 million. However, this is equivalent to one month's demand of imports (import requirement) for the economy which signifies that the annual proceeds of the country's main export commodity can only accommodate one month's worth of imports. This further affects the forex availability and the exchange rate misalignment which was highlighted in chart 12. The forex shortages and the exchange rate misalignment increase inflationary pressures which trigger the attention of monetary policy authorities and results in the tightening of the monetary policy stance to contain inflation. However, due to the high interest payments on public debt and high government expenditures, the macroeconomic indicators do not respond to the signals of the policy stance due to the government's appetite to borrow and spend, thus rendering the transmission mechanism of monetary policy ineffective.

6.0 Risks and Vulnerabilities in the Non-Bank Financial Sector

The different non-bank financial institutions (NBFIs) in the Malawi financial system are structured differently. As such a risk or vulnerability in one type of NBFI does not necessarily imply a risk or vulnerability in another sector.

However, it is pertinent to note that the NBFIs are likely to face common risks such as the low foreign exchange reserves, weak economic growth and high debt level amid rising interest rates.

6.1 Microfinance Sector

The microfinance sector, comprising microfinance institutions and SACCOs, remained fairly sound during the period under review. Liquidity and earnings were satisfactory while asset quality and capital remained fair.

Deposit Taking Microfinance Institutions: The deposit taking subsector remained well capitalized during the review period despite registering an increase in capital ratios. Core capital and total capital ratios increased by 0.7 and 0.1 percentage points to 23.6 percent and 28.1 percent, but remained above the regulatory benchmark of 10.0 and 15.0 percent for core capital and total capital ratios, respectively. However, despite meeting the core capital ratio requirements, one deposit taking institution was undercapitalized during the period. The institution was directed to submit a recapitalization plan to the office of the Registrar by end of February 2024.

Non-Deposit Taking Microfinance Institutions: The Non-Deposit Taking Microfinance Institutions subsector remained fairly capitalized during the review period. However, one of twelve non-deposit taking institution, comprising 0.1 percent of the total sub-sector assets, had core capital below the minimum capital requirement of K100.0 million. Despite this, total equity capital for the sub-sector increased by 54.6 percent to K29.2 billion. The growth in equity capital was as a result of an increase in equity capital in one of the large institutions in the sector.

Asset quality improved as the NPL ratio decreased by 1.4 percentage points to 4.5 percent in December 2023, and remained below the industry ceiling of 5.0 percent. The ratio was an improvement from 5.9 percent in June 2023. In absolute values, gross loans increased by 68.3 percent to K45.2 billion whereas NPLs decreased by 22.8 percent to K1.3 billion, hence the movement in the NPL ratio.

Financial Cooperatives: The performance of the Financial Cooperatives (SACCOs) sub-sector remained satisfactory during the period under review. In terms of capital, the capital adequacy ratio increased by 1.9 percentage points to 30.7 percent during the period under review, registering above the minimum regulatory requirement of 10.0 percent. This notwithstanding, one institution was undercapitalised, while three were pending liquidation due to insolvency. The undercapitalised institution is under enforcement action.

The sub-sector registered a growth in total assets, earnings registered a surplus, while asset quality, as measured by the NPL ratio which registering at 3.8 percent, remained satisfactory as it was below the maximum acceptable benchmark of 5.0 percent.

Liquidity for the subsector was rated satisfactory at 15.9 percent, which was above the minimum regulatory ratio of 10.0 percent of sum of redeemable shares and deposits. However, the ratio decreased from the 16.3 percent reported in June 2023. The continued positive trend of liquidity was on account of improved liquidity and funds management practices following the Registrar's persistent supervisory actions issued to the SACCOs.

Risks and vulnerabilities to the Microfinance Sector: Risks in the microfinance sector persisted during the review period. Microfinance institutions continued to face interest rate risk derived from fixed lending rates against floating borrowing rates from commercial banks (due to changes in policy rate). Further, exchange rate risk persisted as microfinance institutions which access credit lines from abroad as working capital will have to repay relatively more funds than initially planned due to depreciation of the kwacha. During the review period, One NDTI and one DTI had loans amounting to US$13.0 million and US$5.8 million, respectively, from various financial institutions in foreign countries.

Counter party risk remained inherent in the microfinance sector. Microfinance institutions and SACCOs have savings deposits and investments with other financial institutions, especially banks and capital markets institutions. This poses a contagion risk in the sense that should the associated financial institution fail, it would adversely impact the operations of the MFIs and SACCOs. Similarly, liquidity risk remained inherent as some institutions, especially SACCOs, were still experiencing liquidity challenges mainly due to delayed remittances by government ministries, departments and agencies.

6.2 Capital Markets

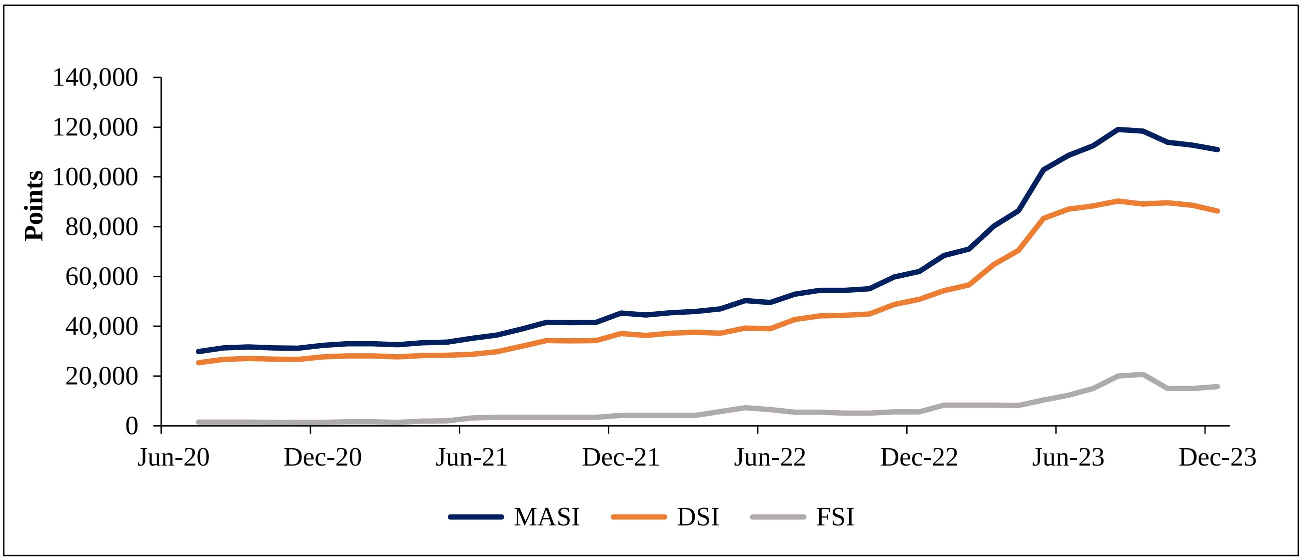
The capital market registered an increase in both the all-share index and trading activity during the six-month period to December 2023. The return on the Malawi All Share Index (MASI) increased following a rise in both the Foreign Share Index (FSI) to 15,792.06 points at end December, 2023 from 87,071.03 points as at end June. This was on account of share price losses registered on six domestic counters. Ten (10) counters gained value while six (6) counters had share price losses. The share price gains outweighed share price losses, hence the MASI gained 2,294.24 points and closed at 110,951.21 points at end December 2023. The return on MASI was below the return on money market investments[6] and inflation during the nine-month period to September, 2023.

[6] Yields on 364 days Treasury bills averaged 22.72 percent, while inflation was 30.52 percent on the nine-month period to September, 2023.

There were no listings on the primary stock market. As such, the total number of companies on the Malawi Stock Exchange remained at sixteen (16). However, 30 Malawi Government debt securities were listed on the primary debt market, while three Treasury notes matured during the period.

Market Capitalization Total Market Capitalization (TMC) increased by 2.22 percent to K5.99 trillion (USD3.56 billion) as at end December 2023 attributed to share price gains registered on both the domestic and foreign counters. On account of share price gains registered on the foreign counters. During the period under review, domestic market capitalization moved downwards by 0.76 percent and closed at K5.20 trillion due to losses in the share price for six domestic counters. On the contrary, foreign market capitalization increased by 28.76 percent to K793.82 billion at the end of December 2023. This was due to share price gains registered on the foreign counters.

Chart 12: Trends in MASI, DSI and FSI (Indices)



Source: Reserve Bank of Malawi

Market Turnover

The volume and value of shares traded declined when compared to the previous period under review with the number of shares traded decreasing by 25.69 percent to 261.0 million from 351.2 million shares traded in the first half of 2023. Meanwhile, the value of shares traded increased by 42.69 percent to K45.4 billion from K31.8 billion registered in the first half of the year. The downturn in trading activity was attributed to seasonal trends in investor behaviour. Trading activity in the second half of the year is usually driven by the release of unaudited half-year financial statements by listed companies after which trading activity tends to decline in the third quarter of the year as investors anticipate the release of trading statements in respect of the financial year.

Debt Market: Thirty (30) Treasury securities comprising five (5) development bonds and twenty-five (25) Treasury notes with a total nominal value of K1.7 trillion were listed on the primary debt market in September 2023. However, seven (7) Treasury securities with a total nominal value of K299.9 billion matured during the period under review. Consequently, the total number of debt securities listed on the Malawi Stock Exchange stood at eighty (80) Treasury securities, with nominal value of K3.7 trillion. There was no secondary trade registered on the debt market.

Market Intermediaries: Market intermediaries generally complied with respective regulatory requirements. However, the Registrar did not renew the license of one portfolio manager on account of failure to meet minimum capital and operational requirements. Another portfolio manager remained under liquidation. Meanwhile, the Registrar appointed a firm to conduct a forensic audit of the portfolio manager. The forensic audit is in progress and expected to be completed within the first quarter of 2024.

Risks and Vulnerabilities to the Capital Markets: Risks in the capital market comprises counterparty risk which remains a key inherent risk to the capital markets sector in relation to private debt securities while operational risk is largely identified in the portfolio management industry where internal controls may be integrally weak**.**

Mitigation measures include strengthening of supervision of the sector to ensure compliance with regulatory requirements. In particular, the Registrar is in the process of conducting a diagnostic review of the entire eco-system of capital markets, including the regulatory and supervisory framework for market players. The recommendations from the review will help to support the stability of the capital markets.

6.3 General Insurance Sector

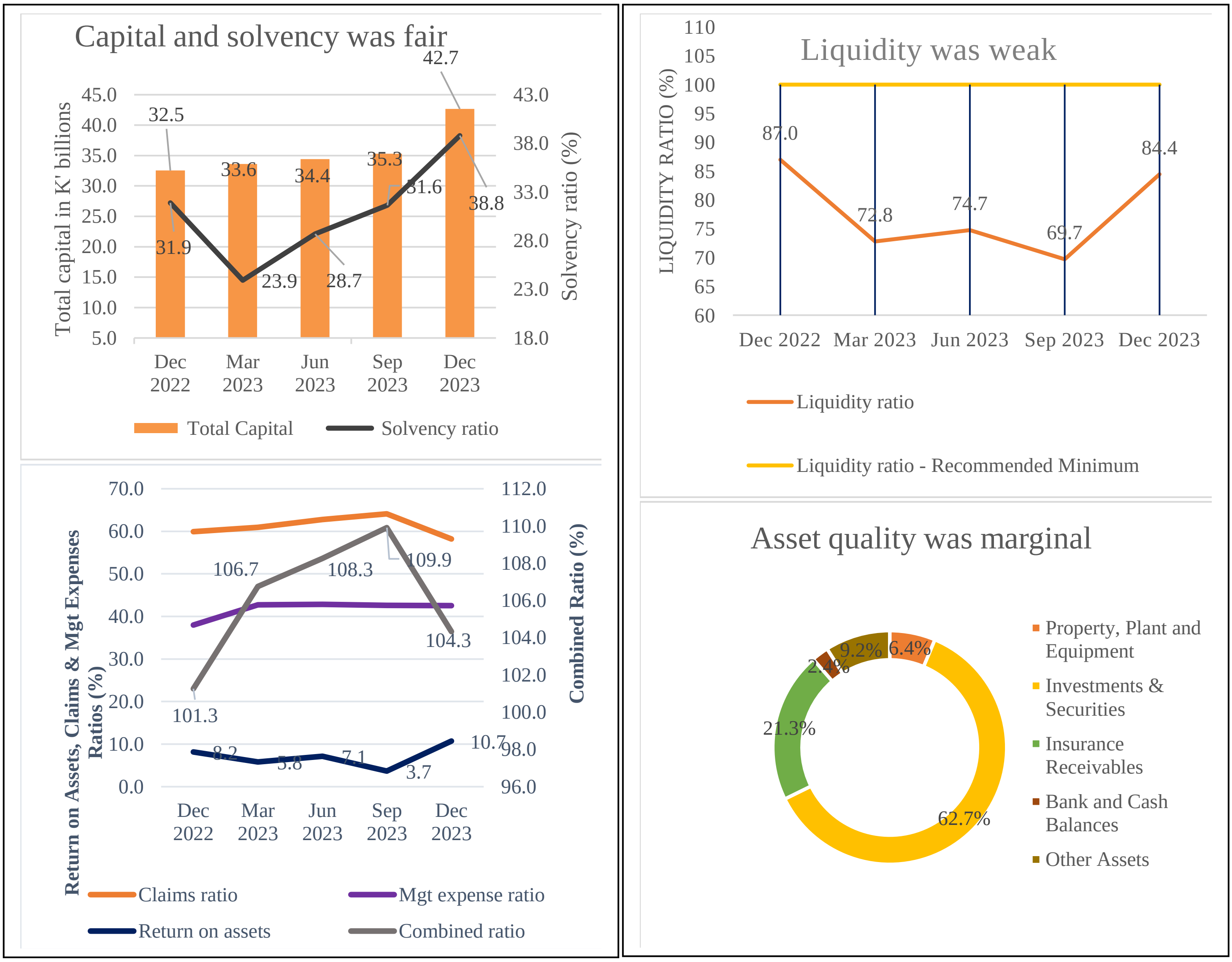
The general insurance sector remained sound during the review period, registering positive growth, adequate capital and solvency, and satisfactory earnings.

However, minor asset quality and liquidity weaknesses persisted, mainly linked to insurance receivables, and high operating expenses continued to put pressure on underwriting profits .

The general insurance sector closed the final half of the year with a solid capital buffer. The sector's solvency ratio improved to 38.8 percent, as of December 2023, from 28.7 percent registered as of June 2023 against the regulatory requirement of 20 percent, indicating an adequate capital position. The main drivers of the improvement in the solvency ratio were an increase in valuation of some of the general insurance assets, retained profits, revaluation gains, and capital injection.

However, as of December 2023, two insurers had inadequate capital, with solvency below the minimum requirement. The two insurers contributed 21.6 percent of the total gross premium.

Chart 13: General Insurance CAMEL Indicators



Source: Reserve Bank of Malawi

Asset quality for the sector improved and was assessed to be generally sound with a fairly diversified investment portfolio, in spite of continuing risks posed by insurance receivables. Investments and securities increased to 62.0 percent of total assets, while insurance receivables decreased to 21.2 percent from 24.5 percent in June 2023. This is positive, as it reduces credit risks and ensures prompt resource availability to meet claims and other obligations. However, insurance receivables still constituted 53.2 percent of the sector's total capital, which is higher than the recommended limit of 50 percent, exposing it to counterparty risks.

The liquidity of the general insurance sector improved but remained unsatisfactory. The sector's liquidity ratio increased to 84.4 percent in December 2023; an improvement compared to the 74.7 percent growth registered in June 2023. Nevertheless, the improved liquidity ratio is still below the required regulatory requirement of 100 percent. Only two of eight general insurers met the recommended liquidity ratio as of December 2023. The sector's weak liquidity is due to high insurance receivables resulting from late premium payments, which compromise insurers' ability to fulfil their policy obligations promptly.

Risks to the General Insurance Sector

Capital and Solvency risks were moderately high. Two out of eight insurers failed the solvency test due to undercapitalisation and weak assets, which may affect their ability to pay claims or lead to complete failure. The industry is also exposed to credit and liquidity risks, particularly regarding insurance receivables, that could lead to potential credit losses and negatively impact cash flows. Delayed premiums worsen solvency and prevent earning opportunities.

During the review period, contagion risk remained heightened as two insurers had an insufficient solvency margin as of 31 December 2023. Insurers are interconnected through reinsurance and subrogation. Contagion risk is a threat if one insurer fails, affecting others.

Market risk persisted in the second half of the year due to high inflation, depreciation of the local currency against major trading currencies and increased interest rates. Changes in inflation and the depreciating exchange rate of the Kwacha could lead to a rise in the cost of paying for future insurance obligations. Moreover, since 69.2 percent of the sector's investments are in fixed-income securities, fluctuations in interest rates could considerably impact their value and the earnings they generate.

Climate change and weather-related risks remain a concern for the general insurance industry. The rising frequency and severity of weather-related losses threaten the sector's resilience. In 2023, cyclone Freddy caused extensive damage to lives, properties, and operations with consequential increase in insurance losses. The full impact on the sector is unknown. Weather risks may worsen as the rainy season progresses.

Lastly, compliance risk emanating from the implementation of IFRS 17 remains moderate. General insurance companies have yet to fully implement IFRS 17 requirements as they have yet to configure their core system.

Furthermore, a lack of technical capacity and skills is hindering the implementation of IFRS 17. Non-compliance of these accounting standards can cause audit qualification of financial statements and potentially misrepresentation, leading to disastrous effects on the insurer's operations.

6.4 Life Insurance Sector

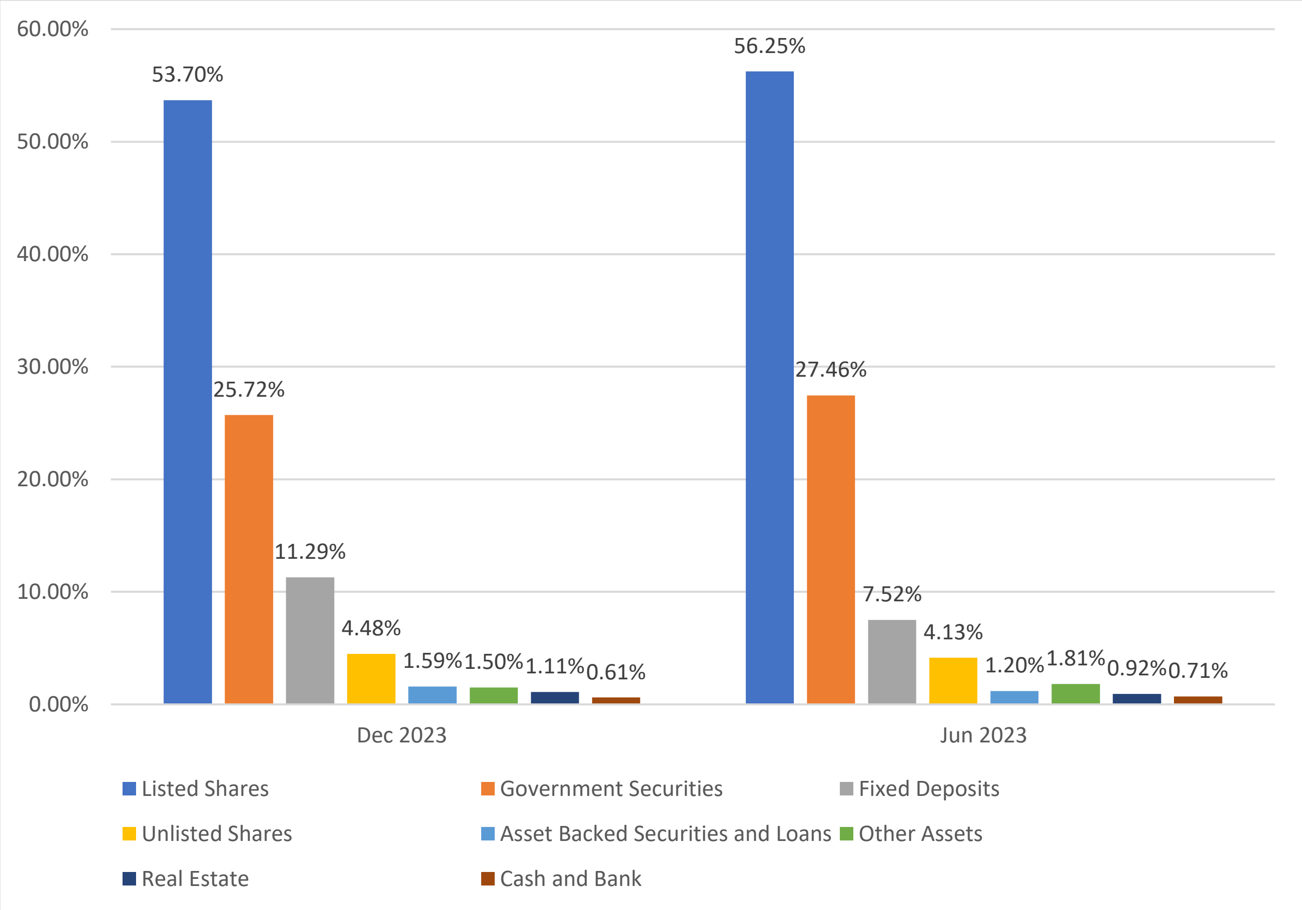
The life insurance sector remained resilient in 2023 despite continued challenges, including high inflation, upward policy rate adjustment, exchange rate volatility, forex shortages, and uncertain economic conditions. In July 2023, the policy rate was adjusted to 24.0 percent from 22.0 percent in the first quarter. The adjustment led to significant gains for life insurance companies due to higher returns from listed equities and fixed income securities. Whilst earning performance was strong in the year, a bulk of earnings were supported by unrealized investment income that was inherently prone to market volatility and potential downturns, which undermined the quality and sustainability of earning performance. Additionally, macroeconomic pressures could exacerbate the challenges of increased premium payments for policyholders. This could reduce the affordability of life insurance, which in turn can affect its demand in the economy. The harsh economic environment poses significant risks to the insurance industry since it can lead to higher volumes of surrenders and cancellation of policies, ultimately reducing insurance penetration in Malawi.

Despite the aforementioned concerns, the insurance industry has proven to be resilient to both domestic and external shocks. In December 2023, the industry's capital and reserves increased by 57.3 percent to reach MK159.0 billion. This increase was primarily driven by retained earnings which rose by 62 percent. The overall financial strength of the insurance sector, as measured by the solvency ratio, remained strong. As of December 2023, the solvency ratio for the sector increased to 165.0 percent from 155.9 percent in June 2023, surpassing the regulatory benchmark of 120 percent. All six life insurance companies exceeded the minimum solvency requirement.

Despite progress, having a high asset concentration in few instruments continues to pose a significant risk to the life insurance sector. The industry’s 53.7 percent asset concentration on the listed shares on the stock market exposes the sector to potential adverse fluctuations in the stock market prices. It is important to note that a significant decrease in the stock market prices could potentially cause a great deal of harm to the life insurance sector. In addition, as of December 2023, approximately

25.7 percent of life insurance assets were invested in government securities, which makes them vulnerable to sovereign exposure risk. Furthermore, purchasing government bonds can result in revaluation losses when interest rates are rising.

Chart 14: Life Insurance Asset Composition



Source: Reserve Bank of Malawi

The earnings performance of the life insurance sector was satisfactory. The life insurance industry's profits after tax increased by 80.1% to K55.5 billion from the corresponding period. Due to growth in investment income, the sector's return on equity increased to 45.6% from 36.0% in December 2022.

The sector registered an increase in claims ratio on group risk products, however, the individual life business claims experience was relatively unchanged. The claims experience for group risk products rose to 26.4 percent in December from 23.9 percent in June 2023. However, the claims ratio for individual life business remained stable at 32.3 percent.

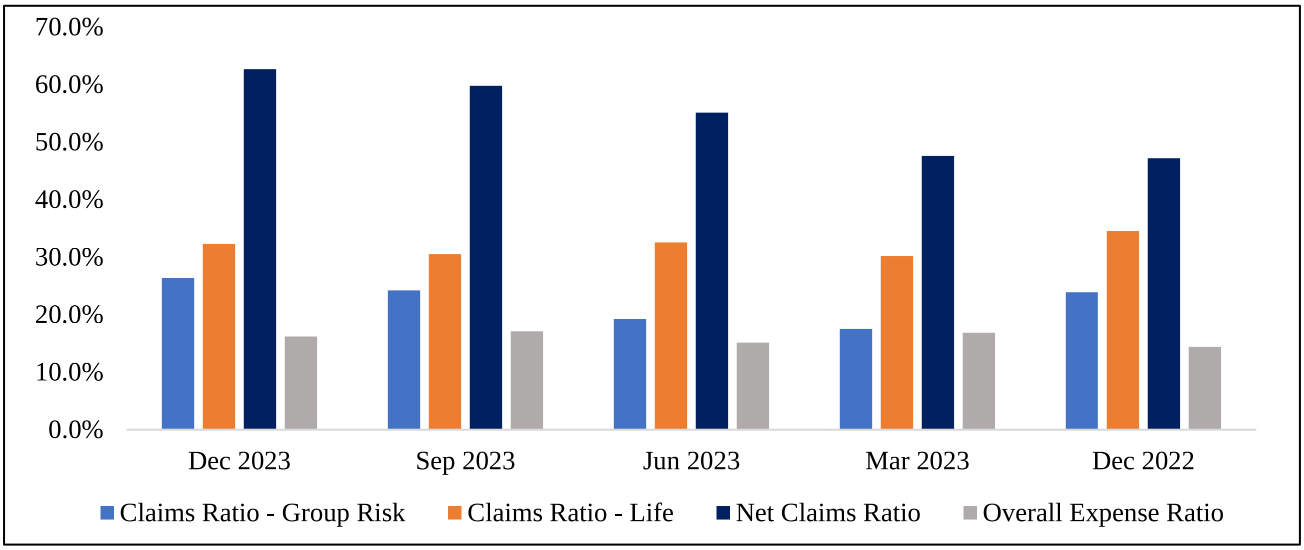
Other Risks to the Life Insurance Sector

Concentration risk remains a significant risk to the life insurance industry considering 79.4 percent of the assets are concentrated in listed equity market and government securities. Hence, the sector is exposed to fiscal and market risks.

Additionally, there is concentration risk due to insurance companies holding a significant number of shares in a single listed company, making them vulnerable to share price fluctuations.

Credit risk remained elevated for smaller life insurance companies. The debtor's ratio declined to 5.3 percent as of December 2023 from the previously reported 11.2 percent in December 2022. Smaller insurance companies had a significantly higher insurance debtor's ratio, averaging above 17 percent. This above-average debtors' ratio is due to weak credit policies and poor collection practices among small life insurers.

Chart 15: Life Insurance Claims and Expense Ratio



Source: Reserve Bank of Malawi

Contagion and market risk remained high during the period under review. Life insurance is crucial for mobilizing resources and providing long-term finance for the capital and banking sectors. The failure of any major insurance company can pose a significant risk to the economy. The insurance sector continues to face market risk due to high inflation, exchange rate fluctuations, and rising interest rates. Market risk can negatively impact the investment income and asset value of insurance companies, which can, in turn, have a negative impact on shareholders and policyholders.

Lastly, compliance risk emanating from the implementation of IFRS 17 remains moderate. As of December 2023, only a few life insurers had adopted IFRS 17 due to challenges in configuring their core systems to meet the new financial reporting standard.

Outlook: Life insurance companies encounter several challenges which can negatively impact their profitability. These challenges include inflation, currency fluctuations, and credit and equity risks. In addition, the implications of adopting IFRS 17 for recognising revenue from insurance contracts are still uncertain, which introduces an element of unpredictability that could adversely affect the industry's overall profitability and capital enhancement. Despite these challenges, the life insurance industry is expected to maintain resilience, even in challenging economic conditions. Insurance providers will continue to play a significant role as a source of capital and financial funding for various other industries.

6.5 Pension Sector

The pension sector faced multiple challenges in the past year. Key was the prevailing macroeconomic instability characterised by high inflation, and high interest rates. Nonetheless, despite the challenging economic environment, the pension sector managed to remain stable and resilient during the half year to December 2023. Asset growth and annual investment returns were recorded high. However, there is still a significant threat due to the high concentration of pension assets in listed equities and government securities, which poses a concentration risk.

Financial position of the pension sector

The financial position of the pension sector improved as evinced by growth in total assets, investment income, and annual pension contributions. **The assets of the sector grew to K2.5 trillion from K2.3 trillion in June 2023, marking a growth of K0.2 trillion in the second half, compared to the K0.7 trillion recorded in the six months to June 2023.** The sector experienced significant increase in contributions but modest increase in investment income during the six months period ending December 2023. Annual contributions grew by 117.6% to K203.3 billion from K93.4 billion in June 2023. Additionally, the investment income increased by 31% to K776.3 billion from K589 billion registered in June 2023, primarily driven by the stock market's positive performance.

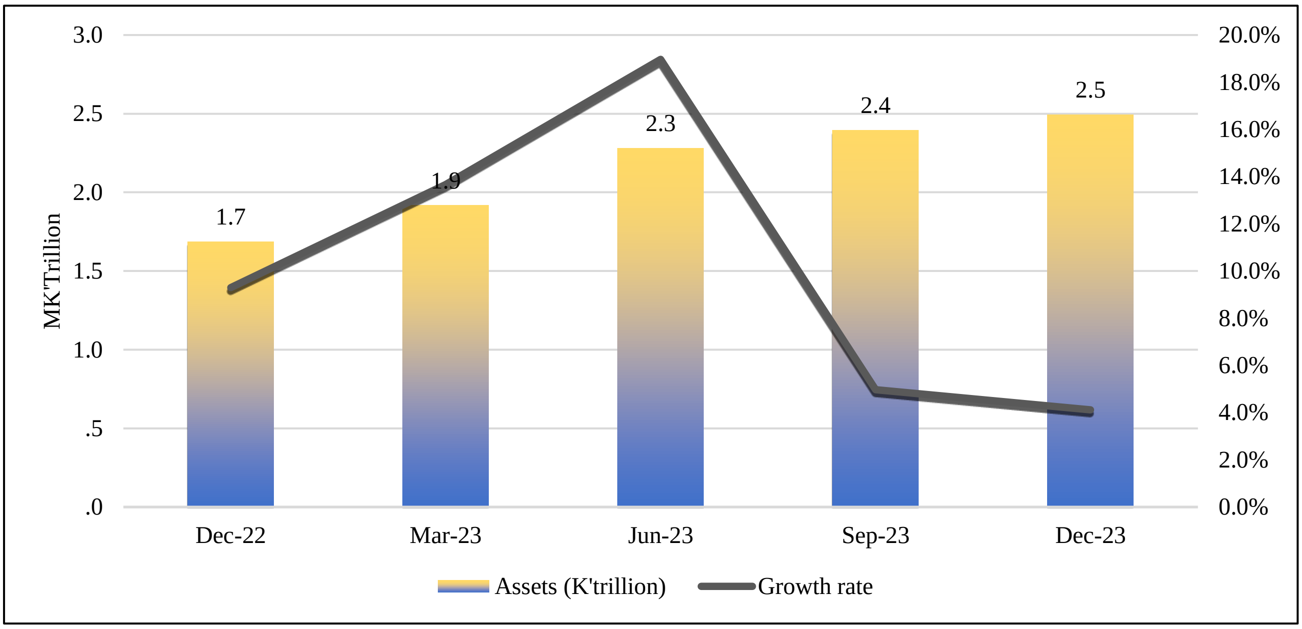
The pension sector however, faced challenges from the non-remittance of pension contributions, amounting to K35.5 billion as of December 2023. In addition, the high concentration of assets in listed equities and government securities posed a risk to the pension sector.

Pension sector asset allocation

The investments determines exposures to market risks and gives an indication of how they react over time to macroeconomic and geopolitical development. At the end of 2023, the total investment assets of the sector reached a market value of approximately K2.5 trillion, representing an increase of

8.6 percent from the June 2023 position. The increase can be broadly explained by the increase in equity values as of 2023.

Chart 16: Growth Rate in Pension Assets



Source: Reserve Bank of Malawi

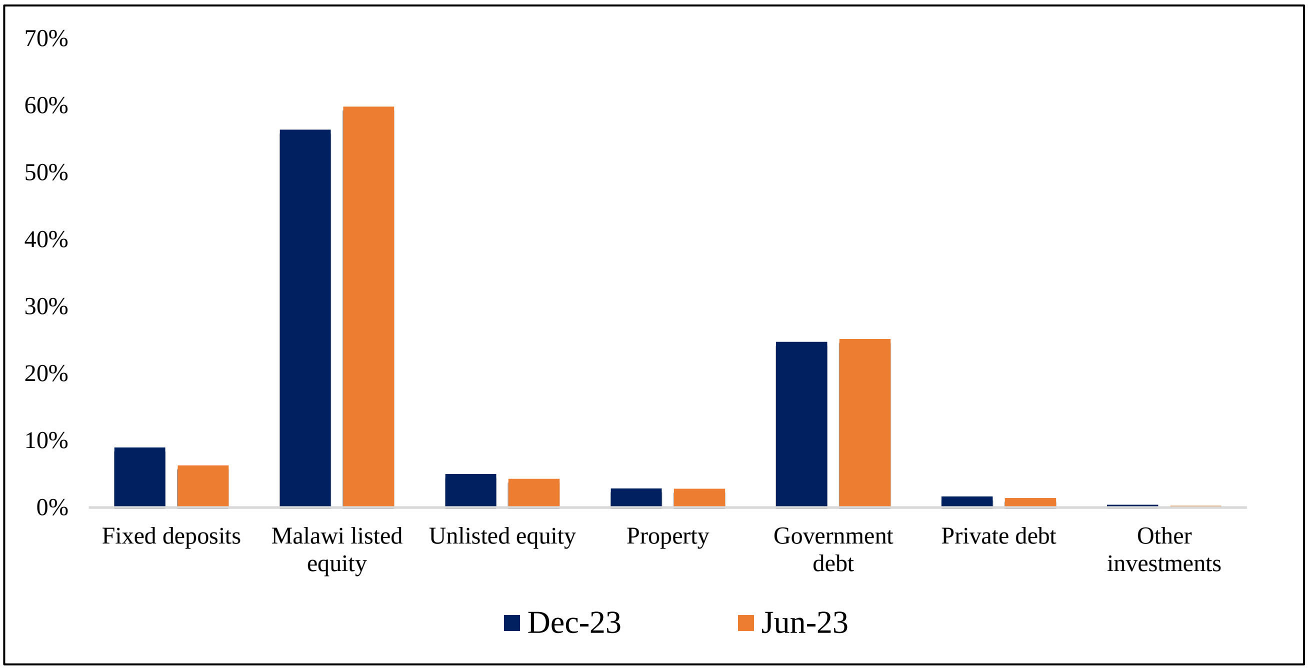
Despite a decline in relative share proportions, the pension sector assets remained predominately concentrated in listed equities and government securities despite decline in share proportions., the share of government securities to total investment marginally decreased to 24.7 percent from 25.1 percent in June 2023. In the same way, the proportion of listed equity as a percentage of total investment decreased to 56.4 percent from 59.8 percent in June 2023. The value of listed equities stood at K1.4 trillion, while government securities amounted to K605.2 billion. Having a large portion of assets in listed equities and government securities puts pension funds at risk from fluctuations in stock prices and interest rates.

Risks from Pension Development

Credit risk remained elevated during the period under review. The pension industry has experienced a growth in pension arrears, which increased from K31.2 billion in June 2023 to K35.5 billion. The government and parastatals have contributed 54 percent of the total contribution arrears. Moreover, the industry's allocation of pension assets in unlisted equities and unlisted debt poses the risk of credit or default by counterparties.

Inflation and currency risk posed a significant threat to the pension sector. The value of member savings has been eroded by the increase in inflation to 34.5 percent. Furthermore, the realignment of the local currency in November 2023 exacerbated the situation by further diminishing the real value of pension funds.

Chart 17: Pension Sector Asset Composition



Source: Reserve Bank of Malawi

Funding risk: The elevated contribution arrears continue to impact the timely settlement of pension benefit claims, leading some members to experience prolonged waiting periods before receiving their benefits.

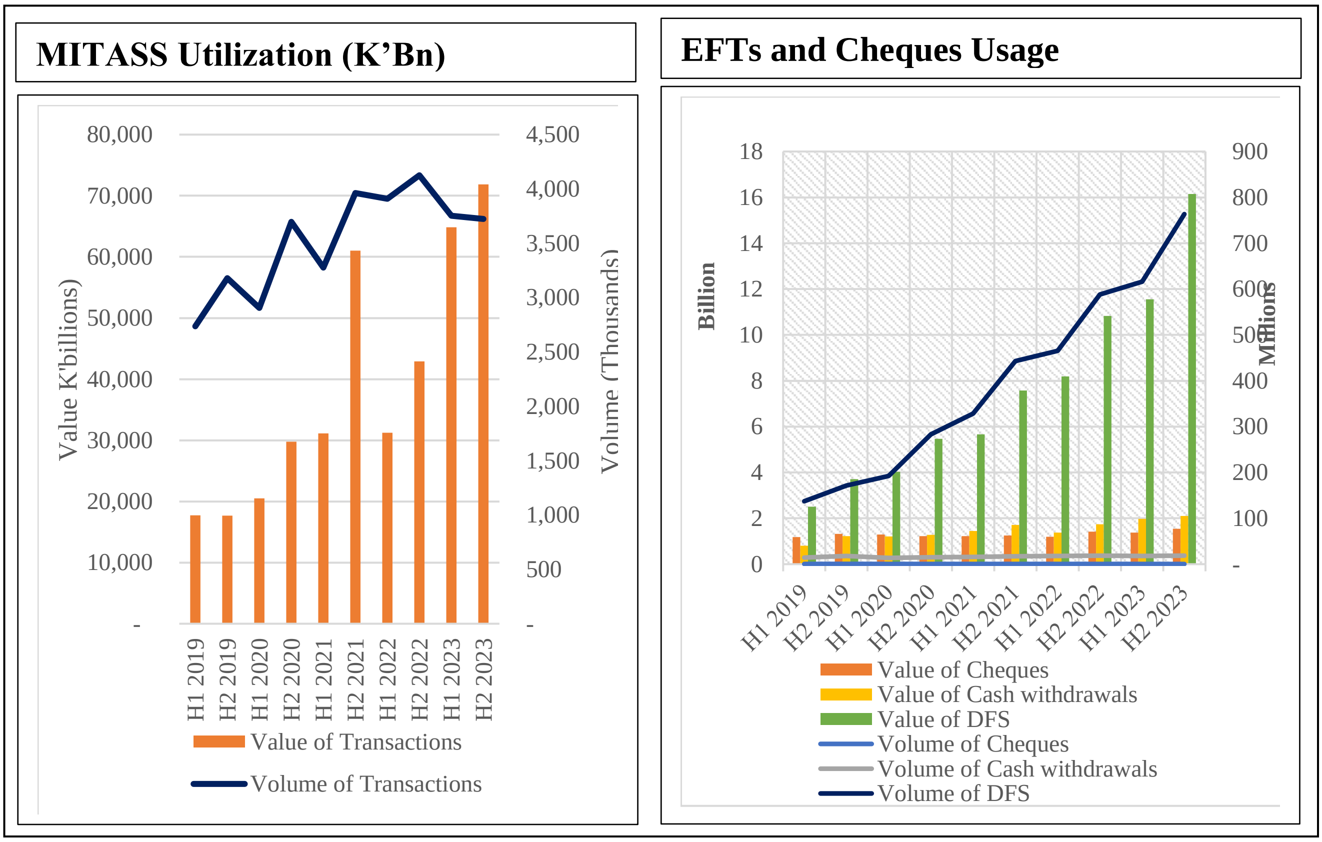
To mitigate some of the above risks, the Registrar issued a press release to warn all employers to settle arrears. The Registrar plans to utilize powers under the Pension Act of 2023 that have significantly strengthened the Registrar's authority to impose more stringent penalties for defaulting employers.

Regarding market risk, the Registrar actively engages with pension funds, promoting diversification of investment assets. Further, the Registrar is in the process of developing a directive on investment of pension assets in a bid to promote diversification. Meanwhile, investment managers continue to adjust their investment portfolios and strive to pursue strategies that can yield real returns in the face of challenging economic conditions during the reviewed period.

6.6 National Payment Systems

The country's major payment systems infrastructure (MITASS) remained stable and available for facilitating smooth payment, clearing and settlement of transactions from various payment streams during the second half of 2023.

Chart 18:Performance of MITASS



Source: Reserve Bank of Malawi

Relative to the first half of 2023, total volumes of transactions processed in the MITASS slightly declined by 0.8 percent to 3.72 million during the period. Despite the drop-in volume of transactions, the corresponding value of transactions surged by 10.8 percent to K71.9 trillion during the same period. This mixed performance shows that most of the transactions were of relatively high value, mostly interbank money market transactions which contributed at least 77.5 percent of total MITASS transactions during the period.

In terms of composition, while large value interbank transactions dominated in terms of value as they accounted for 93.3 percent of the total value of transactions, the industry has seen the dominance of Electronic Funds Transfers (EFTs) over cheques in the past few years, suggesting a substitution effect as more people migrate to quicker and safer means of payments.

For instance, during the period under review, EFTs contributed 85.1 percent of the total volume processed in the system, with cheques only contributing 9.3 percent of the total volume of transactions. This entails that the majority of payment transactions are processed and settled in real-time, thereby mitigating the settlement risk associated with deferred settlement arrangements.

Risks emanating from the Payment Systems. The payment sector is exposed to various risks that could potentially interrupt the smooth functioning of the payment infrastructure in the country. These risks include operational risks caused by network unavailability and power outages, cyber security and fraud risks, especially to retail DFS services, as well as contagion risks due to existing interconnectedness.

During the period under review, fraud risk in mobile money services materialized, but its impact was minimal and did not cause instability in the financial system. Payment service providers are encouraged to continue educating the public through various channels, including Short Message Service (SMS), on how to keep and not reveal their login credentials to anyone since most fraud cases occur through social engineering tactics. Furthermore, the RBM will continue collaborating with other regulatory authorities to minimize fraud and enhance trust in mobile money services. This will help maintain confidence in the national payments system and ensure its safety and efficiency.

Additionally, the RBM will continue to monitor the effectiveness of the risk mitigation measures that have been implemented to safeguard against risks that could affect the smooth operation of key payment infrastructure in the country.

7.0 Summary of Stress Test Results for the Banking Sector

The Registrar of Financial Institutions conducted a stress testing exercise of the banking sector using data as at end December 2023. The Cihak Model was used to assess the resilience and vulnerabilities of institutions in the banking sector to potential shocks arising from credit, liquidity, interest rate, foreign exchange rate, and income risks. The shocks scenarios adopted were informed by historical data on key financial soundness indicators and macro-economic scenarios; and the impact was measured against capital, earnings and liquidity positions.

The pre-shock positions for capital, earnings and liquidity were satisfactory as depicted by core capital ratio of 17.1 percent; return-on-asset ratio at 5.4 percent; and a liquidity ratio of 55.1 percent against regulatory and recommended benchmarks of 10.0 percent, 1.0 percent and 25.0 percent, respectively.

Overall, the stress testing exercise exhibited resilience of the sector to majority of the shocks including successive default of large borrowers, haircuts on liquid assets, interest rate risk, foreign exchange rate risk and income risk. Notwithstanding, the exercise also revealed some vulnerabilities to credit risk shocks on economic sectors, and the overall combination of shocks.

7.1 Credit Risk: Effects of increase in NPLs per economic sectors

This shock aimed to test the resilience of the sector to defaults in economic sectors as per the default rates indicated in Table 4 which were progressively applied from minor, to moderate and major shock scenarios.

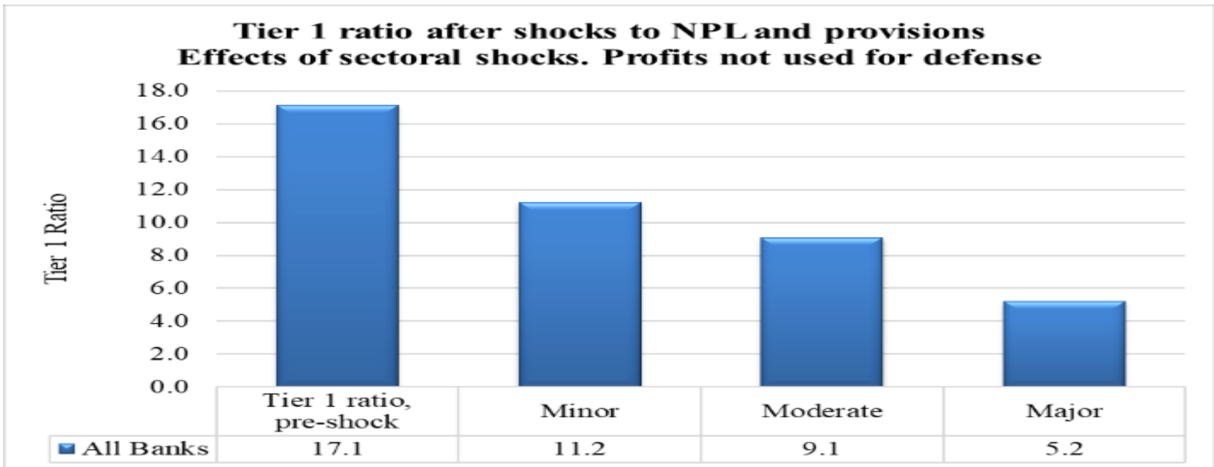
Table 4: Credit Shocks (Percentage increase in NPLs) per Industrial Sector

Sector	Minor	Moderate	Major
Agriculture, forestry, fishing & hunting	30	40	60
Mining & quarrying	15	20	25
Manufacturing	25	35	45
Electricity, gas, water & energy	25	35	45
Construction	25	35	45
Wholesale & retail trade	30	40	60
Restaurants & hotels	40	60	80
Transport, storage & communication	25	35	45
Financial services	15	20	25
Community, social and personal services	30	40	60
Real estate	15	20	25
Assumed Provisional rate (%)	50	50	50
Impact on RWA/capital (%)	100	100	100

Source: Reserve Bank of Malawi

The test revealed that the capital available in the sector was adequate to withstand a minor shock as capital ratio remained above the regulatory benchmark at 11.2 percent. In contrast, the sector became susceptible in the moderate and major shock scenarios as core capital ratios declined to 9.1 percent and 5.2 percent, respectively, thus in breach of the regulatory limit.

Chart 19: Effects of Sectoral Shocks on Core Capital Ratio



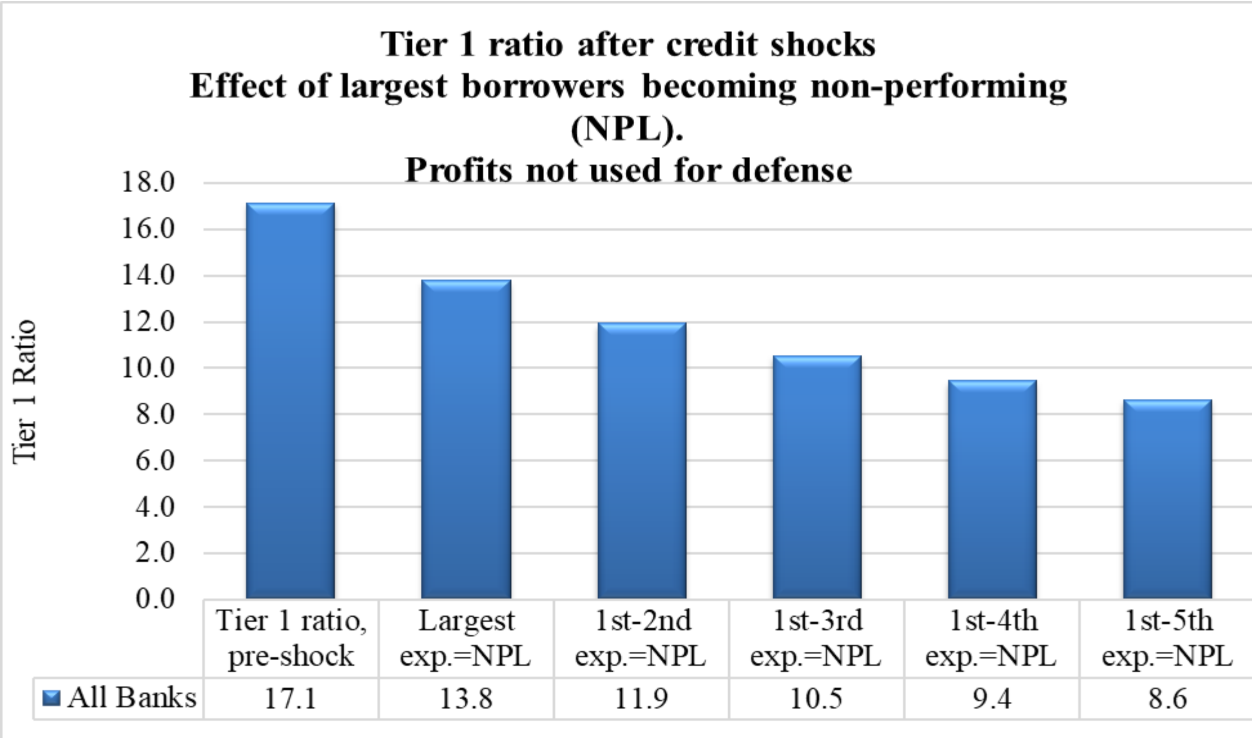
Source: Reserve Bank of Malawi

On an individual basis, five banks sustained core capital ratios above 10.0 percent limit in the minor shock scenario, three banks in the moderate shock scenario and one bank in the major shock scenario.

Effect of Large Borrowers Defaulting

This shock simulated the successive default of the top five borrowers, while assuming an impairment provisioning rate of 50.0 percent on new NPLs.

Chart 20: Effects of Largest Borrowers becoming non-performing



Source: Reserve Bank of Malawi

Notably, the sector was resilient to the shock up to the successive default of the top three borrowers as core capital reduced to 10.5 percent (see Chart 23). However, the sectors core capital ratio declined to 9.4 percent and 8.6 percent following the successive default of the top four and five borrowers. Individually, four of the eight banks demonstrated resilience to the shock by reporting core capital ratios above the 10.0 percent regulatory minimum in all shock scenarios.

7.2 Liquidity Risk

This stress test simulated two shock scenarios namely: hair-cuts to liquid assets while measuring the impact on liquidity ratios; and simulation of deposit runs at different rates and measuring the number of days banks would stay afloat before exhausting all its available liquid assets (see Table 5). The severity of shocks were applied progressively at both bank-specific (BS) and system-wide (SW) level.

Table 5: Liquidity Risk Stress Scenarios (Assumed haircuts and rate of deposit withdraw)

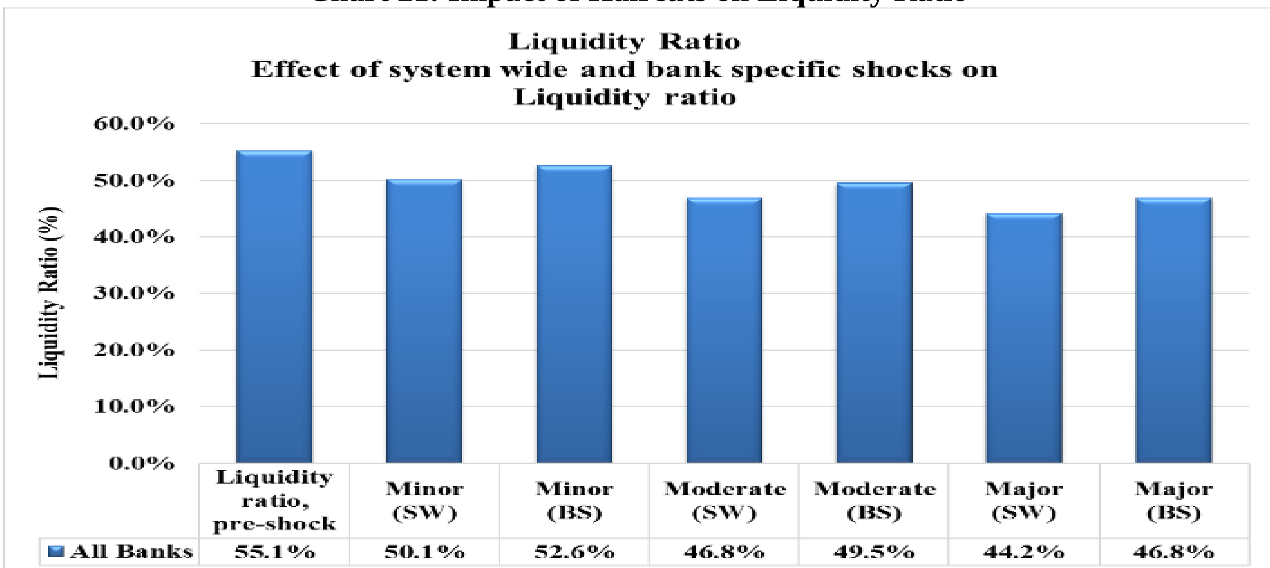
Liquidity Risk Shock	Minor		Moderate		Major	
Hair cuts	**Systemic**	**Bank Specific**	**Systemic**	**Bank Specific**	**Systemic**	**Bank Specific**
Cash	0%	0%	0%	0%	0%	0%
Cheques	10%	5%	20%	15%	25%	20%
Balances with RBM	0%	0%	15%	10%	20%	15%
Local Registered Stock	20%	10%	35%	25%	50%	40%
Nostro	10%	5%	20%	15%	25%	20%
Interbank	20%	10%	30%	15%	50%	20%
Short Term investments	10%	5%	15%	10%	20%	15%
Bills of Exchange	10%	5%	15%	10%	20%	15%
Deposit Run	10%		20%		30%	

Source: Reserve Bank of Malawi

Impact of Hair-Cuts on Liquidity Ratio

The sector was resilient to this shock as liquidity ratios remained well above the prudential limit of 25.0 percent in both system-wide and bank-specific major shock scenarios at 44.2 percent and 46.8 percent, respectively. Individually, all banks were resilient to this shock as they sustained liquidity ratios above the prudential limit in all shock scenarios.

Chart 21: Impact of Haircuts on Liquidity Ratio



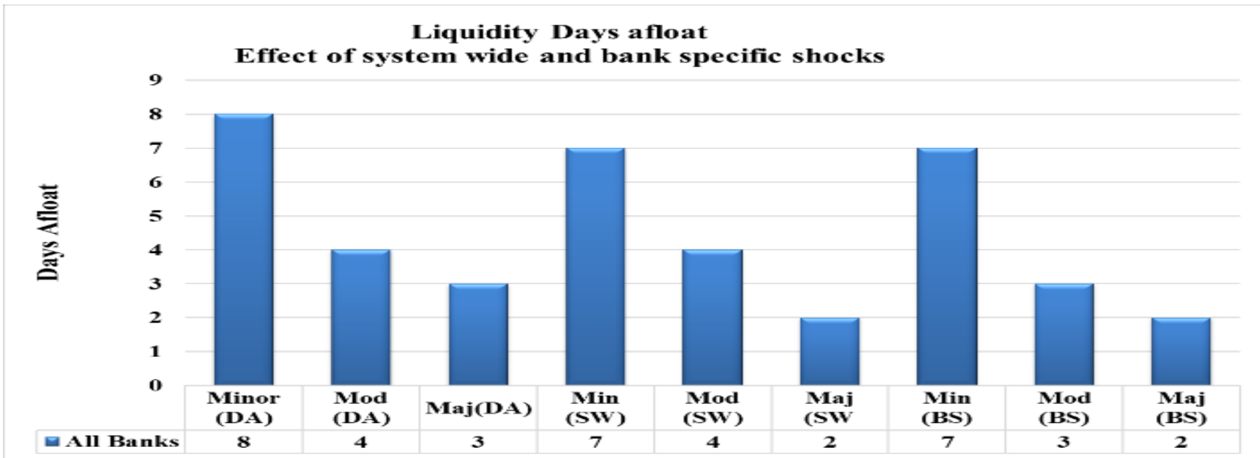
Source: Reserve Bank of Malawi

Impact of the Deposit Run

This shock scenario was designed to assess the ability of the sector to survive a daily liquidity drain following sudden deposit withdraws by customers without resorting to external liquidity support.

Daily deposit run-off rates were set at 10.0 percent, 20.0 percent and 30.0 percent for minor, moderate and major shock scenarios, respectively and were simulated with corresponding hair-cuts (refer Chart 21) with results measured against a benchmark survival period of five days.

Chart 22: Effect of System Wide and Bank Specific Shocks-Liquid Days Afloat



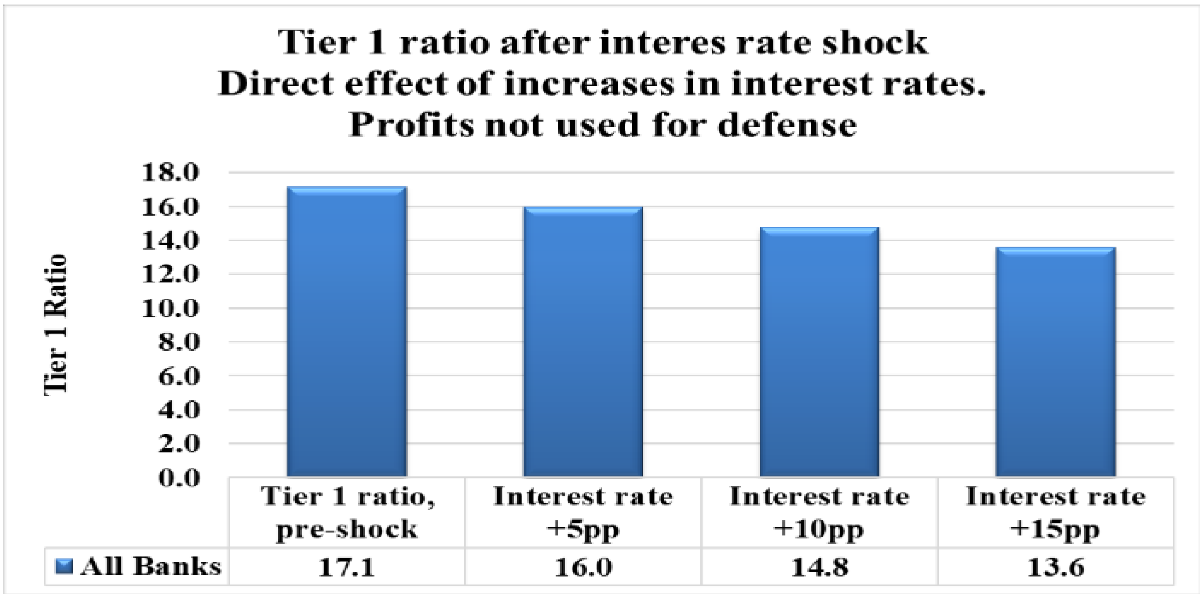
Source: Reserve Bank of Malawi

The stress results revealed that the sector would only survive a minor shock of 10 percent deposit run. Individually, six banks met customer demand for deposits in the minor case scenarios at bank specific level while five banks managed a system-wide scenario. Beyond the minor shock scenarios, only one bank survived the moderate shock scenario in both system-wide and bank specific cases. No banks survived the major shock scenarios.

7.3 Interest Rate Risk

This shock assessed the resilience of the sector to fluctuations in interest rates by measuring its impact on the balance-sheet net interest rate sensitivity gap. Scenarios simulated included both upwards and downwards shifts in interest rates, particularly by 5.0 percentage points; 10.0 percentage points; and 15.0 percentage points in the minor, moderate and major shock scenarios, respectively.

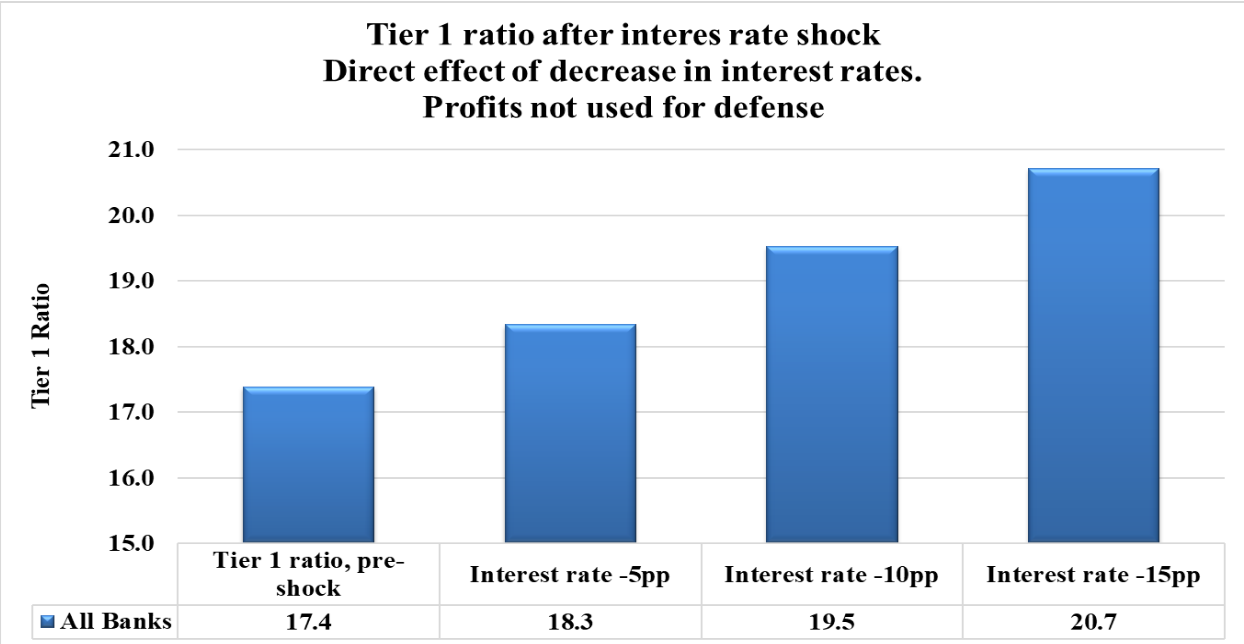
Chart 23: Direct Effects of increase in Interest Rates



Source: Reserve Bank of Malawi

Notably, the sector had more interest rate sensitive liabilities than assets, thus being liability sensitive. Therefore, increase in interest rates resulted to decline of the sector's core capital ratio (See Chart 23) while decrease in interest rates led to increase of the core capital ratio (Chart 24). All in all, the sector was resilient to all shock scenarios.

Chart 24: Direct Effects of decrease in Interest Rates



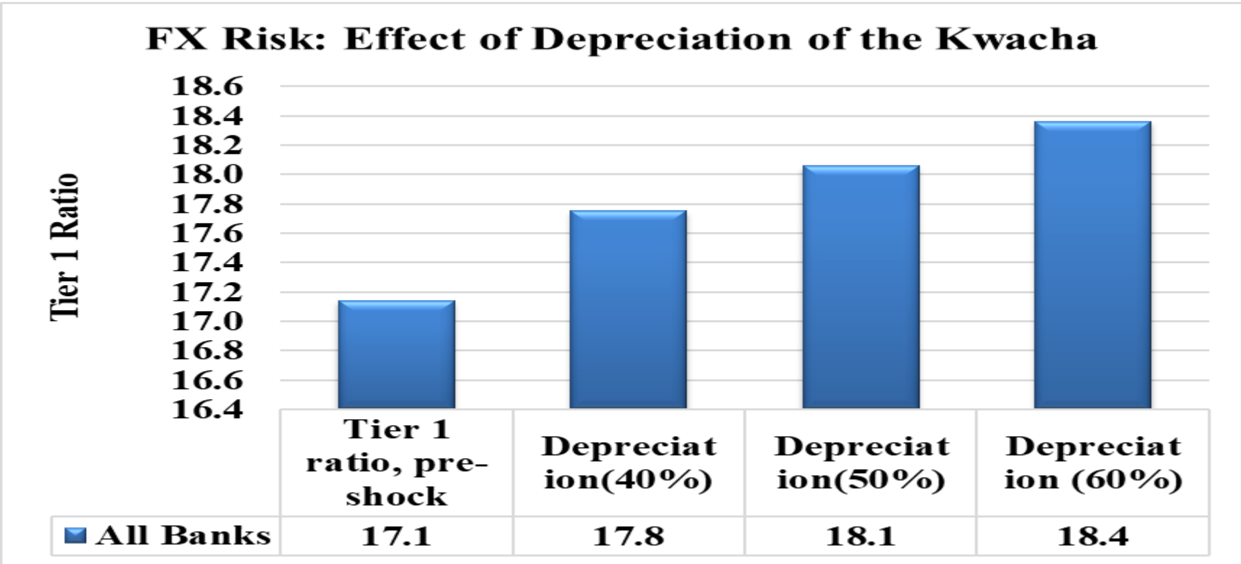
Source: Reserve Bank of Malawi

On an individual bank basis, one bank's core capital ratios increased while seven banks' core capital ratios declined as interest rates rose. Conversely, seven banks progressively increased in core capital ratios while core capital ratio for the remaining one bank declined as interest rates decreased.

7.4 Foreign Exchange Rate Risk

This shock aimed to assess the resilience of the sector to the depreciation of the Kwacha against major trading currencies. Depreciation rates of 50.0 percent, 75.0 percent and 100.0 percent were adopted for minor, moderate and major shock scenarios, respectively.

Chart 25: Effects of Depreciation of the Kwacha on Core Capital



Source: Reserve Bank of Malawi

Stress test results indicated that depreciation of the Kwacha against major trading currencies would result in increase of core capital ratio for the sector (see chart 25). This is attributed to the sector's net long position in foreign currency. Conversely, appreciation of the Kwacha against major trading currencies implied a decline in the sector's core capital.

On a solo bank level, all core capital ratios increased as the Kwacha depreciated against major trading currencies except for two banks, nonetheless, core capital ratios for all banks remained above the prudential limit.

7.5 Income Risk

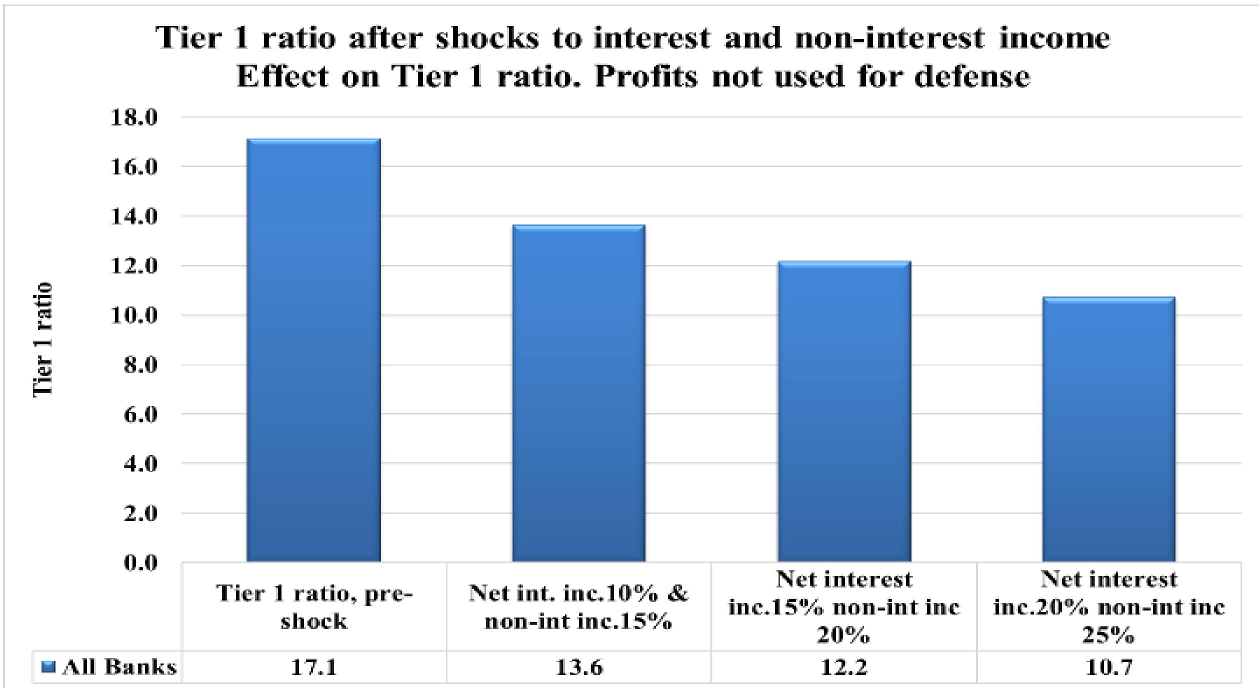
Income risk stress tests were designed to assess the impact of declines in both interest income and non-interest income on the sector's core capital ratio and ROA.

Scenarios adopted included decline of a 10.0 percent and 15.0 percent in the minor shock scenario; 15.0 percent and 20.0 percent in the moderate shock scenario; and 20.0 percent and 25.0 percent in the major shock scenario, for interest and non-interest income, respectively.

Effect on Core Capital after Shocks to interest and non-interest Income

Core capital ratio declined to 10.7 percent in a major shock scenario thereby indicating that the sector would remain resilient to shocks on income.

Chart 26: Effects on Core Capital Ratio after Shocks to Interest and Non-Interest Income



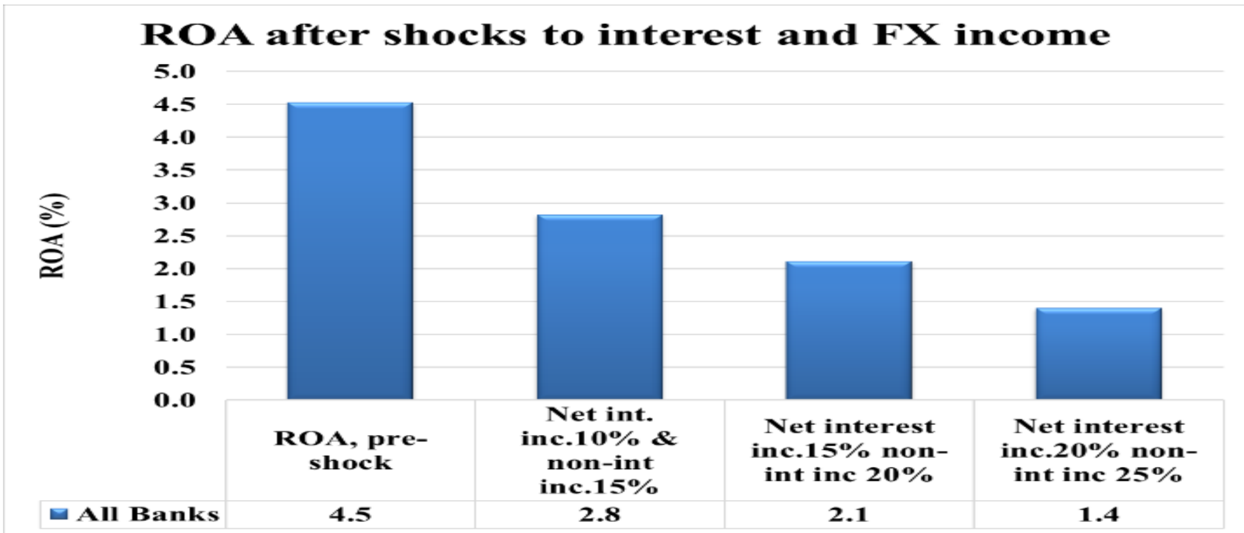
Source: Reserve Bank of Malawi

Individually, four banks were resilient to all income risk shocks as they maintained core capital ratios above the regulatory benchmarks in all shock scenarios. The other four banks however succumbed to at least moderate-income shocks.

Effect on ROA after Shocks to Interest and Non-Interest Income

The impact of income shocks was also evaluated against the sector's ROA ratio. As at end December 2023, ROA of 4.5 percent for the sector was deemed satisfactory (refer to chart 26).

Chart 27: ROA after Shocks to Interest and Non-Income



Source: Reserve Bank of Malawi

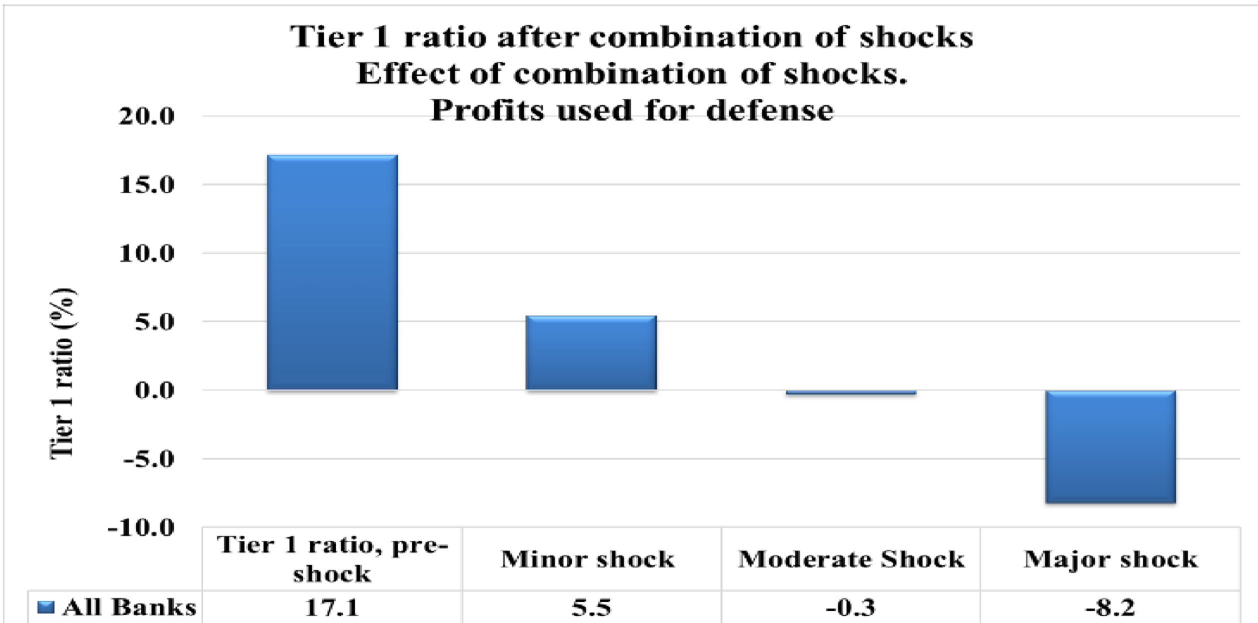
Results of the stress test indicated that the sector was resilient as ROA remained above 1.0 percent even after a major shock scenario. Individually, six of the eight banks survived the income shocks by maintaining ROA above 1.0 percent in the major shock scenario.

7.6 Combination of Shocks

The test simulated a combination of shocks to evaluate the impact of multiple shocks occurring simultaneously to account for the non-exclusive nature of shock events. Thus, four shocks were covered namely; credit shock on economic sectors, foreign exchange rate risk, increasing interest rate risk, and autonomous shocks to income.

The results revealed that the sector was vulnerable to the shock as core capital ratio declined below the regulatory benchmark in all shock scenarios. Particularly, core capital ratio declined to 5.5 percent, 0.3 percent and negative 8.2 percent in the minor, moderate and major shock scenarios, respectively (See Chart 28).

Chart 28: Effects of Combination of Shocks on Core Capital



Source: Reserve Bank of Malawi

Notably, credit risk shocks had the largest impact on core capital, seconded by income risk; while impact of interest rate risk and foreign exchange rate risk shocks were minimal. Similarly, all banks individually succumbed in all the combination of shocks scenarios as each bank registered core capital ratios below the regulatory limit.

Conclusion

The stress testing exercise provided valuable insight on resilience and vulnerabilities in the banking sector considering inherent risks and adverse movements in the macro-financial fundamentals. The sector particularly indicated resilience to haircuts on liquid assets, shocks to interest rate risk, foreign exchange risk and income risk. The sector also depicted some resilience to the successive default of top five borrowers.

This notwithstanding, the sector portrayed vulnerabilities in respect to credit risk shocks (increase of NPLs in various economic sectors); and a deposit run on the sector's liquidity measured against number of days afloat. Furthermore, the sector was also succumbed to the combination of shocks.

Box 4: Stress Testing Model Issues

The RBM used the stress testing model developed by Martin Cihak of the IMF. The model has been modified and adapted at various stages in order to incorporate particular aspects of the economy and the banking sector. In its present form, the stress testing spread sheet allows analysis of the effect of the various stress testing scenarios on measure of capital adequacy, liquidity and earnings.

In respect with capital measure, the Core Capital ratio was chosen. However, other measures of capital adequacy may be selected, e.g. Total equity/Risk weighted assets or Total equity/Total assets (Leverage ratios). In the model, banks and authorities are assumed not to take an action to mitigate the shock. The RBM will continue to periodically review the model to enhance the stress testing process.

8.0 Bank Lending Survey Results

Introduction

The Reserve Bank of Malawi conducted the second 2023 bi-annual Bank Lending Survey from 27th November 2023 to 1st December 2023. The survey was aimed at obtaining and analysing commercial banks' perceptions of risks affecting the banking system and developments in Malawi's credit market. The survey reviewed the six-month period from July to December 2023, as well as expectations for the six-month period up to June 2024. The survey was conducted using a qualitative questionnaire that comprised rating, ranking and open-ended questions. Questionnaires were administered on demand for and supply of credit, credit standards for approving loans, non-performing loans, systemic risks in the banking system and a number of ad-hoc questions were included on recent developments in the financial sector. All eight banks in Malawi participated in the survey, representing a response rate of 100.0 percent. This report presents the findings of the survey.

In summary, a majority of banks perceived an increase in demand for credit across all three economic agents (households, small and medium enterprises (SMEs) and large enterprises) in the period under review. The perceived increase in demand for credit was in general, largely attributed to financing needs with respect to seasonal commodity financing, rising consumption expenditure and additional working capital. However, there has been moderate uptake of credit by large enterprises, as business slowed down in the period under review. This was attributed to the unstable macroeconomic environment characterized by adverse factors such as rising inflationary pressures and interest rates; acute foreign exchange shortage and fuel scarcity. In terms of looking ahead to June 2024, banks envisage continued increase in demand for loans and credit lines across the three economic agents, as the deterioration of macroeconomic fundamentals is expected to continue suppressing purchasing power.

In terms of the supply of credit, most banks indicated that their credit standards and conditions for the approval of loans and credit lines to economic agents remained tightened in the second half of 2023 for both short term and long-term loans. The tightening position points to a persistent deteriorating macroeconomic fundamental characterized by rising interest rates. The tightening impact of banks' cost of funds on credit standards for loans to firms remained contained and broadly unchanged compared with the previous quarter. In the first half of 2024, most banks expect to further tighten standards and conditions for lending as they anticipate that the macroeconomic environment will continue deteriorating.

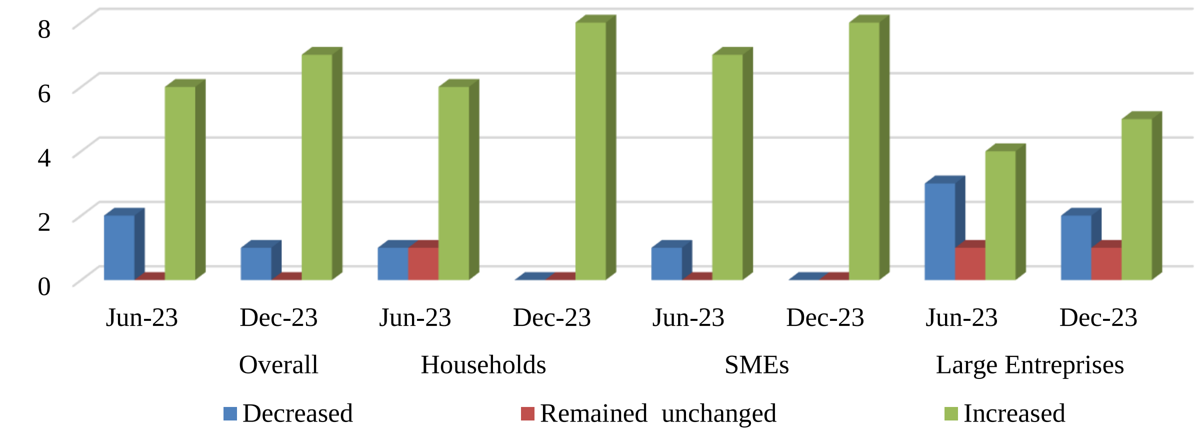
In terms of non-performing loans (NPLs), most banks perceived an increase in NPLs across all the three economic agents. This was attributed to the deteriorating macroeconomic fundamentals characterized by the continued rise in inflation and interest rates; and foreign exchange shortages which affected the capacity of borrowers to service their loan obligations. In the first half of 2024, most banks anticipate NPLs from all economic agents to increase. This is mainly attributed to banks' expectations about continued deterioration of the macroeconomic fundamentals characterized by rising inflation and interest rates, declining disposable income, the effects of the local currency realignment and the forex shortages.

8.1 Perceptions on Demand for Credit

The majority of banks perceived an increase in demand for loans and credit lines across all the three economic agents in the period under review, July to December 2023 (Chart 29). This confirms the developments in private sector credit as credit to the private sector from commercial banks rose from K1.07 billion to K1.21 billion during the second half of 2023. Nonetheless, annual private sector credit growth decelerated to 17.9 percent in December 2023 from 24.1 percent in December 2022. In real terms, the annual growth rate in private sector credit remained negative and stood at minus 11.3 percent in December 2023 from minus 1.3 percent in December 2022. The deceleration in the growth rate of private sector credit is largely supported by tight monetary stance implemented in 2023 to curb the high inflation.

The perceived increase in demand for credit was largely attributed to the deteriorating macroeconomic fundamentals characterized by adverse factors such as rising interest rates, forex shortages, and rising inflationary pressures, which have undermined both business and personal purchasing power, driving increased appetite for credit to augment working capital for business agents and consumption expenditure for individual borrowers. Consequently, this has prompted some existing and new customers to request additional financing on their facilities from the banks in order to cushion the impact of rising costs. Further, some banks embarked on initiatives to expand their consumer lending portfolio in particular with civil servants' loans.

Chart 29: Demand for loans by Sector



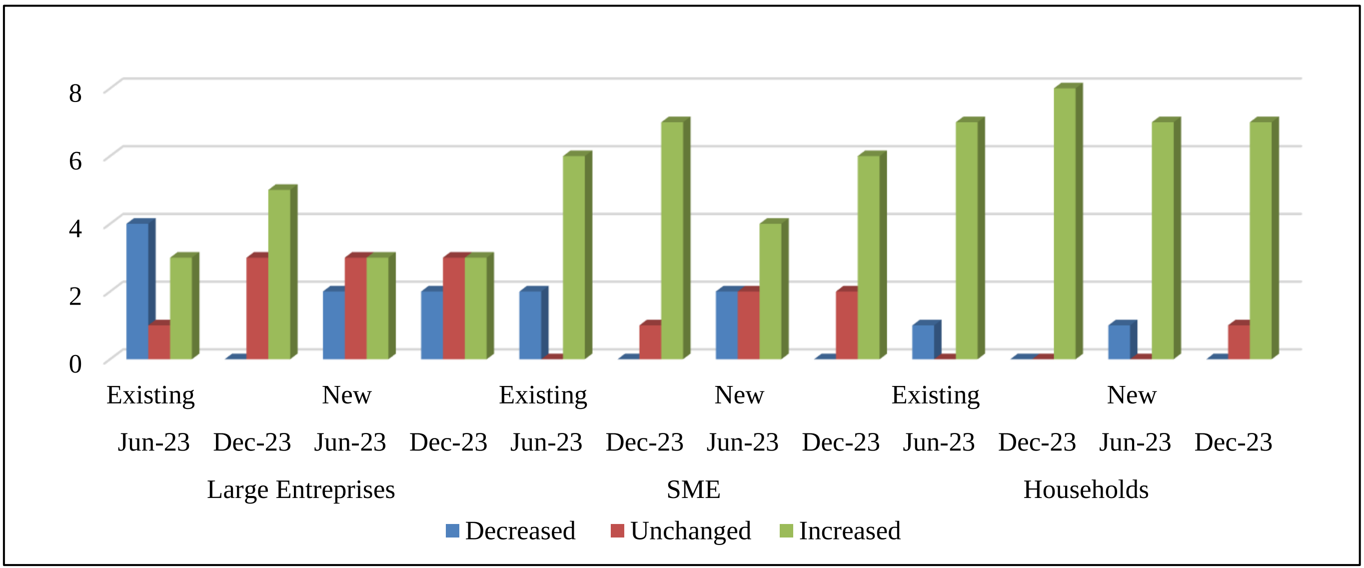
Source: Reserve Bank of Malawi data

Specifically, for households, seven out of eight banks perceived an increase in the demand for loans in the period under review. Meanwhile, for SMEs, all eight banks perceived an increase in demand for loans and credit lines in the December 2023 survey position, however, for large enterprises only five banks out of the eight perceived the increase in credit demand in the second half of the year.

8.1.1 Composition of Demand for Loans by Existing and New Customers

The survey found that the perceived increase in the demand for loans and credit lines for SMEs and households in most banks was attributed to both existing and new customers during the second half of 2023 (Chart 30). Specifically, for SMEs, seven of the eight banks indicated that the increase in demand for loans and credit lines was from existing customers while in the category of new loans only six of the eight banks attributed the increase from new customers. For households, all eight banks indicated that the increase in demand was on account of existing customers, while in the category of new loans, only seven out of the eight banks attributed to the increase from new customers. Meanwhile, for large enterprises, five of eight banks indicated that the increase in demand for loans was from existing customers while in the category of new loans, three out of eight banks attributed to the increase for new customers.

Chart 30: Contribution to demand for loans

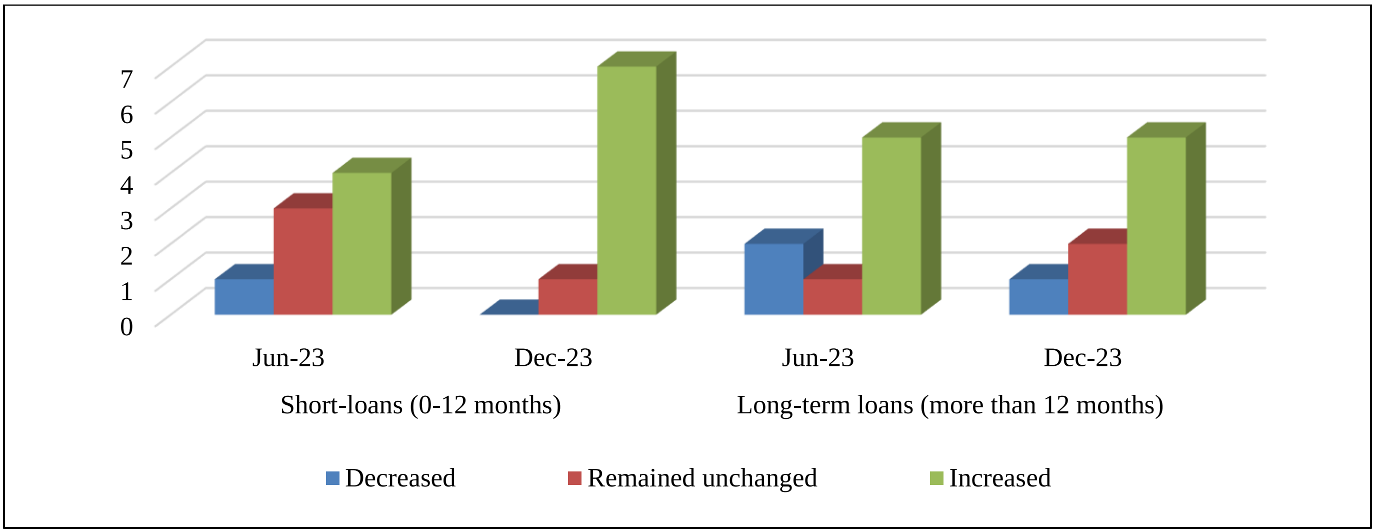


Source: Reserve Bank of Malawi data

8.1.2 Demand for Loans by Duration

The findings of the survey revealed that seven out of the eight banks perceived an increase in demand for short-term loans in the second half of 2023 whilst five out of eight banks perceived an increase in demand from long term loans. It is worth noting that the banks' perception of demand for long term loans remained unchanged while the demand for short term loans increased from four banks to seven banks recorded in the December 2023 survey (Chart 31).

Chart 31: Demand for loans by tenure

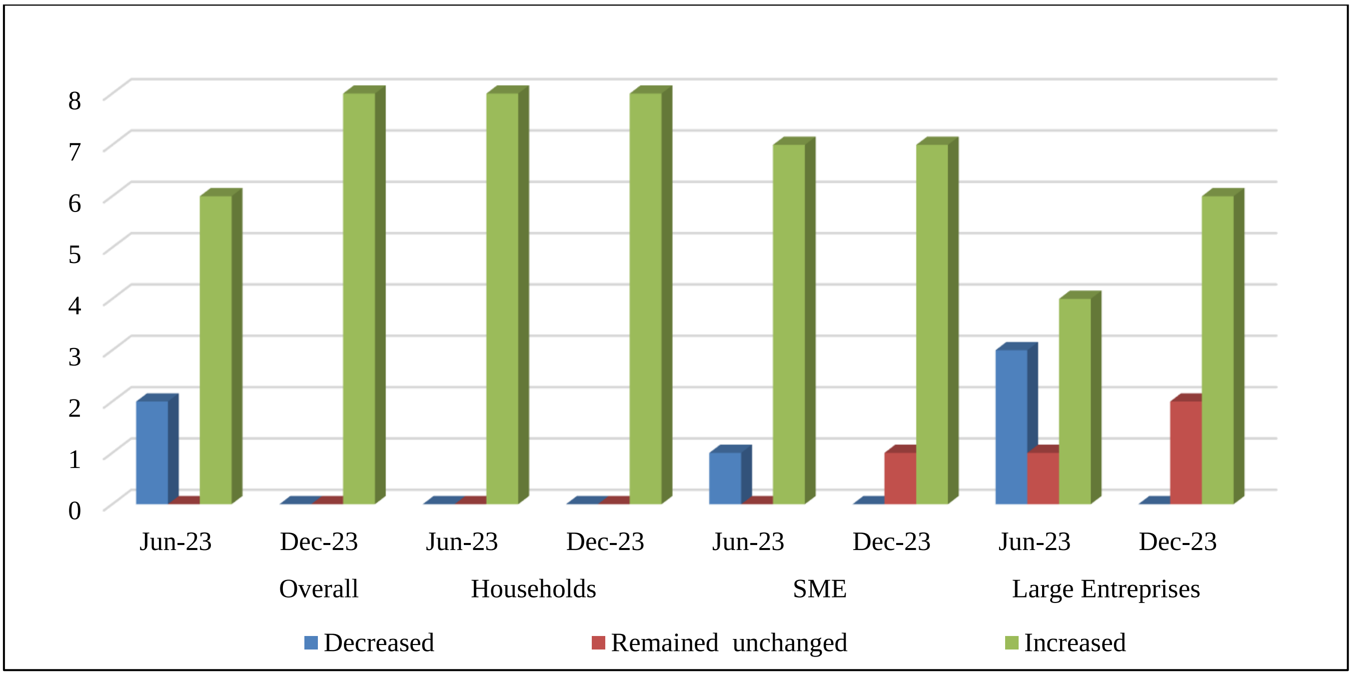


Source: Reserve Bank of Malawi data

8.1.3 Outlook for Demand for Loans

In terms of outlook, looking ahead to the period up to June 2024, banks envisage continued increase in demand for loans and credit lines across the three economic agents, as macroeconomic fundamentals are expected to continue deteriorating and suppressing purchasing power. Further, banks perceive continued low supply of foreign exchange, which could further exert downward pressure on the local currency and increase working capital gaps for economic agents that have import dependent businesses.

Chart 32: Projected Demand for Credit

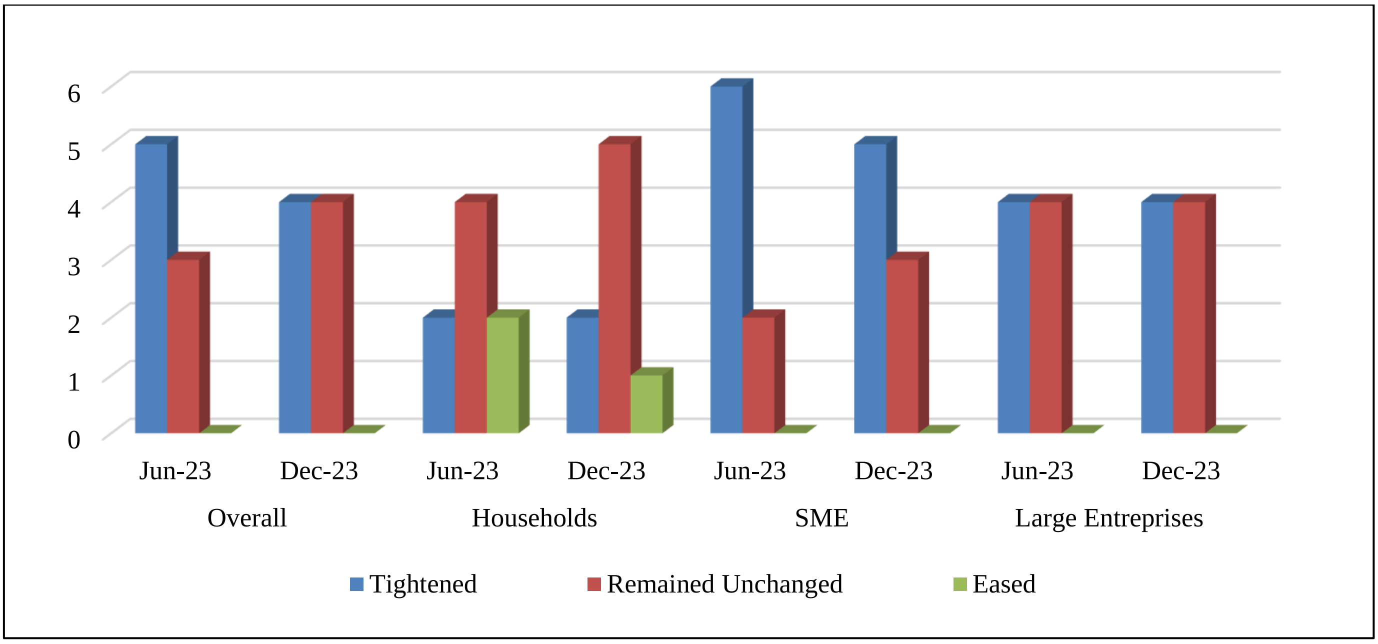


Source: Reserve Bank of Malawi data

8.2 Developments in Credit Supply Conditions

In the second half of 2023, a majority of the banks continued to maintain tight credit standards and conditions for approval for both short term and long-term loans, similar to the position reported in the previous survey period, July to December 2023. Precisely, four of the eight banks tightened further credit standards and conditions, while the remaining four banks reported to have maintained the tight credit standards and conditions for approval of loans. To a large extent, the factors that contributed to further tightening of credit standards and conditions for approving loans stemmed mainly from an increase in the default rate of economic agents and the banks' perception on the uncertain macroeconomic environment.

Chart 33: Credit Supply Conditions



Source: Reserve Bank of Malawi data

Specifically, for large enterprises, four of the country's eight banks reported that they maintained tight credit standards and conditions for approval of loans. This is similar to the position in the June 2023 survey. In contrast, four out of the eight banks reported to have tightened further the credit standards and conditions for approval of loans to the large enterprises.

Regarding the SMEs sector, six banks reported that they had tightened further the credit standards and conditions for approval of loan while two banks reported to have maintained the credit standards and conditions for approval of loans to the sector in the second half of 2023. For households, four out of eight banks reported that they maintained tight credit standards and conditions for approval of loans, however, four banks out of the eight banks continued to tighten credit stands and conditions for approval of loans similar to the position in the June 2023 survey. However, lending to SMEs and households reflected a substantial growth, as economic agents in these categories attempted to augment their eroded purchasing power due to inflationary pressures.

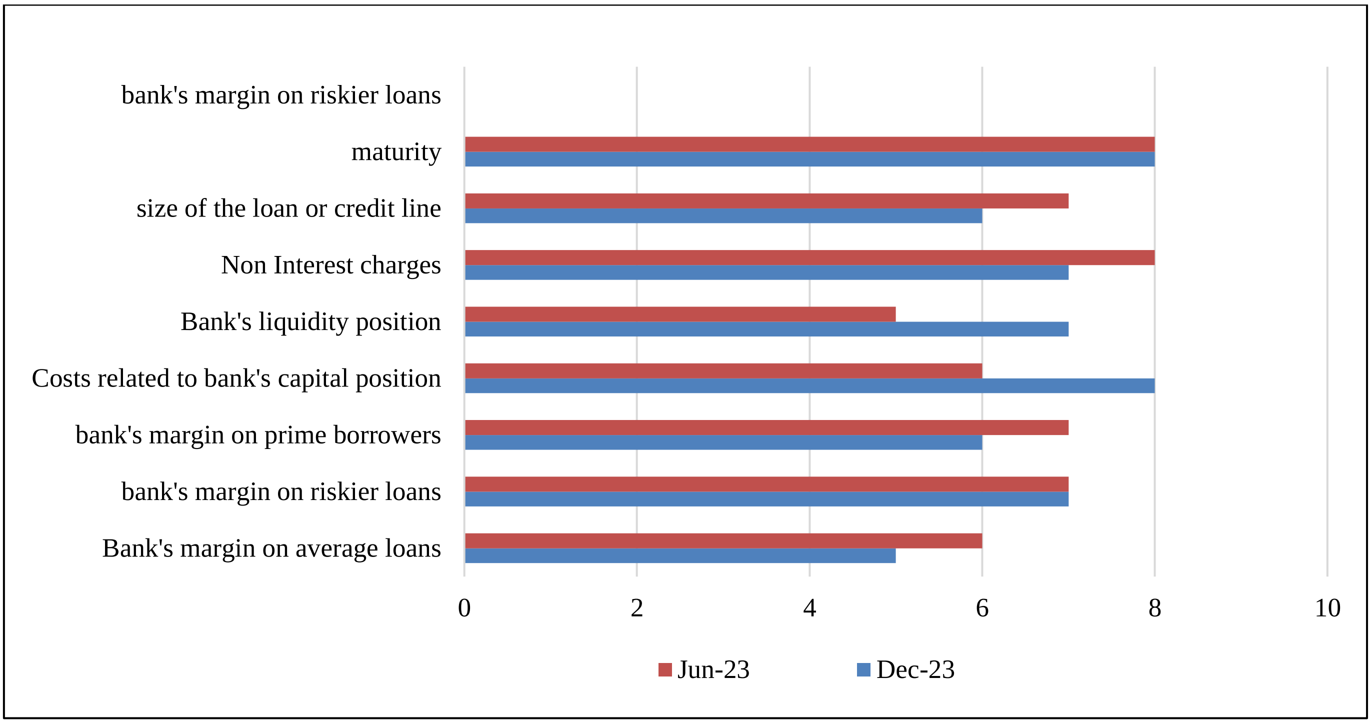
The upward adjustment of the policy rate to 24.0 in July 2023 from 22.0 percent and the subsequent increase in attendant interest rates, coupled with persistent inflation have caused banks to take a cautious approach in their intermediation role. This is on account of a perceived adverse impact on their balance sheets on account of possible further loan defaults.

Thus, most banks expect to tighten somewhat credit standards and conditions in the next six months to June 2024, in particular for SMEs and large enterprises, owing to expectations of a continued unstable macroeconomic environment due to rising inflation and ongoing acute foreign exchange shortage. Meanwhile, banks expect credit standards and conditions for households to ease somewhat. This is mainly attributed to the access of payroll loans which are deducted at source and reduce the risk of default.

8.2.1 Factors Affecting Credit Supply Conditions by Sector

In addition to the uncertain macroeconomic environment, banks cited a number of individual bank specific factors that led to generally tight credit standards and conditions for approval of loans in the second half of 2023. These factors included, inter alia, bank liquidity position, non-interest charges, bank's margin on prime borrowers, bank's margin on average loans and bank's margin on riskier loans (Chart 34).

Chart 34: Bank specific factors affecting tightened credit supply conditions



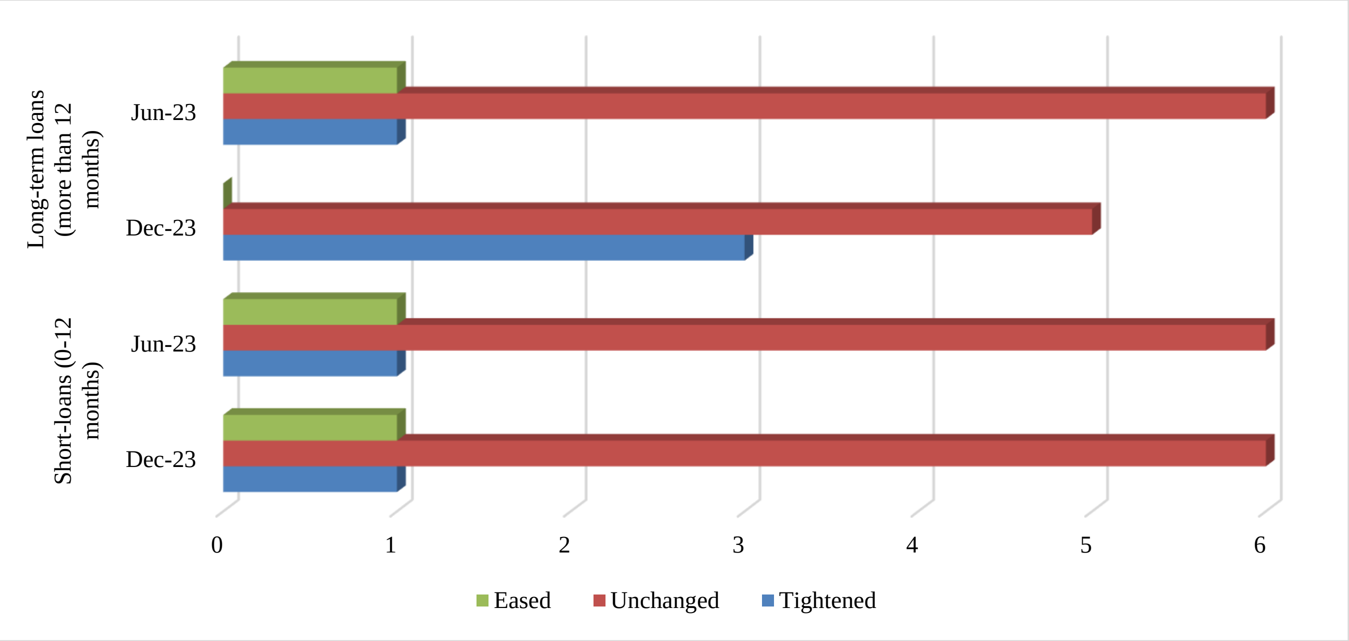
Source: Reserve Bank of Malawi data

8.2.2 Developments in Supply Conditions by Duration

In terms of loan duration, the credit standards and conditions for approval of loans showed marks of tightening in the long term whilst the standards and conditions for short term loans remained unchanged in the second half of 2023.

For short-term loans, six banks reported to have maintained the credit standards and conditions for the approval of loans while one bank indicated that it tightened the conditions and one bank indicated easing of credit standards. Meanwhile, five out of the eight banks reported that credit standards and conditions for approval of long-term loans remained unchanged in the period under review while three banks indicated to have tightened the conditions further unlike one bank in the previous survey (Chart 35). The major reasons cited by banks for the tightening of credit standards and conditions for the approval of loans include high risk of default attributed to the unstable macroeconomic environment.

Chart 35: Credit supply conditions by tenure



Source: Reserve Bank of Malawi data

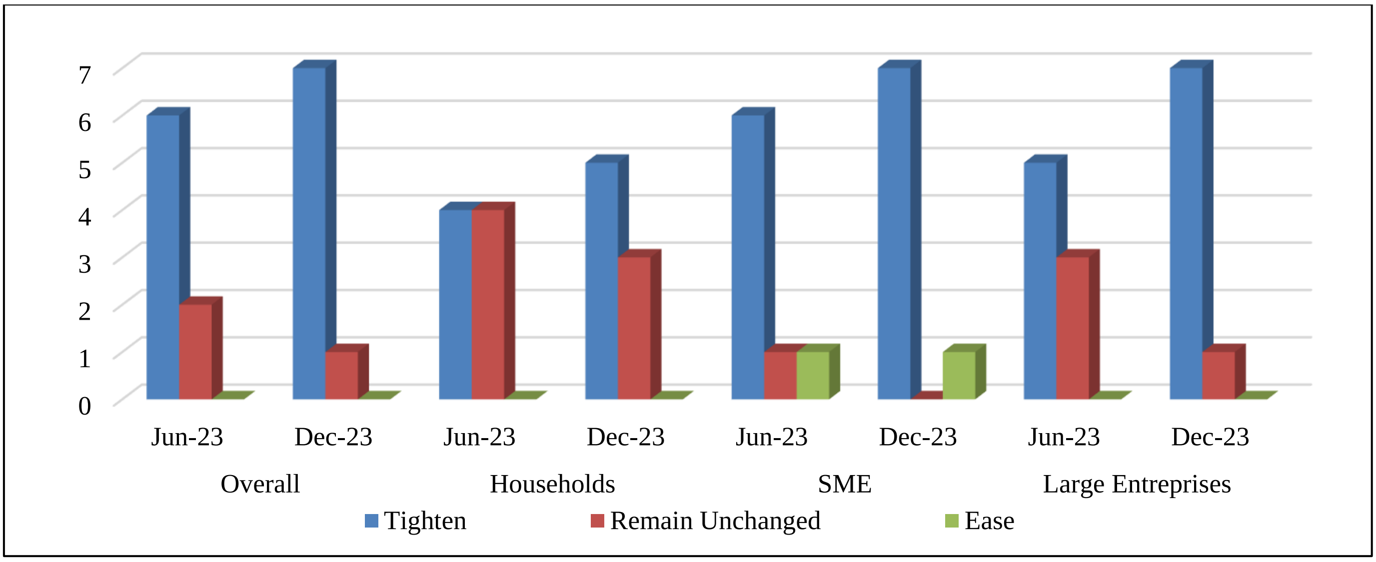
8.2.3 Prospects for Credit Supply Conditions

Most banks expect to tighten somewhat credit standards and conditions for approval of loans in the next six months to June 2024 for all economic agents, owing to expectations of a continued unstable macroeconomic environment due to rising inflation, rising interest rates, high public debt and ongoing acute foreign exchange shortages.

Overall, seven out of the eight banks indicated that they will further tighten credit standards and conditions for approval of loans while one bank indicated that they will maintain the credit stands and conditions for approval of loans. The major reasons cited for the anticipated tightening include the deteriorating macroeconomic fundamentals, which has increased cost of business operations and the need to reduce exposure to the risk of default.

Specifically, for households, five banks indicated that they will further tighten the credit standards and conditions for the approval of loans, while three banks reported that they will leave the conditions unchanged. Similarly, for SMEs, seven banks reported that they expect to further tighten credit standards and conditions for approval of loans while for large enterprises, seven banks reported that they expect to further tighten credit standards and conditions for approval of loans while one bank indicated that they will maintain the standards. Meanwhile, one bank reported that it will ease the credit standards for SMEs for the sector in order to grow the loan book in the sector.

Chart 36: Prospects for credit supply conditions

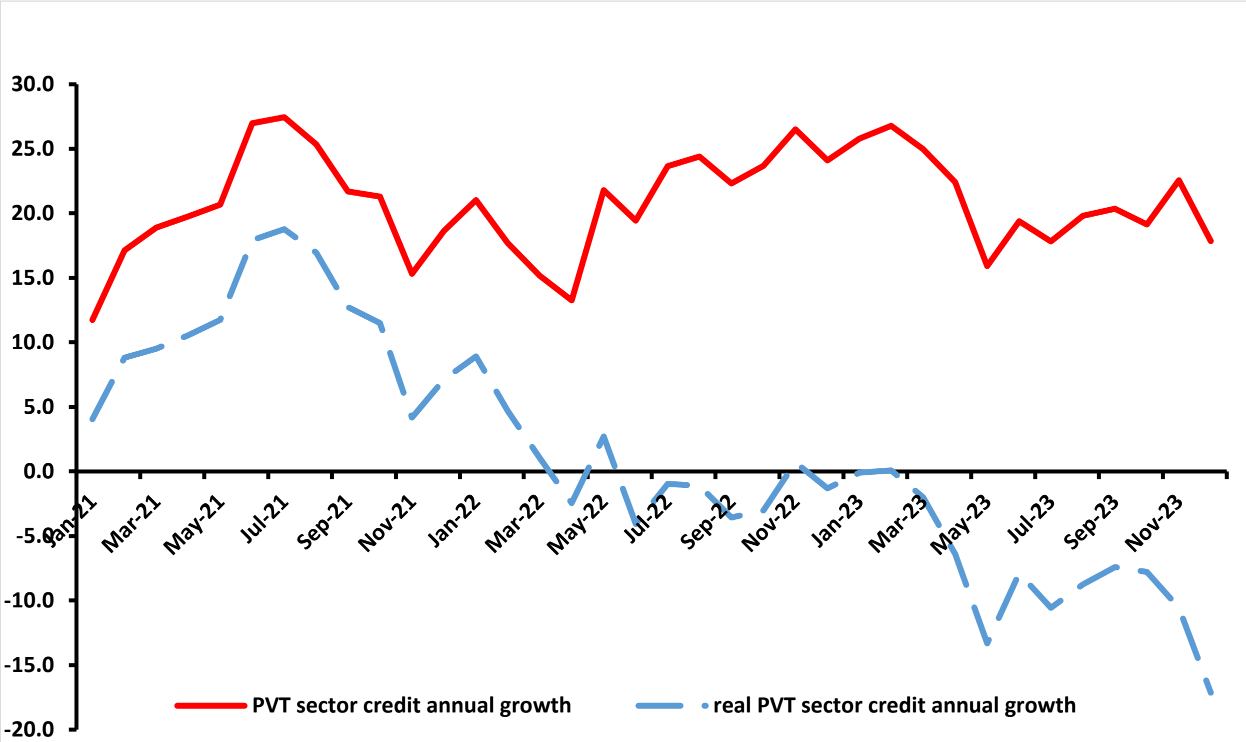


Source: Reserve Bank of Malawi data

8.3 Actual outturn in Private Sector Credit

Despite the perceived increase in demand for credit during the review period, the annual growth in private sector credit decelerated to 17.9 percent in December 2023 from 24.1 percent in December 2022. In real terms, the annual growth rate in private sector credit remained negative and stood at minus 11.3 percent in December 2023 from minus 1.3 percent in December 2022 (Chart 37). The deceleration in the growth rate of private sector credit was supported by tight monetary stance implemented in 2023 to curb inflation, coupled with the aforementioned cautious approach by the commercial banks in their intermediation role.

Chart 37: Annual Growth Rates of Private Sector Credit



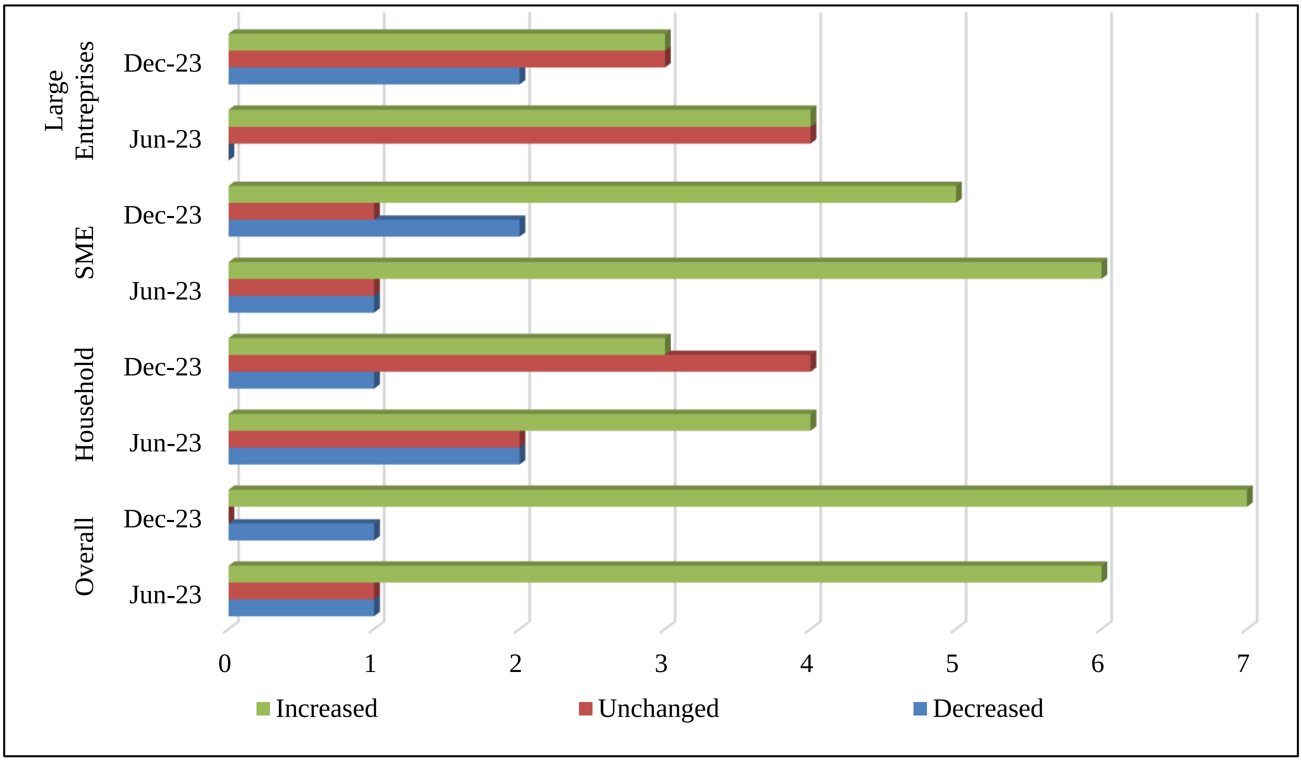
Source: Reserve Bank of Malawi data

8.4 Development in Non-Performing Loans

Most banks perceived an increase in NPLs across all economic agents in the period under review. This was attributed to the deteriorating macroeconomic fundamentals characterized by the continued rise in inflation and interest rate; acute foreign exchange shortage; and high public debt, among others.

Seven out of the eight banks reported that NPLs increased while one bank indicated a decrease in NPLs during the period (Chart 37). In terms of client categories, a majority of the banks perceived an increase in NPLs for SMEs. For SMEs sector, five out of the eight banks perceived an increase in NPLs, one indicated that NPLs remained unchanged and two banks perceived a decrease in NPLs.

Chart 38: Non-Performing Loans



Source: Reserve Bank of Malawi data

In terms of the distribution of NPLs by economic sector, NPLs were concentrated in four sectors namely: Wholesale & Retail Trade, Restaurants & Hotels, Community, Social and Personal Services, and Agriculture, Forestry, Fishing & Hunting. What is worrisome is that non-performing loans continue to be prevalent in some of these sectors to which substantial credit is extended.

Looking ahead, most banks anticipate the defaults on all economic agents to increase in the forecast period of January to June 2024. This is mainly attributed to banks' expectations on the effects of the foreign exchange shortage and local currency realignment, rising inflation, rising interest rates, high public debt and tight fiscal policy, hence expected decline in disposable income.

8.5 Conclusion

The findings of the survey showed that the majority of banks perceived an increase in demand for loans and credit lines across all the three economic agents in the period under review. The increase in demand for loans was largely attributed to a rise in commodity financing (agricultural inputs) due to the commencement of the agricultural marketing season, rising consumption expenditure and demand for additional working capital following the increase in the cost of living and production during the period under review.

In the first half of 2024, banks envisage continued increase in demand for loans and credit lines across the three economic agents, as inflationary pressures are expected to continue suppressing purchasing power. This will exert pressure on business operations and increase demand for credit by economic agents to cover for working capital needs in their operations. Similarly, banks perceive forex shortages to persist, which could further exert downward pressure on the local currency, and increase working capital gaps for economic agents that have import dependent businesses. banks anticipate the demand for credit to rise, on account of the need to facilitate trading of agricultural commodities during the 2023 agriculture marketing season and the need to support rising consumer expenditure, inventory and working capital gaps.

Further, the survey found out that most banks continued to tighten credit standards and conditions for approval of loans and credit lines for both short term and long-term loans, as well as across all the economic agents. The banks indicated that the uncertainty in the macroeconomic environment mainly explained their continued cautious approach in loan approvals. Most banks expect to tighten somewhat credit standards and conditions in the next six months to June 2024, in particular for SMEs and large enterprises, owing to expectations of a continued unstable macroeconomic environment due to rising inflation and ongoing acute foreign exchange shortages. On the other hand, credit conditions and standards are expected to remain unchanged for individual lending in the next six months to June 2024 following the increase in payroll loans.

On developments in the NPLs, most banks reported an increase in non-performing loans (NPLs) across all the three economic agents in the period under review on account of the unstable macroeconomic environment. Looking ahead, most banks anticipate an increase in the NPLs across all economic agents in the forecast period of January to June 2024.