

POSITION PAPER

Financial Stability Department



SOUTH AFRICAN RESERVE BANK

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Position paper:

Overview of the South African Reserve Bank's policy framework for the provision of emergency liquidity assistance to banks



Contents

- 1. Acronyms and abbreviations..... 3
- 2. Definitions 4
- 3. Introduction 5
- 4. Guidelines and considerations when developing the criteria for providing ELA 7
- 5. Guidelines for ELA collateral..... 8
- 6. Interest rate on ELA 11
- 7. Duration of ELA..... 12
- 8. SARB’s criteria for providing ELA to banks 13
- 9. Disclosure of ELA 15
- 10. Consultation and coordination with the National Treasury 15

1. Acronyms and abbreviations

CLF	committed liquidity facility
EAD	exposure at default
ELA	emergency liquidity assistance
FSRA	Financial Sector Regulation Act 9 of 2017
FSLAA	Financial Sector Laws Amendment Act 23 of 2021
HQLA	High-quality liquid assets
IFRS	International Financial Reporting Standards
LCR	liquidity coverage ratio
LGD	loss given default
LOLR	lender of last resort
NSFR	net stable funding ratio
RCLF	restricted committed liquidity facility
SARB	South African Reserve Bank
SARB Act	South African Reserve Bank Act 90 of 1989
SIFI	systemically important financial institution
UCITS	Undertakings for Collective Investments in Transferrable Securities

2. Definitions

For purposes of this document, the following definitions apply:

‘closed-bank resolution’ means a resolution strategy in terms of which a bank is wound up and ultimately ceases to operate under its own licence.

‘emergency liquidity assistance’ means the liquidity assistance provided to a bank that is experiencing liquidity shortages and that is unable to alleviate the liquidity shortage through private sources of funding or the standing facilities available from the central bank.

‘lender of last resort function’ means the function of a central bank to provide additional liquidity during times of distress, or when private sources of liquidity are not available to protect the smooth functioning of the financial system in addition to its normal liquidity management operations.

‘liquidity management operations’ means the liquidity management transactions of the SARB as part of its ongoing monetary operations, including the weekly repurchase rates (repos) and overnight standing facilities.

‘open-bank resolution’ means a resolution strategy by means of which the viability of a failed or failing bank is restored and it continues to operate under its own licence.

‘recovery plan’ means a plan in terms of Directive 1 of 2015 – a bank should be able to manage its own affairs in such a way that it can recover from severe stress without relying on official support.

‘resolution plan’ means a plan, that will be compiled by the SARB, that sets out the appropriate resolution strategy for a particular bank as required by the Financial Sector Laws Amendment Act 23 of 2021.

‘resolution strategy’ means the management of the affairs of a bank, by the SARB, that has failed or is likely to fail in terms of clause 51 of the Financial Sector Laws Amendment Act 23 of, 2021.

‘systemically important financial institution’ means a systemically important financial institution (SIFI) designated as such by the Governor of the SARB in terms of section 29 of the Financial Sector Regulation Act 9 of 2017 (FSR Act).

3. Introduction

- 3.1 In the normal course of business, the South African Reserve Bank (SARB), as the central bank, provides liquidity to banks experiencing liquidity shortages through its standing facilities. The accommodation facility is available to all registered banks by means of repurchase transactions, and liquidity is provided only on condition that the relevant bank provides the SARB with eligible assets as security. When the eligible assets of a particular bank have been depleted and the liquidity shortage of the bank persists, the SARB may, at its discretion, provide liquidity assistance to the bank as part of its lender of last resort (LOLR) functions. The LOLR functions of the SARB are provided for in the South African Reserve Bank Act 90 of 1989 (SARB Act)¹. LOLR operations could include either the creation of additional aggregate liquidity through special operations (systemic liquidity)² or the provision of additional liquidity to a specific institution that is experiencing a temporary liquidity shortage (emergency liquidity assistance).
- 3.2 The SARB’s financial stability mandate, as articulated in the Financial Sector Regulation Act 9 of 2017 (FSR Act), may require it to provide emergency liquidity assistance (ELA) to financial institutions, to assist them with overcoming periods of liquidity stress while continuing to perform their critical functions, and to ensure that the payment, clearing and settlement systems continue to function efficiently. In terms of section 11 of the FSR Act, the SARB is responsible for protecting and enhancing financial stability in normal times or, when a systemic event has occurred or is imminent, restoring or maintaining financial stability.
- 3.3 This paper provides an overview of the SARB’s policy framework for the provision of ELA to banks in the interest of protecting financial stability. The policy framework

¹ South African reserve Bank Act 90 of 1989.

² The Financial Stability Review, First Edition 2021, sets out a list of the actions taken by the SARB during the initial stages of the COVID-19 in 2020 to protect financial stability.

of the SARB focuses on idiosyncratic requests for ELA and provides for, among others, the criteria, legal requirements and collateral guidelines that should be in place to enable the efficient provision of ELA, when needed.

- 3.4 In terms of section 10(1)(f) of the SARB Act, which provides that the SARB may grant loans and advances under certain conditions, the SARB has the power to provide ELA to financial institutions. To this end, section 10(1)(f) read together with section 10(1)(s) of the SARB Act authorises the SARB, in accordance with the recognised and established customs and functions of central banks, to provide ELA to banks (as the LOLR), by means of collateralised loans³.
- 3.5 The provision of ELA is underpinned by the SARB's other functions, namely the administration and oversight of the national payment system, management of money market liquidity, implementation of monetary policy, as well as the regulation and supervision of financial institutions.
- 3.6 The SARB's policy framework is not intended to be a prescriptive, unyielding framework, but rather as a consistent guideline against which the SARB will assess individual situations. As it stands, the SARB Act does not restrict the SARB's ability to provide loans. While this provides the SARB with flexibility in pursuing its financial stability responsibilities, the SARB needs to exercise its powers in a transparent and consistent manner. The risks associated with inconsistent policy application are exacerbated by the fact that financial stability is a policy area that covers a broad range of activities which deal with many uncertainties and that requires significant levels of judgement to be applied in most cases.
- 3.7 The provision of ELA requires high levels of cooperation, both within the SARB and between the SARB and other relevant authorities. The SARB's policy framework sets out clear mechanisms and processes that will assist with the coordination of decisions on the provision of ELA.

³ The SARB Act contains conditions for the provision of uncollateralised loans. These are not relevant for ELA or the purpose of this policy framework.

3.8 The purpose of this discussion paper is to communicate and provide guidance on the SARB's policy framework for the provision of ELA to banks (Framework).

4. Guidelines and considerations when developing the criteria for providing ELA

4.1 Given that ELA is provided to a bank that is unable to raise liquidity in the market or through the SARB's normal operations and standing facilities, it is not something that happens regularly in the SARB. The circumstances under which ELA must be considered can differ significantly from one situation to another, for example, it may differ due to:

- i. the characteristics of the bank(s) involved;
- ii. the reason(s) for the distress (liquidity shortage);
- iii. the economic environment;
- iv. regulatory requirements; and
- v. the amount required and type of collateral available.

4.2 Due to the different circumstances in which ELA may need to be considered, it is impossible to develop an extensive list of detailed requirements. As such, central banks have traditionally relied on four overarching principles when considering applications for the provision of ELA. These traditional principles were first set out in Lombard Street⁴ as follows:

- i. The ELA must be provided at a penalty rate.
- ii. The bank applying for ELA must be solvent.
- iii. The ELA must be temporary.
- iv. The ELA must be provided against acceptable collateral.

⁴ Lombard Street: A description of Money Market' (1873), Walter Bagehot

4.3 Detailed discussions on these principles are set out in the sections below. The SARB also considered the legislative framework within which it must perform its functions and past experiences with providing ELA and systemic liquidity in times of distress.

5. Guidelines for ELA collateral

5.1 In line with the SARB Act, the SARB should only provide liquidity against collateral. A bank requiring ELA is likely to have used a large part of its high-quality liquid assets (HQLA) and may already be in breach of its liquidity coverage ratio (LCR), liquid asset requirement (LAR) and/or cash reserve requirement (CRR). ELA, by definition, implies that a bank no longer has eligible collateral available for the SARB's normal operations, and therefore must pledge other assets for emergency borrowing.

5.2 The SARB may consider extending the list of acceptable collateral that it accepts for ELA, at increasingly punitive haircut percentages. These percentages will increase in accordance with the risk of a potential loss of value for the SARB, if it has to take delivery of these assets. Below are high-level criteria, based on the relevant assets class/category, which will be considered in determining the applicable percentages:

- i. In the case of **marketable assets**, the risk will depend on the price volatility of the asset and its market liquidity. The haircut should protect the SARB against a fall in the price of the assets or an inability to sell the assets without a significant loss, in the event of a default on ELA-related transactions. In general, the higher the price volatility and the lower the market liquidity, the larger the haircut.
- ii. In the case of **non-marketable assets** (typically loans and advances on the failing bank's balance sheet) the haircuts will be larger as the SARB will not be able to sell these assets in the market, in the event of a default on ELA, and the SARB will become exposed to the credit risk relating to these assets.

The haircuts are determined based on the quality of the assets offered as collateral.

5.3 The various categories of assets that can be used for ELA and the recommended haircut ratios are listed in **tables 2A to 2C** below.

Tables 2A – 2C Guidelines on acceptable collateral and haircuts

Table 2A				
Category 1: Eligible collateral in terms of the standardised approach for credit risk				
Issue rating in respect of debt securities	Residual maturity	Sovereigns	Other issuers	Securitisation exposure
AAA to AA-/A-1	≤ 1 year	0.5	1	2
	> 1 year; ≤ 5 years	2	4	8
	> 5 years	4	8	16
A+ to BBB-/ A-2/ A-3/ P-3 and unrated bank securities qualifying as eligible collateral in terms of the simple approach	≤ 1 year	1	2	4
	> 1 year; ≤ 5 years	3	6	12
	> 5 years	6	12	24
BB+ to BB-	All	15		
Securities issued by the central government of the Republic of South Africa or the SARB, repayable and funded in rand	≤ 1 year	1		
	> 1 year; ≤ 5 years	3		
	> 5 years	6		
Main index equities, including convertible bonds and gold		15		
Other equities, including convertible bonds, recognised on a licensed exchange		25		
Undertakings for Collective Investments in Transferable Standards (UCITS)/Mutual funds		Highest haircut applicable to any security in which the fund may invest		

Table 2B		
Category 2: Eligible collateral for the CLF or RCLF		
Banks that have assets packaged in a form that qualifies for the SARB's committed liquidity facility (CLF) or restricted committed liquidity facility (RCLF), in excess of the size of facilities that they have contracted, can use these assets for ELA. Haircuts could be similar as for the CLF, because the quality of the assets should still be the same. However, to distinguish ELA from the CLF or RCLF, the SARB could consider increasing the pricing of the ELA facility on a case-by-case basis.		
Table 2C		
Category 3: Performing loans		
Performing loans less portfolio credit impairments (stage 1 and 2 IFRS 9 credit impairment) raised against the portfolio		
Homeloans	20% – 30%	
Commercial mortgages	20% – 50%	
Credit cards	50% – 70%	
Vehicle and asset finance	35% – 45%	
Term loans – Wholesale	20% – 50%	
Terms loans – Retail	50% – 70%	
Other	40% – 70%	

5.4 The reasoning behind the proposed haircuts is as follows:

- i. **Category 1 collateral** consists of debt securities that have market value. Haircuts are based on the current haircuts in the Basel framework for credit risk, updated according to the implementation of this framework in South Africa.
- ii. The specification of **Category 2 collateral** is based on the list of acceptable collateral for the RCLF, which was made available to interested banks with effect from December 2020. Haircuts are also based on CLF/RCLF haircuts.
- iii. **Category 3 collateral** consists of loans secured by other performing assets on banks' balance sheet, less portfolio credit impairments raised against the asset class. Exposure at default (EAD), weighted according to the loss given default (LGD) has been used as the base on determining the range of haircuts to be applied. This has been compared to the specific impairments as a percentage of defaulted EAD.

- 5.5 Collateral values must be maintained at a level exceeding the amount of ELA provided, after applying the haircuts. If there is a deterioration in the value of collateral, it must be topped up by additional eligible collateral.
- 5.6 The provision of ELA will be subject to the signing of an ELA agreement between the SARB and the bank(s) involved, in terms of which the assets will be ceded to the SARB against the provision of the ELA.
- 5.7 Notwithstanding the above, it should be noted that ELA will always be provided at the discretion of the SARB, even if banks have collateral in place. The bank(s) cannot rely on ELA as a recovery option.

6. Interest rate on ELA

- 6.1 Conventional theory, such as *Bagehot's Dictum*⁵, states that ELA must be provided at a penalty rate, to prevent moral hazard and an over-reliance on the availability of ELA. The theory is based on a belief that banks should be penalised for having to rely on the central bank's support and for not properly managing their liquidity risk. Practically, a penalty or punitive rate aims to ensure that banks first exhaust all other avenues of liquidity before approaching the central bank for ELA.
- 6.2 Experiences during the recent global financial crisis and the introduction of new resolution powers have challenged the stated conventional theory, based on the following arguments:
- i. The stigma associated with ELA is a natural deterrent for abuse of the facility, more so than the pricing.
 - ii. A bank that requires (and qualifies for) ELA is already in a weak financial position. An excessively high interest rate on ELA reduces its chances of recovery.

⁵ Bagehot's Dictum reflects the view of Walter Bagehot in his seminal paper '*Lombard Street: A description of Money Market*' (1873) which states that "...in times of financial crisis central banks should lend freely to solvent depository institutions, yet only against sound collateral and at interest rates high enough to dissuade those borrowers that are not genuinely in need."

- iii. Strengthened resolution frameworks provide for a range of more effective punitive measures to address moral hazard than a penalty on ELA, including bail-in powers and the power to remove senior management in cases of fraud or mismanagement.
- 6.3 ELA should not be seen as a form of subsidised funding or to unfairly benefit a specific bank. However, under certain circumstances, it may be appropriate for the SARB not to charge a penalty rate on ELA. The SARB will determine the applicable interest rate on a case-by-case basis, considering the following factors, among others:
- i. The resolution strategy followed (e.g. open or closed resolution).
 - ii. The likely duration of ELA.
 - iii. Other penalties on shareholders and management.
- 6.4 The aim of a penalty rate – to encourage banks to first exhaust other avenues of funding before approaching the SARB for ELA – is met by the requirement that banks should first exhaust all recovery options (see Table 1 below).

7. Duration of ELA

- 7.1 The underlying principle regarding the duration of ELA is that it is a temporary source of liquidity support, and as such, banks cannot rely on it indefinitely.
- 7.2 The ELA contract between the SARB and a bank will specify the period for which ELA will be provided. If ELA becomes a lasting lifeline on which a bank remains dependent, it defeats the purpose of the assistance and can have various negative consequences, such as:
- i. representing a competitive advantage over other banks that rely only on private sector funding;
 - ii. creating a dependency on the SARB that erodes the incentives for proper liquidity management; and

- iii. putting the SARB in a position where it almost becomes obliged to continue supporting the bank in the process building up significant financial risk.
- 7.3 The duration of ELA, as contracted, will be influenced by at least the following two factors:
- i. The resolution strategy for a specific bank. It should be determined from the outset how long the execution of an adopted resolution strategy is expected to take. For strategies such as purchase and assumption and orderly wind-down, the duration of the ELA should be linked to the timeframe of the transaction. ELA duration may be longer for a SIFI with an open-bank resolution strategy, which may require ELA in some form, even after it exists resolution, until the market regains confidence in its sustainability.
 - ii. The specific scenario that led to the liquidity challenges, and how long these circumstances are expected to impact the bank's liquidity position.

8. The SARB's criteria for providing ELA to banks

- 8.1 Guided by the factors set out in sections 4 to 7 above, the SARB developed a set of criteria that must be met by banks when applying for ELA. Table 1 below sets out the criteria that will be applied by the SARB in considering a request for ELA.
- 8.2 The consideration of an application for ELA will be undertaken on a case-by-case approach, and all applications must meet the criteria as set out in Table 1.

Table 1: Criteria to decide whether to provide ELA

Binding criteria
a. Accounting solvency
ELA should only be provided to a bank that has accounting solvency (i.e. assets > liabilities), based on the latest regulatory returns combined with an assessment by the

Prudential Authority (PA). If the SARB provides liquidity on a secured basis to an institution that it knows or suspects to be insolvent, it puts itself ahead of unsecured creditors in the event of a liquidation, thereby reducing the liquidation value available to other creditors. Notwithstanding any moral concerns, this is likely to be challenged in court.

b. Viability

Even if a bank is still technically solvent, it should have a viable business model. ELA represents temporary liquidity support to a bank that, under normal circumstances, is profitable, sustainable and able to adhere to regulatory standards, without assistance.

c. Regulatory compliance

The bank should be able to meet the minimum regulatory liquidity requirements (LCR, NSFR, Liquid Asset Requirement and Cash Reserve Requirement) in normal circumstances, even though it may be experiencing a temporary breach due to specific events.

d. Adequate collateral

The SARB Act requires ELA to be collateralised. Collateral protects the SARB against losses if a bank is not able to repay ELA – therefore the collateral must be of sufficient quality. Paragraph 7 and Annexure B provide guidelines on collateral that could be considered for the purposes of granting ELA, recommended haircuts to be applied and top-up requirements for collateral.

e. Recovery options exhausted

ELA should only be provided if a bank has exhausted its liquidity buffers and sources of private sector funding and liquidity. This includes a requirement that the bank has invoked its recovery plan and implemented all feasible contingency funding options. This

criterion includes a requirement that shareholders of the bank have made all reasonable efforts to provide liquidity support as a demonstration of their own commitment.

f. Fit and proper management

There is no *prima facie* evidence that the board of directors and the management are not fit and proper, or that the liquidity problem is due to fraud.

g. Adequate information

A bank applying for ELA should be able to promptly provide the PA and/or the SARB with adequately detailed and timeous information to enable the PA/SARB to make an informed decision.

9. Disclosure of ELA

9.1 The disclosure of ELA is at the discretion of the SARB. The SARB is therefore able to exercise its judgement to determine whether early disclosure will support or harm the feasibility of the specific bank or financial stability in general.

10. Consultation and coordination with National Treasury

10.1 Although the SARB has been bestowed with an explicit mandate to protect and enhance financial stability and legislative⁶ work is underway to reduce the reliance on public funds, the SARB is required to operate within a policy framework that is agreed between the Governor of the SARB and the Minister of Finance⁷. Additionally, the SARB must consult with National Treasury (NT) in dealing with failed or failing banks as there remains a possibility that the support of NT could be required in specific circumstances.

⁶ Provisions introduced through the Financial Sector Laws Amendment Act 23 of 2021 aimed at strengthening South Africa's resolution framework for financial institutions.

⁷ FSR Act section 11.

10.2 To this end, the SARB will inform NT about an ELA application in the following instances:

- i. If there is an expectation that a bank may be placed in resolution, which has to be approved by the Minister of Finance.
- ii. If a bank is unable to provide adequate collateral for ELA, and for financial stability purposes it is deemed necessary to still provide the ELA, in which case NT could be approached for a guarantee for ELA.

10.3 Generally, the SARB will, in its assessment of an application for ELA, also assess the need to consult NT about an application for ELA in the specific circumstances.