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Weathering the Covid-19 storm: The response of macro-prudential policy

Palesa Mnguni, Mpho Rapapali and Witness Simbanegavi

Abstract

In response to the Covid-19 pandemic, the PA reduced the LCR from 100% to 80%; lowered Pillar 2A capital requirements from 1% to 0%; provided capital relief on loan restructures; and issued guidance on dividends and the application of IFRS 9. The Pillar 2A capital relief has likely made about R280 billion available, increasing banks' unencumbered capital and creating room for banks to absorb losses. Risk-sharing through the loan guarantee scheme should help support credit extension. Paradoxically, the reduction in the LCR threshold to 80% has coincided with the LCR rising to 150% in July, on the back of investment by banks in government bonds. This is suggestive of crowding out. Credit extension remains subdued. Increased credit risk, heightened uncertainty and lower profitability may partly explain banks' reluctance to extend new credit. The capital relief measures, while sound, carry potential downside risks that should be monitored to maintain confidence in and resilience of the banking sector.

1. Introduction

The Covid-19 pandemic has strained global economies, and South Africa is no exception. The lockdowns implemented in South Africa to help contain the spread of the coronavirus have resulted in a substantial economic slowdown, company failures and unemployment. To help blunt the economic impacts, the Prudential Authority (PA) of the SARB implemented temporary regulatory relief measures to alleviate pressure on the banking system and to help support the economy. This note discusses the PA policy interventions in light of their stated objectives, likely impacts on the economy and the soundness of the banking sector.

2. PA capital and liquidity relief measures

Capital relief measures implemented by the PA include; lowering of the liquidity coverage ratio (LCR), lowering the Pillar 2A capital requirement, allowing banks to draw down against their capital conservation buffers after consultation with the PA and capital relief on restructured loans that were in good standing before the Covid-19 crisis. To complement these measures, the PA issued guidance on the payment of dividends and bonuses, and the application of the expected loss accounting principle (IFRS 9).

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2.1 Liquidity coverage ratio

Financial markets were volatile in March 2020, as risk-averse depositors moved out of long-term funding into short-term funding.¹ This caused market liquidity to decrease and consequently placed banks under pressure to meet their LCR requirements.² At the same time, high-quality liquid assets (HQLAs) decreased in value due to negative mark-to-market adjustments caused by increases in the yields of the underlying instruments. In light of this, the LCR requirement was temporarily reduced to 80% from 100% to ease (financing) pressure on banks, and to boost resources at the disposal of banks to meet liquidity demands and reduce the likelihood that lending is curtailed.³

Paradoxically, the LCR increased to 150% in July 2020, following a slight decrease to 130% in March 2020, and well over the new minimum requirement of 80% (Figure 1). The higher LCR followed from banks increasing their holdings of HQLAs, which mostly consists of government securities.⁴ Bank holdings of government bonds reached R509 billion in July 2020, after rising to R477 billion in April 2020 following South Africa's exclusion from the FTSE World Government Bond Index. Treasury bills increased to R311 billion in July 2020, from R286 billion in April 2020 (Figure 2), possibly reflecting government's increased funding at the short end, given the historically low short term rates. It appears that banks utilised excess funds to purchase 'risk-free' interest-bearing assets rather than increasing their risk exposure by supplying additional loans to households and firms, or in response to weak demand for credit. As the economy reopens, banks should use part of the 20% LCR 'fat' to supply new loans.

Figure 1: The liquidity coverage ratio

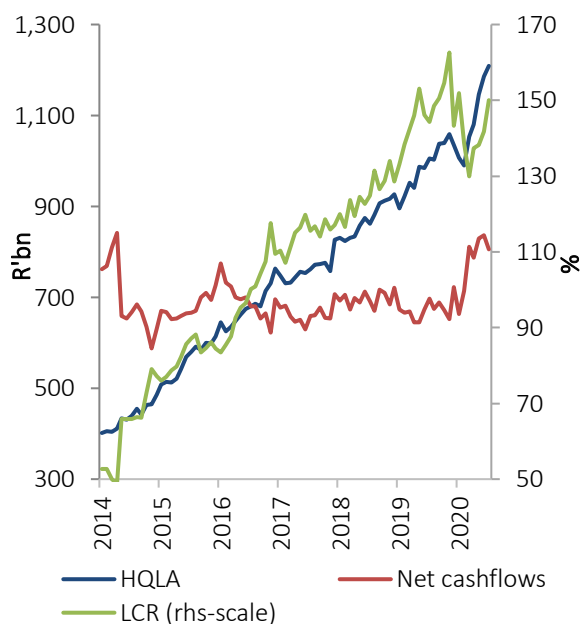
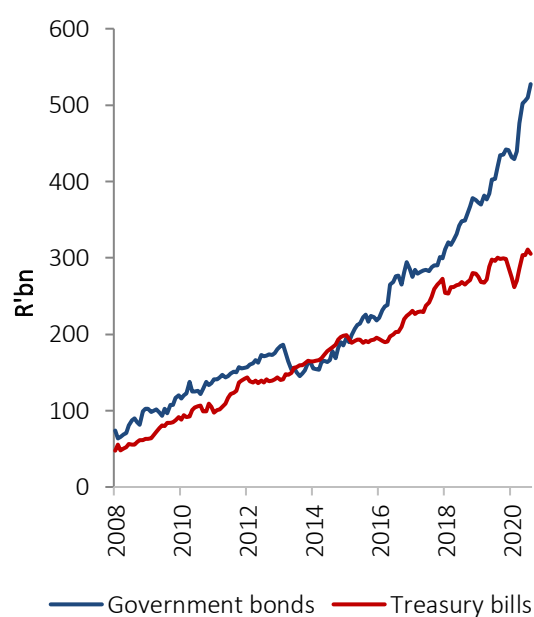


Figure 2: Banks' holdings of gov. securities



Note: Net cash outflows are the denominator of the LCR ratio, and refer to cash outflows from deposits, loans, secured lending, credit/liquidity facilities, etc., during a 30 day stress period.

Source: Prudential Authority and SARB BA900.

¹ [D1/2020](#): Temporary measures to aid compliance with the liquidity coverage ratio during the Covid-19 pandemic.

² The LCR engenders bank resilience by requiring that banks hold adequate stocks of high quality liquid assets to meet their liquidity needs during a 30 calendar day liquidity stress scenario.

³ This is notwithstanding the fact that South African banks had ample liquid assets to cover net cash outflows prior to the Covid-19 crisis, with the LCR well above the minimum requirement of 100% (Figure 1).

⁴ It is likely that the high average LCR masks bank specific dynamics which may have driven the decision to lower the LCR. It is likely that the policy announcement itself helped reduce uncertainty about bank compliance to LCR regulations, thereby reducing pressure on banks. The high LCR can be explained in part by the recovery in bond prices and the increased demand for credit by government.

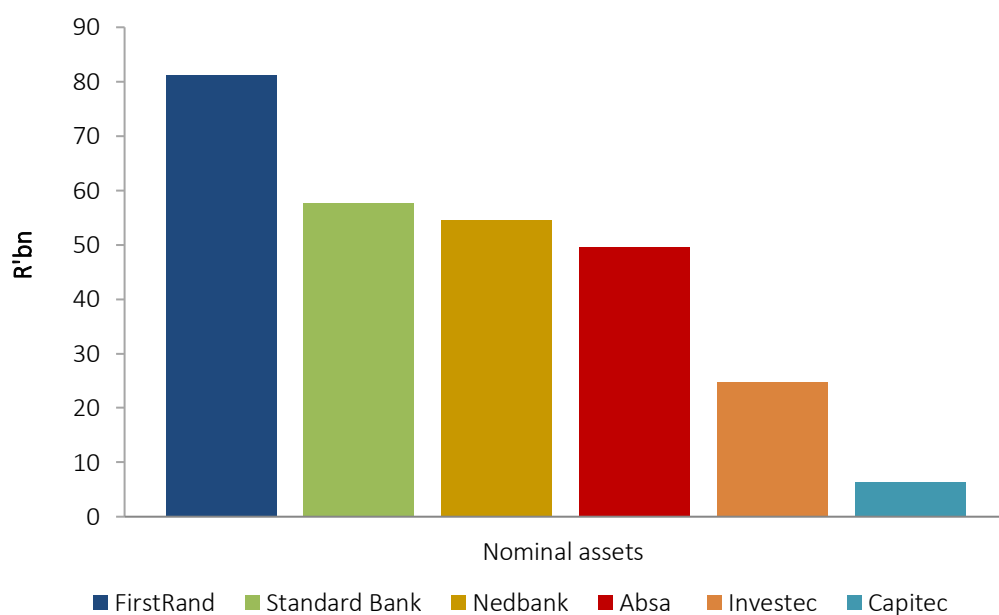
2.2 Pillar 2A capital relief and restructured loans

In response to pressure on banks' capital supply due to Covid-19, the Pillar 2A capital requirement for systemic risk management was temporarily reduced from 1% of risk-weighted assets (RWA) to 0%.⁵ This was done to provide banks with funds to use for operations without the need to draw against the capital conservation buffer. In addition, banks may also draw down against their capital conservation buffers (currently 2.5%) after consultation with the PA.

Additionally, the PA allowed banks to restructure loans that were in good standing before the pandemic, provided the borrower risk profile remains unchanged. This means banks are not required to hold additional capital and reserves for the loan restructures meeting the set criteria.⁶ This reduces capital pressure on banks and increases the supply of loanable funds relative to a no intervention scenario. Equally, banks have allowed borrowers to restructure with minimal to no penalty.⁷

Figure 3 shows that for the top 6 banks (FNB, ABSA, Standard Bank, Nedbank, Investec and Capitec), the Pillar 2A relief has potentially made about R280 billion available.^{8,9} Evidently, banks have ample funds available at their disposal to supply new loans.

Figure 3: Resources made available through pillar 2A relief



Source: The Basel III risk and capital management annual report, authors' own calculations.

⁵ Banks are required to hold a minimum capital requirement of 8% of risk-weighted assets, a systemic risk capital requirement (Pillar 2A), an idiosyncratic risk capital requirement (Pillar 2B), a capital conservation buffer, a countercyclical capital buffer (currently inactive) and a domestic systemically important bank (D-SIB) buffer.

⁶ Ordinarily, distressed loan restructuring raises the credit risk, requiring banks to increase loan provisioning – D7/2015

⁷ Anecdotal evidence suggests that banks have been reluctant to provide further loans to borrowers who benefited from the Covid-19 debt restructures - a form of penalty.

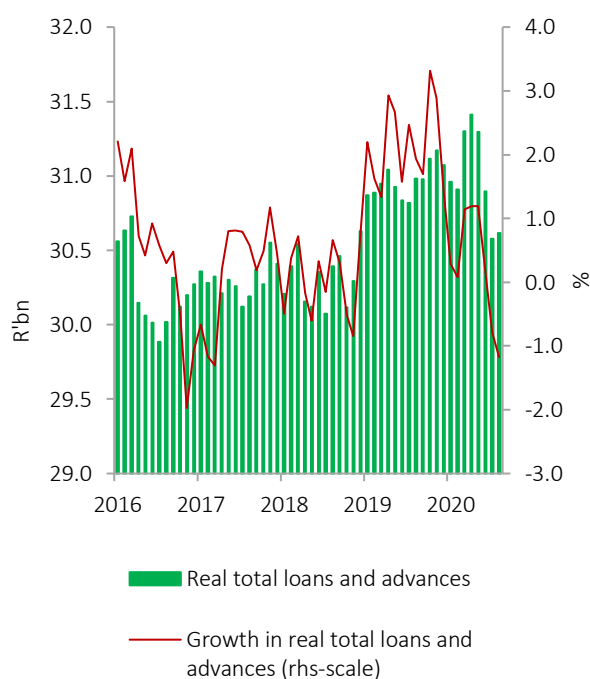
⁸ We follow the methodology proposed by Rand Merchant Bank (RMB), which uses banks' average RWA density (the ratio of average RWA to total assets) to estimate funds available for lending. Unlike the Prudential Authority, who decreases the total capital adequacy ratio (CAR) by 1% due to the reduced Pillar 2A, we first lower the common equity tier 1 (CET1) ratio by 0.5% and then subtract the remaining 0.5% from the CAR.

⁹ Our estimate of about R280 billion is close to the Prudential Authority's R300 billion. The slight difference could be due to the fact the PA's estimate is based on the total banking market, while our measure is calculated for the top 6 banks, which make-up about 82% of the market.

Growth in real total loans and advances rose to 1.2% in April 2020, but decelerated thereafter, contracting by 1.2% in August 2020 (Figure 4). Real growth in loans to the corporate sector continued to decelerate after rising by 1% in April, to eventually contract by 2.2% in August. Real loan growth for households has also slowed from 0.4% y-o-y in April to contract by 0.1% in August.¹⁰ Both the number of loan applications received and granted declined significantly in April due to the level 5 lockdown, but have since largely recovered (Figure 5).

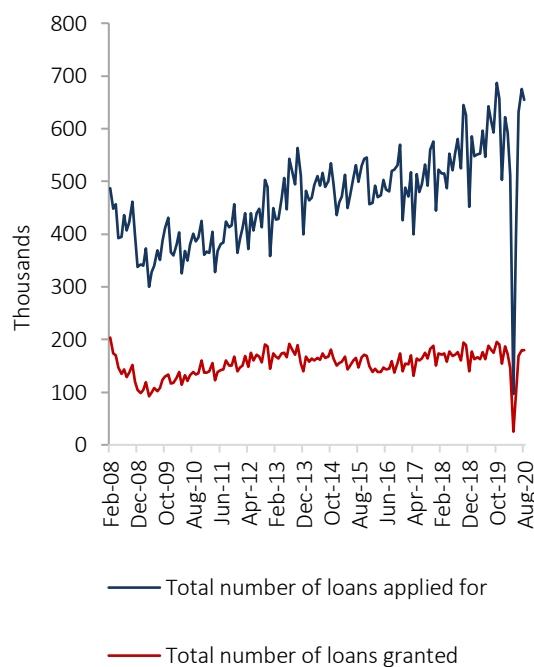
The key question is whether banks will use the available space to increase lending to the real economy. Banks may take a more cautious approach for several reasons. First, credit risk has been trending upwards for the last two years (Figure 6) and is likely to continue as households and firms experience increased financial strain due to the pandemic. Second, the Covid-19 loan restructures have increased bank exposures, and thus banks may want to first see how these exposures evolve as the economy recovers.¹¹ Third, banking sector profits have come under pressure this financial year, hence the funds from capital relief measures are likely to be used to absorb losses.¹² Lastly, the lure of low-risk and reasonably high-yielding government bonds may discourage lending to the real economy. Indeed, the observed high LCR may be indicative of crowding out.

Figure 4: Growth in real credit extension



Source: SARB BA900.

Figure 5: Total number of loans applied for and granted¹³



Source: SARB BA900.

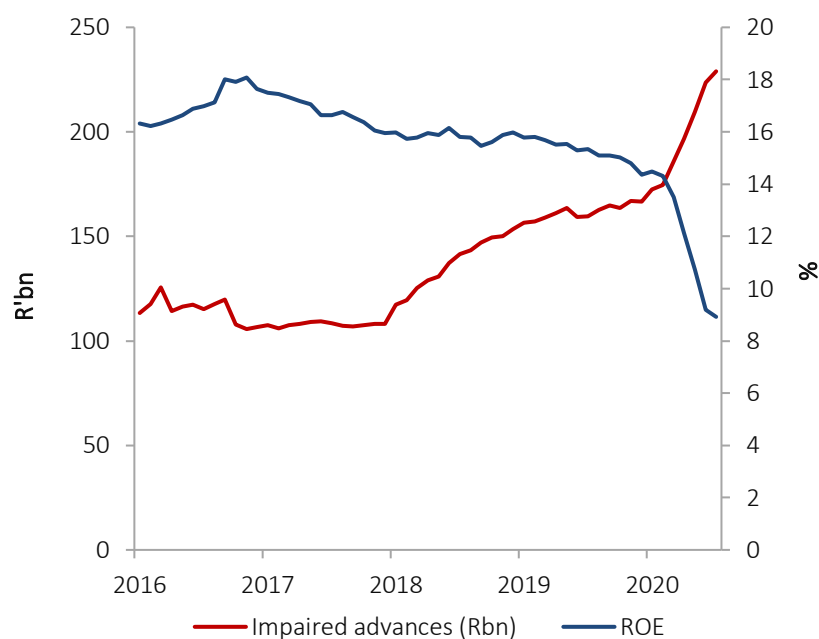
¹⁰ The m-o-m picture shows a stronger pick-up in credit extension to households as the economy has reopened (Figure A1 in Appendix).

¹¹ As of August 2020, banks provided R33.5 billion in Covid-19 related debt restructuring; with consumers granted R19.5 billion in restructures (84% of applications were approved) while businesses received debt restructures of R14.01 billion (95% of applications approved).

¹² Return on equity decreased from 10.7% in May to 9.2% in July, trending downwards for three consecutive years (Figure 6).

¹³ This includes only instalment sale, leasing finance and mortgage advances.

Figure 6: Bank profitability and credit risk exposure



Source: Prudential Authority of the SARB.

2.3 Guidance on dividends, bonuses and IFRS 9

To complement the capital relief measures, the PA requested banks to consider withholding the distribution of dividends and executive bonuses during the crisis, and instead use the relief for the purposes for which it was granted—i.e. to support the resilience of banks, continued credit extension and to absorb the losses that the banks may incur.¹⁴ Based on the dividends from five banks, the guidance, if adhered to, could result in R50 billion worth of capital being retained in 2020 (Table A1, in the appendix).¹⁵ However, dividends may be lower this year on account of lower bank profitability.

The PA also provided guidance on the implementation of the International Financial Reporting Standard 9 (IFRS 9) with respect to the determination of expected credit losses.¹⁶ The guidance allows banks flexibility in interpreting IFRS 9 to reduce the strain on their expected loss provisioning levels and thus help ease their capital requirements during the Covid-19 crisis period. Specifically, accounts affected by payment holidays, loan restructures and government guarantees need not automatically be treated as having had a ‘significant increase in risk’. Rather, consideration has to be made as to whether the perceived ‘substantial’ increase in risk will be sustained post the temporary relief period. This stance supports enhanced credit extension relative to a stricter interpretation of IFRS 9.¹⁷

¹⁴ South Africa is not alone in this. See for instance Mathias Drehmann et al. 2020. “Buffering Covid-19 losses – the role of prudential policy”.

¹⁵The five banks include Standard Bank, ABSA, FNB, Nedbank and Capitec.

¹⁶ [G3/2020](#): International Financial Reporting Standard (IFRS) 9 in response to the Coronavirus pandemic (Covid-19).

¹⁷ Under IFRS 9, when banks create credit they are required to recognize provisions on 12-month expected losses (i.e. stage 1 loans). Once a loan experiences a ‘significant increase in risk’, it moves to stage 2, and if it is impaired, to stage 3; where provisions are calculated over the lifetime of the loan.

2.4 The loan guarantee scheme

While the capital relief measures are necessary for banks to continue to credit extension, they are not sufficient. To incentivise credit extension, risk-sharing between the financial and public sectors is critical.¹⁸ Government, through the SARB, has made a R100 billion loan guarantee scheme available to support lending to small and medium sized firms, with the option to extend the scheme by another R100 billion should it be deemed necessary. The drawdown on the guarantee has been disappointing however, with only R14.5 billion lent to firms by August 2020. Many firms and banks have reduced their appetite for risk in light of the Covid-19 pandemic and the uncertainty it has caused.¹⁹ Other possible reasons for the low uptake include restrictive scheme conditionalities and that the scheme was made available late. Take-up is expected to improve as the economy reopens and following adjustments to the scheme conditionalities.

3. The potential dark side of capital relief measures

The capital relief measures implemented by the PA, while sound, have potential (but low probability) pitfalls which require continual monitoring. First, the additional capital provided by the relief measures could lead banks to take excessive risks by lending to already distressed borrowers, thereby increasing the debt burden for households and firms.²⁰ This could result in the deterioration of asset quality, with potential ripple effects for bank balance sheets, and ultimately credit availability. Second, aggressive credit extension spurred by excess liquidity could feed inflation, particularly if demand were to recover faster than supply. Third, reduced capital buffers may negatively impact the resilience of banks, and thus their ability to absorb future shocks. Lastly, if not adequately coordinated, the guidance concerning dividend payments and IFRS 9 implementation pose risks, including the potential to raise the equity funding costs for South African banks and raising investor concerns about the credit risk exposure of banks. These risks are neither immediate nor high, particularly given the conservative nature of the SA financial sector, but we flag them here as worthy of monitoring.

4. Have the regulatory relief measures met their objectives?

While it is too early to tell, we note the following. Market liquidity has improved and the LCR remains strong. Relief measures have likely provided about R280 billion—funds that could be loaned to households and businesses. Debt restructuring in excess of R30 billion has been granted and banks remain sound, with no drawdowns against the capital conservation buffer as of June 2020. Lastly, some R14 billion has been accessed through the loan guarantee scheme.

However, growth in credit extension remained muted in July 2020, though m-o-m data is more encouraging. The Covid-19 pandemic and the uncertainty around it may have affected both the demand and supply of loans. Banks may have tightened lending standards due to increased credit risk and pressure on profits, while households and firms may have reduced their demand for loans due to increased financial strain and uncertainty, and closure of large parts of the economy during this period. The increase in LCR may also be suggestive of some crowding out.

¹⁸ In terms of the scheme a bank's loss is limited to 6 percentage points of the amount loaned by that particular bank. Losses are distributed as follows: the first loss buffer is the net margin on the loan portfolio (2%), followed by the credit premium (0.5%) and then the bank. Any remaining losses are borne by the National Treasury.

¹⁹ See [Intellidex](#).

²⁰ The household debt to income ratio was 73% in 2019Q4, down from its 90% peak during the 2008/09 financial crisis—pointing to greater capacity by households to take on more debt.

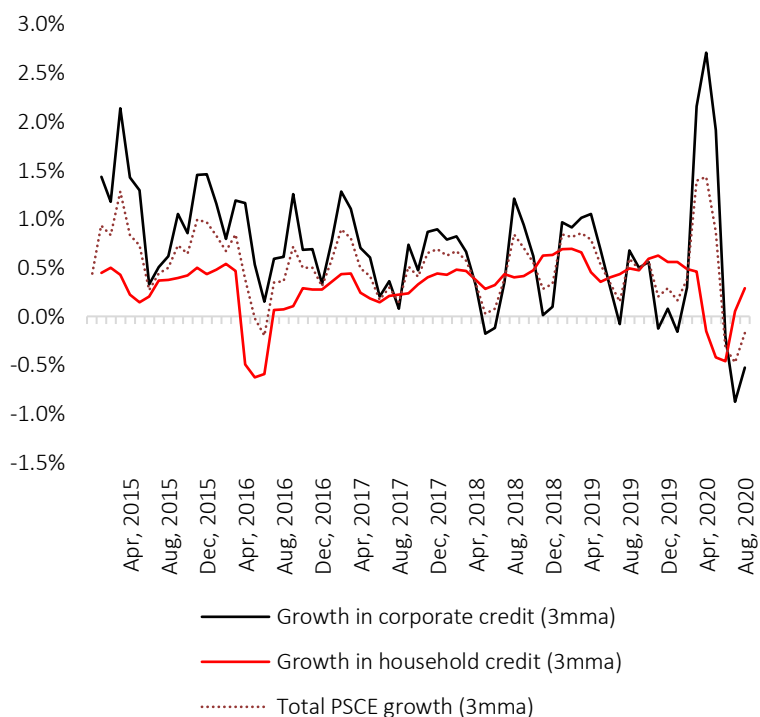
5. Conclusion

The easing of macro-prudential regulations could release an estimated R280 billion, while the R100 billion loan guarantee scheme facilitates risk-sharing. These measures should incentivise banks to continue lending—supporting preservation of productive capital and economic recovery. Banks have granted over R30 billion in debt restructures to date. However, high credit risk and low profitability may see banks becoming more risk-averse, while the lure of high-yielding government bonds may lead to crowding out of the private sector.

The PA capital relief measures should not compromise financial sector stability, particularly given that banks entered the crisis with excess capital and liquidity. However, there are risks that require continuous monitoring. There is a need to strike a balance between encouraging banks to make use of the flexibility in regulations, while also maintaining market transparency, and have the confidence that banks will absorb instead of exacerbate risk.

Appendix

Figure A1: Credit extension—3-month moving average



Source: own calculations

Table A1: Dividends of the top 5 banks

R' billion	FY17		FY18		FY19	
	Interim	Final	Interim	Final	Interim	Final
Absa	4.83	3.99	4.96	4.42	5.17	5.71
Capitec	0.79	0.52	0.93	0.61	1.09	0.73
FirstRand	6.62	6.62	7.63	8.22	8.13	8.38
Nedbank	3.11	2.97	3.35	3.40	3.54	3.57
Standard Bank	7.10	6.45	8.21	6.90	8.68	7.30
Total	22.45	20.55	25.08	23.53	26.62	25.69

Source: Respective banks' financial statements.