Box 3 Introducing collateral substitution for repurchase auctions

Participating commercial banks[1] are currently required to pledge[2] collateral[3] at the weekly main repurchase (repo) auction with the South African Reserve Bank (SARB), as the central bank does not provide unsecured loans. The pledged collateral cannot be replaced or substituted during the term of the contract, which is normally for a duration of seven days.

The new approach to be implemented will introduce the option to replace or substitute pledged collateral in a repo transaction with assets of at least equal quality. This flexibility will enhance the effectiveness of both repo-based refinancing [4,5] and monetary policy implementation. The SARB's systems are in place to accommodate this new collateral substitution approach and implementation is anticipated during the second quarter of 2020, once the Global Master Repurchase Agreement has been signed by all stakeholders.

The initiative will align the SARB's repo operations with global best practices and improve the efficiency of internal workflows, while market participants will benefit from collateral optimisation.[6] Substitution will facilitate the efficient allocation of collateral and will be mainly focused on the main repo auction. On aggregate, there will be reduced fragmentation across the SARB's operations and functions (as large quantities of collateral

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1 Commercial banks are required to enter into a Global Master Repurchase Agreement with the SARB to participate in the weekly main repo auctions.

2 Securities pledged by participating banks as collateral are kept in the Central Bank Collateral Management System.

3 Securities eligible as collateral for repo transactions are stipulated in a money market operational notice. See http://www.resbank.co.za/Markets/Domestic/MarketDocuments/Pages/List-of-Eligible-Collateral.aspx

4 Repo-based refinancing was introduced on 9 March 1998.

5 Such refinancing is concluded through open market operations where the central bank provides liquidity to the money market in exchange for high-quality liquid assets as collateral, with an agreement that such securities are repurchased at maturity of the repo, usually after one week.

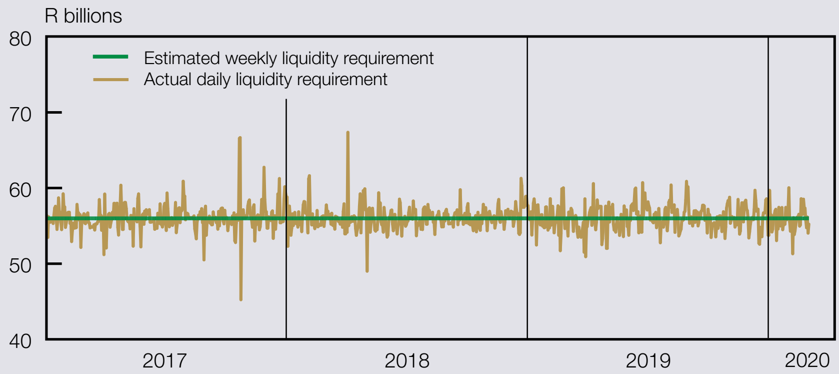
6 Collateral optimisation is a process that identifies and allocates collateral within all the parameters set out by the lender (SARB) and the borrower (a commercial bank) in the most efficient manner.

are held for banks' prudential requirements),[7] while also assisting to collateralise intraday payments settled in the South African Multiple Option Settlement (SAMOS) system. This will afford banks access to collateral held at the SARB for interbank funding. Further benefits include increased money market stability and liquidity in times of financial stress, given the mobility and ease of identifying surplus collateral. This will also ensure that over-collateralisation is avoided and contribute to compliance with regulatory requirements.

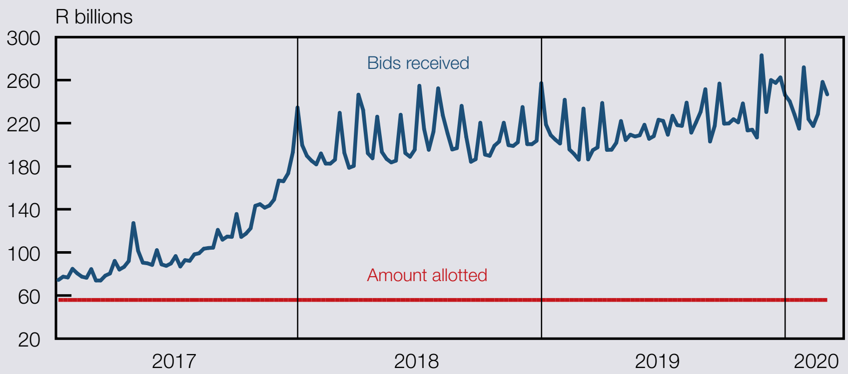
The SARB's open market operations[8] are conducted to influence money market liquidity conditions to maintain a liquidity shortage. Monetary policy is implemented through repo-based refinancing of commercial banks' money market liquidity shortage at the repo rate.

The money market liquidity shortage is currently maintained at a daily average of R56 billion, with bids received in the weekly main repo auction exceeding both the estimated weekly liquidity requirement and the amount allotted by a significant margin, as indicated in the accompanying figure.

Liquidity requirement



Weekly main repo auctions



Source: SARB

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7 Basel III regulatory reforms partly necessitated the review of the current system of collateral requirements as it created increased demand for high-quality liquid assets.

8 Open market operations are policy actions implemented by a central bank to either inject or drain liquidity from the market as a whole. The SARB utilises various instruments at its disposal to maintain liquidity at the required level, including reverse repo transactions, SARB debentures, foreign exchange swap transactions and the movement of public sector funds between the SARB and the market. These are described in the money market section of the *Quarterly Bulletin* as some of the factors that influence money market liquidity conditions.