



# BOTSWANA

## TECHNICAL ASSISTANCE REPORT—BANKING SECTOR SAFETY NET AND CRISIS MANAGEMENT

February 2017

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# **INTERNATIONAL MONETARY FUND**

Monetary and Capital Markets Department



## **REPUBLIC OF BOTSWANA**

### **BANKING SECTOR SAFETY NET AND CRISIS MANAGEMENT**

**Peter Lohmus (Mission Chief), David Doran (Central Bank of Ireland), and  
Geof Mortlock (Independent Consultant)**

**February 2017**

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**GLOSSARY**

BA	Banking Act
BoB	Bank of Botswana
Board	Board of BoB in accordance with BoB Law
BoBA	Bank of Botswana Act
BoBC	Bank of Botswana Certificates
BRRD	Bank Recovery and Resolution Directive
BSD	Banking Supervision Department
CEO	Chief Executive Officer
CF	Credit Facility
D-SIB	Domestic Systemically Important Banks
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
FMD	Financial Markets Department
FMI	Financial Market Infrastructure
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Council
FSU	Financial Stability Unit
FSCOM	Financial Stability Committee
IFSC	International Financial Services Centre
IMF	International Monetary Fund
LEG	Legal Department (IMF)
LOLR	Lender of Last Resort
LTRO	Long Term Refinancing Operation
LTV	Loan to Value
MCM	Monetary and Capital Markets Department (IMF)
MFDP	Ministry of Finance and Development Planning
MPC	Monetary Policy Committee
MPE	Multiple Points of Entry
MOU	Memorandum of Understanding
NBFI	Nonbank Financial Institutions
NBFIRA	Nonbank Financial Institutions Regulatory Authority
NPL	Nonperforming Loan
OMO	Open Market Operations
O/N	Overnight Facility
SLF	Special Lending Facility
SPE	Single Point of Entry
TA	Technical Assistance
VaR	Value at Risk
WG	Working Group

## PREFACE

**At the request of the Governor of the Bank of Botswana (BoB), an MCM technical assistance (TA) mission visited Gaborone from February 24 to March 4, 2016.** The mission<sup>1</sup> provided technical assistance (TA) to better align the bank safety net, bank resolution, and crisis management framework in Botswana with best international practices.

**The mission met with Deputy Governors Moses D. Pelaelo and Andrew M. Motsomi, as well as with Solomon M. Sekwakwa, Permanent Secretary of Ministry of Finance and Development Planning (MFDP).** It also met with senior staff, officials, and advisors of the BoB, as well as with public officials of the Nonbank Financial Institutions Regulatory Authority (NBFIRA), and private sector representatives from the banking and insurance sector.

**This report presents the mission's conclusions and recommendations.** The report is based on data and documents provided by the BoB, the NBFIRA, and a select group of market participants. The mission built its work on the recommendations from previous IMF MCM missions on financial stability, IMF LEG TA mission on modernizing the Bank of Botswana Act and the Banking Act in 2014, as well as the Financial Sector Assessment Program (FSAP) concluded in early 2007.

**The mission would like to express its gratitude to BoB officials, particularly to Mr. Goememang Baattholeng and Ms. Mojadi Kwerepe.** The mission would also like to thank the deputy governors, management, and staff of the BoB, and all its other counterparts, for their excellent cooperation, kind hospitality, the excellent arrangements made to facilitate the mission team's work, and for the time and attention provided.

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<sup>1</sup> The mission comprised Messrs. Peter Lohmus (Mission Chief, MCM), Geof Mortlock (Independent Consultant), and David Doran (Central Bank of Ireland).

## EXECUTIVE SUMMARY

**The current legislative framework guiding bank resolution and financial sector crisis management is weak and the authorities have embarked on revising it.** The BoB lacks some of the legal powers required for implementing corrective action for banks that are in breach of prudential requirements or are conducting their business in an unsound or unsafe manner. In particular, existing corrective action powers are too dependent on the BoB having exercised examination powers, while others are constrained by a linkage to de-licensing powers. Key elements for a corrective action framework, including a contingency plan for dealing with weak banks and guidance on indicative remedial measures based on well-defined triggers, are also lacking.

**Once a bank has become acutely distressed, the BoB has insufficient legal powers to resolve the bank effectively.** The current powers are largely limited to the ability to issue directives to a bank, to place a bank into temporary management, and to apply to the court for the winding up of a bank or commencement of judicial management. The powers are not sufficiently certain or wide enough in scope to provide an effective legal framework for resolution.

**Major amendments are required to the legal framework.** Revisions to the existing Bank of Botswana Act (BoBA) and Banking Act (BA) are needed to remedy the deficiencies in the emergency liquidity assistance (ELA) capabilities, corrective action framework and bank resolution powers. The BoB has made substantial progress in drafting proposed amendments to both laws to address these deficiencies.

**Further strengthening of powers in the draft BoBA and the BA would be desirable in order to provide a comprehensive legal framework for corrective action and bank recovery and resolution.** These include conferring on the BoB specific responsibility for the resolution of banks and strengthening the transparency and accountability of the BoB in relation to financial stability assessments and actions.

**In order to refine the draft legislation, it would be desirable for the BoB to engage staff with appropriate legal skills and experience.** Legal staff would also be an important enhancement to the BoB's capacity to draft ELA legal agreements, examine the legal risks and mobilization of potential ELA collateral, develop recovery and resolution policy, resolution guidance, and other aspects of ongoing supervision.

**The capacity of the financial system to adequately allocate liquidity, when it is needed, should be reviewed.** The effectiveness of the current BoB liquidity providing monetary operations could be reassessed.

**A new ELA facility should enable the BoB to provide liquidity support to solvent and systemically important banks that have an urgent need for liquidity, but who have exhausted eligible collateral for interbank and BoB liquidity-providing operations.** This could be provided against an adequate—but extended—list of collateral and subject to ongoing conditionality of solvency, capital adequacy, and viability, as well as further restrictions on business activities. A detailed and robust set of risk-control measures should be put in place to ensure that the BoB is at all times adequately collateralized and not exposed to undue risks from the provision of ELA. The definition of ‘systemically important’ may be dependent on an assessment of the circumstances at each point in time.

**There is a need to establish a deposit insurance scheme as part of the crisis management framework.** The absence of deposit insurance is an important gap in the framework and would significantly impede the ability to resolve a bank cost-effectively. The absence of deposit insurance also exacerbates the risk of depositor runs and bank contagion in periods of banking sector stress. This issue has been considered by the authorities, but as yet no firm proposals have been developed.

**Contingency planning arrangements are needed.** The BoB has not yet developed a contingency plan for how to implement different forms of bank resolution, including resolution strategies and guidance for implementation. It is essential that BoB develop internal guidance on these matters, so that it is well prepared to respond to bank distress or failure in a timely and effective manner. In addition, there is a need to develop and implement a framework for recovery planning for banks.

**Resolution funding beyond deposit insurance is likely to be required for the resolution of systemically important banks.** It is suggested that a resolution-funding mechanism be established in which the government is the initial provider of funding, and which sets out clear purposes for which funding may be provided, the preconditions for funding, and the capacity to attach terms and conditions to any funding provided. Robust safeguards should be incorporated into the framework to ensure that resolution funding is only provided as a last resort, after loss absorption by shareholders and—to the extent practicable—creditors.

**The development and ongoing maintenance of bank recovery and resolution arrangements should be undertaken by a small, but senior-level resolution team established within the BoB.** In order to minimize the risk of conflicts of interest with banking supervision, the team should be separate from the supervision area but work closely with supervisors, and they should have a separate reporting line from banking supervision.

**Coordination arrangements need to be strengthened.** There is a need for close coordination between the BoB, the MFDP, and the NBFIRA. In order to achieve this, it is suggested that an inter-agency Financial Stability Council (FSC) be established to promote information exchange, cooperation, and coordination in all areas relevant to financial system



stability, including bank crisis resolution. The FSC should not have resolution or other regulatory powers; the powers should remain with the relevant member agencies. An FSC working group could be established tasked with coordinating all elements of bank recovery and resolution. A multilateral Memorandum of Understanding (MoU) should set out their respective responsibilities for bank resolution and the processes for coordination of all stages of bank resolution.

**The development and maintenance of bank recovery and resolution arrangements require close coordination across the BoB.** In particular, there is a need for close coordination between staff in the proposed bank recovery and resolution team, banking supervision, financial markets, financial stability, and payment systems, given the interconnections between the different elements of recovery and resolution issues. An advisory Financial Stability Committee (FSCOM) could be established within the BoB to provide input from the departments of supervision, market operations, payments, and monetary policy and financial stability into the decisions taken by the Board on financial stability. Upon a request for ELA, a meeting of the FSCOM would be convened to bring the relevant information to the governor.

**Cross-border coordination also needs to be strengthened.** This is particularly pertinent, given the strong presence of foreign-owned banks. Although the BoB has entered into bilateral MoUs with some foreign supervisory authorities, it has yet to establish MoUs with others. It is therefore suggested that the BoB seek to establish MoUs with the home authorities of the local systemically important banks, focused on the coordination arrangements for bank recovery and resolution, and that they maintain regular dialogue with those authorities on bank recovery and resolution. Where possible, the BoB should seek to participate in supervisory colleges and crisis management groups for the foreign banks that have a systemically important presence in Botswana.

**Although the focus of this mission has been solely on bank resolution, we have also some regard for the need of effective resolution arrangements in the nonbank financial institutions (NBFI) sector as well as in payment and settlement systems.** Based on the limited analysis undertaken during the mission, our impression is that there are significant deficiencies in the legal powers for dealing with the resolution of NBFIs and payment and settlement systems. The policy frameworks and contingency plans in these areas are also under-developed. We therefore recommend that the authorities address these matters in due course, following substantial completion of the bank recovery and resolution framework.

**The main recommendations of the mission are contained in Table 1.**

**Table 1. Botswana: Table of Recommendations**

Main Recommendations	Relevant Authority	Time 1/
<b>Bank corrective action</b>		
Amend the legislation (BA and BoBA) to strengthen the legal powers for enabling the BoB to respond quickly, effectively, and decisively to banking problems, as well as to strengthen and clarify the powers and mandate to extend ELA (paragraphs 19 and 59).	BoB, MFDP	ST
Develop a corrective action framework and contingency plan for responding to banking problems (paragraph 21).	BoB	ST
Strengthen the early warning system arrangements to enable early detection of bank stress and liquidity vulnerabilities (paragraph 25).	BoB	MT
<b>Emergency liquidity assistance</b>		
Review the existing liquidity management capabilities of the banking system, including the effectiveness of current BoB liquidity-providing market operations and the functioning of the interbank market (paragraph 79).	BoB	ST
The BoB should establish an ELA framework to respond to idiosyncratic liquidity needs of banks and internal ELA governance and authorization procedures should be clearly set out (paragraph 81).	BoB	ST
Clear criteria as to when and why to provide ELA funding to a bank should be set out, including reliable solvency, systemic importance, viability, and capital assessments to enable correct ELA decisions to be made (paragraph 84).	BoB	ST
Internally, the BoB should document and duly authorize the ELA principles, guidelines, and criteria to be followed in order to ensure that it is adequately collateralized and not unduly exposed to potential losses (paragraph 92).	BoB	ST
Devise a detailed and robust collateral assessment and valuation approach surrounding ELA (paragraph 95).	BoB	ST
Develop clear trigger points and metrics against which the provision of funding by the BoB to a counterparty can be assessed on an ongoing basis (paragraph 104).	BoB	ST
<b>Bank recovery and resolution</b>		
Devise a framework for ongoing ex post monitoring of banks' use of funds, business practices, transactions carried out, and any additional conditionality imposed on ELA borrowers should be devised (paragraph 106).	BoB	ST
Revise and strengthen the proposed amendments to the BoBA and the BA to establish a comprehensive set of powers for bank recovery and resolution, benchmarking against the FSB Key Attributes (paragraph 28).	BoB, MFDP	ST

**Table 1. Botswana: Table of Recommendations (concluded)**

Main Recommendations	Relevant Authority	Time
Establish a Financial Stability Council to facilitate coordination between the BoB, the MFDP, and the NBFIRA on financial stability (including resolution) issues (paragraph 54).	BoB, MFDP, NBFIRA	ST
Establish a Financial Stability Committee within the BoB to oversee and coordinate all aspects of financial stability, comprising representatives of banking supervision, the proposed resolution team, financial markets, financial stability, and Payment Systems Department (paragraph 83).	BoB	ST
Develop and implement the policies and arrangements needed to require all banks to establish recovery plans, and require all banks to develop, maintain, and regularly test those plans (paragraph 28).	BoB	MT
Develop the policies and arrangements needed for the BoB to undertake resolvability assessments and develop resolution plans for, at least, all systemically important banks, and for other banks, if resources permit (paragraph 39).	BoB	MT
Establish a multilateral Memorandum of Understanding (MOU) on financial crisis resolution between the BoB, the MFDP, and the NBFIRA (paragraph 53).	BoB, MFDP, NBFIRA	ST
Establish liquidity management, bank recovery and resolution MOUs between the BoB and its foreign counterparts, and seek to participate in cross-border crisis management groups for systemically important banks (paragraph 56).	BoB	MT
Develop a program of workshops, staff training, and regular bank crisis exercises to build capacity in crisis resolution (paragraph 58).	BoB, MFDP, NBFIRA	MT
Develop comprehensive policy proposals for a deposit insurance scheme, with a view to establishing the scheme within the next two to three years, if possible (paragraph 46).	BoB, MFDP	MT
Develop comprehensive policy proposals for resolution funding arrangements (beyond deposit insurance), with associated safeguards (paragraph 51).	BoB, MFDP	MT
Review and assess the adequacy of existing resolution arrangements for payment and settlement systems, and develop proposals as appropriate (paragraph 17).	BoB	MT

1/ ST: Short Term; MT: Medium Term.

## I. BACKGROUND

- 1. The banking sector of Botswana is relatively small.** The size of the banks' assets to GDP was 55 percent and the credit to GDP ratio was 32 percent as of end-2015. About 15 percent of the balance sheet consists of banks' claims on the BoB, including central bank securities holdings. The high policy interest rates ('bank rate'), which have underpinned the BoB's monetary policy over the recent years—including the high yields provided by Bank of Botswana Certificates (BoBCs)—has supported banks' profitability. The ratio of nonperforming loans (NPLs) remains relatively low at 3.9 percent, despite a high share of unsecured lending to the households (a large share of the loans are extended to the employees of the public sector or larger corporate and serviced through direct payroll deductions).
- 2. However, the recent slowdown of the economy and the reduction of policy rates have brought new challenges to the sector.** The interest rate margins have rapidly declined along with the reduction of the bank rate and the BoBC yields as liquidity have tightened. The latter can be attributed to several factors, including the worsening corporate sector liquidity (about 70 percent of deposits are corporate deposits, which are more volatile than those of households) and to the creation of a single treasury account. While the banking system still has a structural liquidity surplus, it is distributed unevenly, leading to occasional idiosyncratic liquidity shortages.
- 3. The banking sector in Botswana is moderately concentrated.** It consists of 10 commercial banks and 3 state-owned "statutory banks" (specially chartered banks). Within the area of commercial banking, 79 percent of banking assets are held by four banks, and two members of that group held about 46 percent of total banking assets as of end-2015. Two out of 10 commercial banks have only recently entered the market. All of the commercial banks are foreign owned in one way or another; some are direct subsidiaries of United Kingdom, South African, and other countries' banking groups.
- 4. Three banks exited from the market during 2014–2015.** In February 2015, the BoB assumed temporary management of one bank, with a view to "finding a resolution to its unsound and deteriorating financial condition." As a part of the International Financial Services Centre (IFSC) initiative, the bank was licensed as an offshore bank and was conducting all of its businesses overseas. In 2014, two foreign subsidiaries voluntarily returned their bank licenses, which had also been granted under the IFSC umbrella.
- 5. Total assets of NBFIs surpass those of the banking sector.** As of end-2015, the total amount of assets under management by investment institutions accounted for 44 percent of GDP and the pension fund assets for about 41 percent of GDP. Furthermore, the cross linkages between the NBFIs and the commercial banks are significant. The NBFIs' wholesale deposits constitute almost 10 percent of banks' total deposits and have increased in recent years. This could propagate and amplify system-wide contagion.

6. **The financial sector is supervised by the BoB and the Nonbank Financial Institutions Regulatory Authority (NBFIRA).** The BoB has regulatory and supervisory responsibility for commercial banks, *bureaux de change*, and one deposit-taking microfinance institution, as well as for statutory banks. It also has oversight responsibilities for the payment system. The NBFIRA supervises the nonbank financial institutions; notably, the insurance industry, pension funds, stock exchange, fund managers, other investment advisory service providers, and micro-lending businesses.<sup>2</sup> The NBFIRA is accountable to the MFDP.

7. **The 2007 FSAP also covered a number of aspects related to the bank resolution framework.** The FSAP recommended “establishing a bank resolution framework that would include broad internal guidelines that take account of the fact that, presently, most banks are foreign-owned subsidiaries.” Further recommendation was given on preparing “internal guidance which could describe the triggers for bank resolution, intervention procedures, authority, liquidation issues, and accountability of the institutions involved in stress or crisis management.”

8. **Botswana’s current legislation for central banking and banking is still lagging behind the evolving financial sector and best international practices.** The BoBA and the BA—whose last significant revisions date back, respectively, to 1996 and 1995—no longer provide an adequate framework for the conduct of the BoB responsibilities. In contrast, the NBFIRA, which was established more recently in 2006, is vested with stronger powers and acts under a more advanced regime, although still with deficiencies compared to international best practice. A LEG TA mission from April 2014 provided assistance in revising the BoBA and the BA, but limited progress has been made since then.

9. **The remainder of the report is structured as follows:** Section II describes the framework and steps for dealing with bank distress and failures. This is followed by a discussion on emergency liquidity assistance in Section III.

## II. DEALING WITH BANK DISTRESS AND FAILURE

### A. Key Elements

10. **The mission team regarded international principles and practices closely in assessing the bank recovery and resolution framework in Botswana and in identifying areas for strengthening.** In particular, we have assessed the current arrangements in Botswana with regard to the relevant aspects of the Financial Stability Board (FSB) *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes), the Basel Committee of Banking Supervision (BCBS) *Core Principles for Effective Supervision* (Core Principles), and the BCBS *Guidelines for Identifying and Dealing with Weak Banks*

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<sup>2</sup> Banking Supervision Annual Report (2014).

(Guidelines). In doing so, we have had careful consideration of the structure of the banking system in Botswana, the institutional arrangements and the need to tailor solutions to the particular characteristics of the Botswana financial system and the resources available to the authorities.

**11. The framework required for dealing with bank distress and failure comprises a number of key elements.** These include:

- Clearly defined and transparent objectives for dealing with bank distress and failure.
- Robust institutional arrangements, including the designation of a resolution authority with well-defined responsibilities, resources, and accountability.
- Comprehensive legal powers.
- Well-developed policies and guidelines for dealing with bank distress and failure, including guidelines on corrective action, resolution strategies, and a toolkit to assist in the implementation of resolution.
- Requirements for bank recovery planning.
- A framework for undertaking bank-specific resolvability assessments and developing resolution plans.
- Deposit insurance in situations where a bank is no longer viable.
- A means of funding resolution (beyond deposit insurance) in situations where some form of open resolution is to be implemented and externally sourced funding is required.
- Domestic and cross-border cooperation and coordination arrangements.
- A program to build and maintain institutional capacity for dealing with bank distress and failure.

**12. This report assesses the existing arrangements in Botswana in each of the above areas.** It sets out recommendations for strengthening the framework for dealing with bank distress and failure in respect of each area.

## **B. Objectives**

**13. Clearly defined objectives are a critical element in the framework for dealing with bank distress and failure.** The legislation governing these areas should establish objectives that are clear and consistent with sound financial stability outcomes. International

guidance and best practice provide helpful points of reference in this regard. In this context, the standard objectives for dealing with bank distress generally focus on restoring a bank to a sound financial condition and compliance with prudential requirements, consistent with the ultimate objective of maintaining the stability of the financial system and protecting depositors. The objectives for bank resolution are well articulated in the Key Attributes and focus on:

- ensuring continuity of systemically important financial services;
- protecting depositors, in accordance with deposit insurance arrangements;
- allocating losses to shareholders and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;
- avoiding reliance on public solvency support;
- avoiding unnecessary destruction of value;
- providing for speed, transparency, and predictability through legal and procedural clarity and advanced planning for orderly resolution;
- promoting effective domestic and cross-border coordination; and
- facilitating market-based solutions, where practicable.

14. **The current law in Botswana does not set out clear objectives for dealing with bank distress and failure.** This has been recognized by the BoB, and proposals for amendments to the BoBA and BA have been developed by the authorities with assistance from the IMF. In most respects, these proposed amendments are satisfactory and would, if implemented, go a long way toward aligning the law in Botswana with international principles and practice. However, it would be desirable to provide further clarity to the objectives by modifying the proposed amendments to both the BoBA and the BA, including by strengthening the focus on promoting financial stability in the BoBA and by including objectives in the BA in relation to banking supervision, corrective action, and resolution. The mission's recommendations in this respect are set out in Appendix I, dealing with legislative issues.

### **C. Institutional Arrangements**

15. **It is important that there be a clearly designated agency responsible for the resolution of banks, and that the agency be adequately resourced for the task, and be accountable for the exercise of its powers.** Currently, the law in Botswana does not explicitly designate a resolution authority, although the BoB is, in substance, the resolution

authority by virtue of its existing powers for resolving banks (albeit, those powers are not adequate, as discussed below).

16. **This has been recognized by the BoB, who is proposing that the law be amended to empower it with the powers needed to discharge the functions of resolution authority in respect of banks.** To that end, proposed amendments to the BA have been drafted, which confer a substantial set of new resolution powers on the BoB. However, there appears to be no proposed amendment to the BoBA explicitly designating responsibility for bank resolution on the BoB. We recommend that the BoBA be amended to address this matter. Specific suggestions are included in Appendix I.

17. **It would also be desirable to clarify the BoB's responsibilities for resolution of payment and settlement systems.** The BoB has broad oversight responsibilities for payment and settlement systems, with a view to promoting payment and settlement systems that meet financial stability objectives. However, the formal mandate in this area lacks clarity in the BoBA. There is no reference in the BoBA to the role of the BoB in resolving distress or failure in payment and settlement systems, and no clear specification of legal powers in this area. Given that payment and settlement system resolution is beyond the scope of this mission, the report does not discuss this matter in further detail. However, it is suggested that the BoB review the BoBA and relevant other laws with a view to clarifying the responsibilities and powers of the BoB for payment and settlement system resolution. Equally, consideration should be given by the BoB to the policies, procedures, and resourcing required to resolve payment and settlement system distress or failure.

18. **It is also important that the resolution responsibilities of other agencies, particularly the MFDP, are explicitly recognized in law.**<sup>3</sup> A matter that is not addressed in any detail in this report, because it lies outside the terms of reference for the mission, is the need for the NBFIRA to be equipped with appropriate resolution responsibilities and powers with regard to the financial institutions that it licenses and supervises. The current law in this area falls well short of the principles established in the Key Attributes and best international practice. It is therefore suggested that the authorities give consideration to assessing the nature of the deficiencies in existing legal and institutional arrangements for NBFIR resolution once the bank resolution framework has been established.

#### **D. Powers**

19. **A fundamental requirement for effectively dealing with bank distress and failure is a comprehensive set of legal powers.** These include powers to:

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<sup>3</sup> We discuss this matter later in the report when considering the role of the MFDP in relation to bank resolution in the context of resolution funding.



- require banks to take corrective actions in circumstances where they are in breach, or are likely to breach prudential requirements, or are otherwise operating in a manner that is prejudicial to the safety of depositors and stability of the financial system;
- enable the supervisor to directly make changes to a bank's operations and structure to facilitate corrective actions, including the power to remove and replace directors and management;
- require banks to prepare recovery plans, undertake periodic testing of the plans, make required changes to the plans, and have the plans reviewed by an external party where appropriate;
- enable the resolution authority to obtain information from banks to facilitate resolvability assessment and resolution planning;
- enable resolution authorities to require banks to make changes to their operations and structure in order to facilitate pre-positioning for resolution in accordance with resolution plans;
- enable the resolution authority to obtain information from banks for the purpose of assessing their financial soundness and to undertake solvency assessments;
- enable the resolution authority to declare a bank to be in resolution and to assume control of the bank, or appoint an administrator to assume control of the bank;
- enable the resolution authority to implement any one or more of a range of resolution options upon non-viability triggers being breached, including: recapitalization of the bank; sale of equity in a bank to another bank; transfer of some or all of the assets and liabilities of a bank to another bank or bridge bank; bail-in liabilities; establishment of a bridge bank; and transfer of impaired assets to an asset management vehicle established for the purpose; and
- enable the resolution authority to share information and coordinate resolution actions with other relevant agencies, both domestic and foreign.

20. **It is also necessary to have a legal framework that includes a comprehensive moratorium for a defined maximum period to facilitate resolution.** There should also be appropriate safeguards in the resolution framework, including clearly specified triggers for the exercise of resolution powers and a process for ensuring that no creditor or shareholder is rendered worse off than if the bank been placed in a conventional liquidation.

21. **The existing law in Botswana is inadequate to facilitate effective corrective actions or resolution of banks.** The powers available to the BoB are very limited, such that it faces severe impediments to the capacity to respond quickly, effectively, and with legal

capability to bank distress or failure situations. This has been recognized by the BoB and draft proposed amendments to the BoBA and BA have been developed to address these deficiencies. Overall, the proposed amendments are comprehensive and in line with the Key Attributes and international practice. However, there are still substantial deficiencies in the proposed draft law which should be remedied before the proposed amendments are submitted to the MFDP (Appendix I). In brief, the main deficiencies are:

- Legal powers relating to bank's corrective action and resolution should be exercisable in relation to banks and any entity in the regulated banking group (i.e., any holding company or subsidiaries), rather than only in relation to banks.
- The triggers for invoking corrective actions would benefit from further specification, enabling early intervention before a bank's condition has deteriorated significantly.
- The BoB should be required to establish a contingency plan to facilitate bank corrective action and resolution, including clearly identified triggers for particular responses.
- The BoB should be empowered to require banks to develop, maintain, and test recovery plans, and to require changes to those recovery plans.
- The BoB should be empowered to undertake resolvability assessments of banks and develop resolution plans for banks and, for these purposes, to obtain information from banks and require the information be audited.
- The BoB should be empowered to require banks to change their operations and structure in a manner specified by the BoB to facilitate recovery and resolution.
- The provisions relating to administration should be modified to make it clear that an administrator can be appointed to any entity in the regulated banking group.
- The provisions relating to administration should enable resolution actions to be implemented at any time after the administrator's appointment, rather than being subject to delays associated with the administrator reporting to the BoB and then having the BoB consider the recommendations from the administrator.
- The provisions in relation to the bail-in of liabilities should be strengthened to include any category of liability other than insured deposits and secured liabilities.
- The law (possibly through a separate act) should provide for the government to provide funding for resolution purposes, subject to appropriate safeguards, including clearly defined purposes and preconditions, and with the capacity to recover funding outlays from the banking industry through levies on banks to the extent of shortfalls (in net present value terms) from the assets of the bank in resolution.

- The BoB should be empowered to establish entities for the purpose of acquiring impaired assets from banks in resolution, where it considers this to be more cost-effective and less disruptive to the financial system and economy than leaving the impaired assets in the failed bank to be liquidated.
- The safeguards for the exercise of resolution powers should be extended and set out in the BA more precisely, including the process for determining whether, and to what extent, creditors and shareholders might be rendered worse off than in a liquidation and associated compensation arrangements.
- The moratorium provision should be limited in duration.
- The BA should enable affected parties to seek judicial review of resolution decisions, but the courts should be prohibited from suspending the process of resolution or ordering any change to resolution decisions, provided that the BoB and administrator exercised powers in accordance with the BA and not in bad faith. Compensation should be the only judicial remedy for court challenges by affected parties, to the extent that the affected party was rendered worse off than in a conventional liquidation.

22. **It is suggested that the BoB engage senior legal advisers to assist in reviewing and refining the draft amendments to the BoBA and BA, working closely with other staff in the BoB and with input from the MFDP.** As noted later, we also recommend that the BoB engage staff with appropriate legal qualification and experience, especially in banking and insolvency law, as permanent staff members. This will assist the BoB to establish the capacity required to perform ongoing supervisory corrective action and resolution functions.

### **E. Corrective Action Framework**

23. **There is no established formalized corrective action policy framework yet, although elements of it are in place in the form of prudential requirements for capital, liquidity, and large exposures that could form trigger elements for corrective actions.** It is recommended that the BoB develop internal guidance that sets out a corrective action framework. This is important both as part of ongoing supervision to facilitate the effective enforcement of prudential requirements and as a framework for dealing with banks that are coming under financial stress and are in need of remedial action. The guidance should set out the triggers for corrective action, including capital ratios, liquidity positions, loan exposure concentration, and NPL ratios among other matters. In relation to each trigger, the guidance would set out indicative actions that the BoB could take if the triggers have been breached. The remedial actions would depend on the trigger and the situation, and could include requirements to suspend distributions to shareholders, suspend lending to related parties, curtail new lending, raise additional capital, change governance and management arrangements, replace directors

and senior management, strengthen risk management and governance arrangements, and implement structural changes in the bank or wider group.

24. **The corrective action guidance should be prepared in accordance with to international principles and practice, including the BCBS Guidelines.** In that regard, the key elements of the contingency plan for corrective actions would include the following:

- mechanisms by which the supervisor will become aware of a weak bank and/or systemic problems, including early warning indicators and stress testing;
- a methodology and associated capacity for the BoB to assess the solvency and liquidity position of a bank and banking group for the purpose of determining the nature of the remedial measures and, if necessary, resolution measures required;
- arrangements to discuss the problems at the bank with its Board and management without delay;
- arrangements to conduct an in-depth assessment, including the use of independent experts, if necessary;
- arrangements for reporting the assessment findings and who will be informed inside and outside the supervisory agency;
- responsibilities for determining the supervisor's detailed course of action;
- the means of communicating and coordinating supervisory action with other relevant parties (in particular, resolution authorities, finance ministries, and central banks);
- internal coordination between relevant departments;
- arrangements for any public announcement, where appropriate, and the subsequent management of public information;
- potential conflicts with the objectives of government or other relevant agencies and how these might be resolved;
- mechanisms for monitoring the success (or otherwise) of supervisory actions and adjusting them as necessary; and
- adequate financial and staff resources for intense supervision, including arrangements for coordinating with, and contributing to, an ongoing resolution planning and resolvability assessment process.

## F. Early Warning Indicators

25. **The BoB needs to ensure that there are reliable early warning indicators of emerging financial system stress.** This will help to facilitate a prompt response to emerging stress in a particular bank, or the banking system as a whole, and reduce the costs and other adverse consequences associated with a banking crisis. It is especially important for the BoB to establish and maintain the ability to respond quickly to an emerging stress situation before it reaches a point of acute bank distress or failure. In this context, early warning indicators are an important complement to the BoB's framework for prompt corrective action. Although the BoB undertakes regular monitoring of banks and conducts stress testing, it does not have a comprehensive framework of early warning indicators.

26. **In the event of stress in the financial system, and in preparation for a response to possible bank distress, the BoB would need to intensify its monitoring of banks.**

Depending on the situation, increased monitoring might include:

- data on daily deposits and withdrawals of deposits by category of deposit;
- changes in holdings of liquid assets;
- the maturity profile of debt (updated regularly);
- actual and projected drawdowns on credit facilities;
- lending to related parties;
- lending to counterparties assessed as being at risk;
- bank funding risk premiums;
- payments or distributions of any kind to shareholders; and
- changes in NPLs.

## G. Crisis Diagnostics

27. **It is recommended that the BoB strengthens its internal guidance on, and capacity to undertake, crisis diagnostics.** This includes the ability to assess the potential systemic impact of a bank in distress, including through impacts on credit, liquidity, payments and settlements, and interbank contagion. The guidance developed by the FSB and the BCBS on the assessment of domestic systemically important banks provides helpful reference material for the purpose of developing a systemic impact assessment framework. The diagnostics framework also requires the BoB to have the ability to assess the financial position of a bank (both as to solvency and liquidity), potentially under acute time pressure, including its capital position, economic solvency, and liquidity. It is suggested that the BoB develop guidance in this area, including a framework to enable supervisors to undertake asset quality reviews and valuations, including within a compressed timeframe. Regular testing of this would be beneficial as part of the overall capacity-building program.

## H. Recovery Planning

28. **Recovery planning by banks is an essential element of a bank recovery and resolution framework.** Recovery plans are intended to enable banks to restore their financial soundness and in compliance with prudential requirements following an adverse impact on their capital or liquidity.

29. **The BoB has not yet initiated requirements for recovery plans for banks or developed policy guidance for this purpose.** It is suggested that this be done as a matter of high priority, particularly for those banks that are considered to be systemically important, but also for all other licensed banks.

30. **The development of recovery planning requirements should be based on guidance developed by the BoB.** The guidance should require banks to prepare recovery plans for two categories of scenario: idiosyncratic shocks (in which just the bank in question has sustained impacts to its capital and liquidity); and systemic shocks (in which all banks are assumed to have sustained impacts to capital and liquidity). The BoB should require foreign-owned subsidiaries to prepare recovery plans in close conjunction with their parent banks, covering both a scenario in which the parent bank is assumed to remain in a sound financial condition, and a scenario in which the parent bank is assumed to have sustained adverse impacts on its capital and liquidity. It would be useful to establish a small team of senior-level staff with responsibility for bank recovery and resolution, with a separate reporting line to a deputy governor.

31. **The BoB should specify requirements it expects to see addressed in recovery plans.** These might include requirements relating to:

- restoration of capital to the required level (including through explicit parent bank support where applicable);
- pre-positioning for capital restoration, including through appropriate preparation for asset sales and capital issuance;
- maintenance of sufficient liquidity to meet obligations under stressed conditions, including pre-positioning for obtaining liquidity support from a parent bank (if applicable), and other private sector sources;
- maintaining depositor and other counterparty confidence;
- maintaining the confidence of credit rating agencies, where applicable;
- identification of regulatory and other legal obstacles to recovery and how these are to be addressed;

- communication with all relevant stakeholders; and
- coordination required between a parent bank and its subsidiary in Botswana.

32. **It is suggested that the BoB assesses what actions it may need to take to assist the banks in their recovery actions.** For example, this could include the fast-tracking of regulatory approvals for capital issuance, temporary relaxation of capital requirements pending the bank completing its recapitalization, and temporary relaxation of large exposure limits as a result of a bank's capital declining, pending recovery.

33. **Consideration should also be given to the nature of coordination required between home authorities for the parent banks and the BoB.** This would include such matters as facilitating parent-bank capital and liquidity injection into the subsidiary in Botswana.

34. **Regular testing of bank recovery plans is important.** It is suggested that the BoB requires all banks to regularly test their recovery plans through crisis-resolution exercises. These exercises provide a means of assessing how well-prepared the banks are to complete their recovery actions within the needed timeframes. They also assist in refining the recovery plans and building greater awareness of recovery plan implementation processes in the banks. The nature of this testing and the result of the tests should be reviewed regularly by the BoB. In the case of foreign bank subsidiaries, the testing of recovery plans should ideally be done in coordination with a testing of the parent banks' plans for the provision of support to their subsidiaries in Botswana.

### **Resolution policy framework**

35. **There is no substantive resolution policy framework in Botswana.** As yet, no contingency plans have been developed by the BoB to set out guidance on bank resolution, such as the options for resolution, the criteria for selecting particular options, the procedures for implementing resolution, checklists of required actions, or guidance on communication and coordination arrangements. There are also no guidelines on how cross-border resolution would be handled in the foreign-owned banks operating in Botswana. Similarly, the MFDP has not yet developed internal guidance on how it would advise the relevant minister as to whether any public funding or financial support should be provided in a bank resolution, the terms and conditions on which such support could be provided, and the means by which any shortfalls in recoveries from the assets of a failed bank to repay government financial support could be recovered from the banking industry.

36. **Effective crisis resolution requires the development of guidance on resolution strategies and implementation arrangements—a crisis resolution toolkit.** The BoB should develop a comprehensive contingency plan that would enable it to respond effectively to a range of plausible bank distress and failure situations, both in respect of the domestic banks and

foreign-owned banks. The contingency plan should cover all significant elements of bank crisis resolution. This would likely include the following:

- The resolution options available to address a range of bank-distress situations, including closed resolution, open resolution by a sale to another bank, open resolution via transfer to a bridge bank, and recapitalization of a failed bank.
- Methods of recapitalization, including cancellation of existing shares, issuance of equity or other capital instruments to new shareholders, and bail-in of liabilities.
- Guidance on the implementation of Single Point of Entry (SPE) recapitalization, where a bank is owned by a foreign bank or holding company—i.e., where capital is injected directly into the bank rather than through the parent entity.
- Guidance on the implementation of Multiple Points of Entry (MPE) recapitalization where a bank is owned by a foreign bank or holding company—i.e., where capital is injected into the bank by the parent entity.
- Guidance on the procedures required to establish a bridge bank.
- Guidance on the procedures required to establish an asset management company.
- Procedures for transferring assets and liabilities, and rights and obligations, from a failing bank to either another bank or to a bridge bank, and potentially transferring impaired assets to an asset management company.
- Guidance on coordination with the MFDP and the NBFIRA.
- Guidance on coordination with foreign resolution authorities.
- Guidance on communications with stakeholders.

Appendix II contains more detail on the issues relating to resolution contingency planning.

37. **The MFDP also needs to develop its contingency plan for bank resolution.** In particular, it is important for the MFDP to establish the criteria it would use to assess whether any public financial support should be provided in a bank resolution, the nature of such support, and the terms and conditions on which any support will be provided to ensure robust safeguards to protect taxpayer interests and minimize moral hazard. The MFDP also needs to identify the means by which any funding outlays not recovered from the assets of the failed bank will be recovered, such as through levies on the banking industry.



## Resolvability assessments

38. **It is suggested that the BoB undertakes a resolvability assessment of all systemically important banks.** These assessments are intended to identify how the BoB would resolve a particular bank cost-effectively and in a manner that is consistent with maintaining financial system stability in the event that it becomes acutely distressed and unable to recover to a position of financial soundness through its own means.

39. **Resolvability assessments should be reviewed regularly and updated to ensure that they remain current.** The resolvability assessment should identify the feasibility of resolution options for each of the banks on the basis of achieving a least-cost resolution that meets the objectives of maintaining financial system stability and protecting depositors.

40. **The resolvability assessment should include such matters as:**

- Identifying the critical (i.e., systemically important) financial and economic functions the bank performs, including the location of such functions by legal entity and jurisdiction, and the interdependencies between such functions.
- Assessing the extent to which key operational functions—such as payment operations, trade settlements, and custodial functions—are outsourced to other group entities or third-party service providers. Consideration should be given to how robust the existing service-level agreements are in ensuring that the key operational functions will continue to be provided to a bridge institution or to surviving parts of a resolved bank when necessary.
- Assessing any obstacles to separating systemically critical functions from the rest of the bank in a resolution and to ensuring their continuity.
- Assessing whether the bank being resolved could retain membership of financial market infrastructures (FMIs), such as payment and settlement systems, pending resolution and whether, if a bridge entity is formed, it could access FMIs.
- Assessing whether banks have in place arrangements that facilitate the transfer of payment operations to a bridge institution or third-party purchaser.
- Assessing whether the appointment of an administrator or the transfer of business to another entity could trigger events of default by counterparties.

## Bank-specific resolution plans

41. **Bank-specific resolution plans should be developed for the systemically important banks.** These plans would be based on the resolvability assessments undertaken by the BoB, and would draw upon the main resolution strategies and options identified by the BoB. The plans would set out the resolution options considered to be practicable for that particular bank and also set out the processes and procedures required to implement each resolution option. This would typically include identifying:

- the critical functions for the bank and banking group;
- the inter-dependencies and the impact of resolution actions on other business lines and legal entities, on financial contracts, on markets and other firms with similar business lines;
- the processes for preserving uninterrupted access to payment, clearing and settlement facilities, and exchanges and trading platforms;
- the internal processes and systems necessary to support the continued operation of the bank's critical functions;
- processes for their cross-border implementation; and
- communication strategies and processes to coordinate communication with foreign authorities.

42. **In the case of foreign-owned banks, the resolution plans should identify resolution options on both an SPE basis and an MPE basis.** The plans would identify the actions needed to implement SPE and MPE forms of recapitalization. This should be done in close coordination with the home authorities of the parent banks, either bilaterally or through multilateral crisis management groups, where these have been established by the home authorities. For situations where home/host coordination is not readily achievable, the BoB should develop resolution strategies that focus on stand-alone resolution options (i.e., recapitalization on an SPE basis where the subsidiary is recapitalized directly through bail-in or other means, or bridge bank or merger resolution options).

43. **In some cases, it may be necessary to require banks to pre-position for resolution options.** For example, it may be necessary to require banks to structure their operations, IT systems, internal controls to enable core banking services (such as deposit taking, payment and settlement services, and lending under committed credit facilities) to be separated from the non-core banking business and transferred to a bridge bank or another existing bank. This pre-positioning is an important component of resolution planning and should be implemented well in advance of any crisis event as a part of resolution planning.

## I. Deposit Insurance

44. **Deposit insurance is an essential element of a bank resolution framework.** It provides a mechanism for giving depositors quick access to their deposits and insulating them from loss, up to a clearly defined limit. As such, it reduces the risk of deposit runs and bank contagion. Deposit insurance enables small- and medium-sized banks to be closed with minimal impact on retail depositors. It also facilitates the transfer of deposit liabilities to viable banks by providing a funding source for such transfers, and thereby gives depositors continued access to the deposits with minimal disruption. Deposit insurance also reduces the risk of government-funded bail-outs by providing a clear demarcation between insured deposits and uninsured deposits and other liabilities. In that regard, it makes bail-in a less disruptive option.

45. **The absence of a deposit insurance scheme in Botswana is a major gap in its bank resolution framework.** This has been recognized by the BoB, who analyzed the issue and is developing preliminary proposals. However, no substantive progress has been made within the government in establishing a deposit insurance scheme.

46. **We recommend that, as a matter of high priority, the authorities develop proposals for a deposit insurance scheme, with a view to establishing a scheme within two to three years.** It is suggested that the BoB and MFDP work jointly to develop a paper for eventual referral to the Minister of Finance, covering:

- the objectives of deposit insurance and the rationale for introducing deposit insurance in Botswana (including the risks to financial stability and the taxpayer if such insurance is not established);
- the coverage of the deposit insurance scheme;
- the deposit insurance limit;
- the functions of the deposit insurance scheme (including the choice between a simple ‘paybox’ scheme versus a risk-minimization scheme);
- institutional arrangements, such as whether the insurance scheme should be operated through a new agency or as part of the BoB;
- the indicative size of a deposit insurance fund;
- funding options, including fully pre-funded by levies on banks, fully post-funded, or a hybrid funding structure (in which banks contribute to a fund through regular levies, and where additional funding can be sourced from the government through a credit line if needed, with banks being levied to repay liabilities to the government); and

- methods of payout and recovery processes.

47. **Given the small size of Botswana’s financial system and the desire to avoid excessive complexity in institutional arrangements, the mission would encourage the authorities to design a relatively simple, but effective, form of deposit insurance.** In this regard, our view is that the scheme might appropriately have the following features:

- A deposit insurance limit that is relatively low, in order to minimize moral-hazard risks and funding costs, but sufficient to cover a substantial majority of retail deposits—particularly deposits held in transaction accounts.
- A paybox scheme, where the only functions of the deposit insurance agency are to collect levies from banks, ensure that banks maintain the pre-positioning required to facilitate accurate calculation of deposits on a ‘single customer view’ basis, maintain the capacity for making rapid payout or availability of funds to enable the transfer of deposits to another bank, and recover funding outlays from the assets of the failed bank in liquidation. Under this arrangement, the deposit insurance agency would not be the resolution authority and would have no powers over the resolution of a bank; its sole purpose would be to perform the deposit insurance function.
- Arrangements to enable depositors to be paid or otherwise given access to their deposits, up to the defined limit, within seven days of the closure of a bank.
- A decision on whether the deposit insurance agency will be affiliated to the BoB (but under separate governance arrangements) or a stand-alone agency.
- Safeguards on the use of the funds in the deposit insurance scheme for wider resolution funding purposes, including that the funds be used only for the protection of insured depositors and only up to the amount that would have been paid to insured depositors under a least-cost option, net of asset recoveries from the failed bank.
- The scheme to be funded by levies on banks, allowing for the fund to reach its target over a reasonable period (e.g., 10 years). Initially, we would suggest that the levy be a uniform rate per deposit, but with the scope to eventually adopt a risk-based levy.
- The scheme to have a funding line with the government to access additional resources to cover any shortfalls between the amount to be disbursed in a bank resolution and the amount available in the fund at the time. The scheme should require to levy banks to repay any debt outstanding to the government, plus interest, and/or where this has not been recovered from the assets of the failed bank.

## **J. Resolution Funding Beyond Deposit Insurance**

48. **In the case of a closed resolution, where a bank is closed and liquidated, funding to repay insured depositors would come from the proposed deposit insurance scheme.**

In the case of a bank resolution where the bank is kept open in some form (either through recapitalization or by a transfer of systemically important and commercially viable business to a bridge bank or another bank), additional sources of funding may be required. This is especially the case with systemically important banks. In such cases, funding may be needed for various aspects of the resolution—e.g., to provide a temporary guarantee of a resolved bank’s liabilities, an indemnity to particular parties, or funding for recapitalization or business transfers where bail-in is not sufficient or practicable.

49. **As a general rule, external funding should only be provided once all assessed losses in the failed bank have been fully absorbed by shareholders and then by creditors in accordance with the ranking of claims in a winding up.** External funding would only be drawn on where the bank in resolution has insufficient funding to complete the resolution or where a decision has been made to exempt some categories of liability from bail-in (e.g., derivatives obligations).

50. **Resolution funding may come from several sources.** The main options are through a resolution fund that is financed through levies on banks (often supplemented with a credit line) or funding from the government. Given the small size of the banking sector in Botswana and the need to first establish a deposit insurance scheme funded by banks, it is suggested that the establishment of a resolution fund be deferred until deposit insurance has been well established and the deposit insurance fund has reached an appropriate target level. This would suggest that, in the meantime and possibly on an ongoing basis, there will be a need for the government to be the source for resolution funding, subject to a number of important safeguards. This has been contemplated by the draft amendments to the BA, where there is provision for the government to provide resolution funding. (In Appendix I, we note the need for the draft provision on resolution funding to be reviewed and amended to strengthen the safeguards for the use of government funds for bank resolution.)

51. **It is suggested that the BoB and MFDP develop proposals for a new law to provide for government funding for bank resolution, subject to a number of safeguards.** These safeguards and other relevant provisions would likely include:

- A clear set of statutory purposes for the provision of any financial assistance, anchored to maintaining the stability of the financial system, such that government funding could only be provided when the BoB, the MFDP, and the minister are all satisfied that the funding is needed to protect the stability of the financial system.

- A requirement that all estimated losses in the failed bank have been fully allocated to shareholders and creditors to the extent practicable, and all market-based sources of funding have been drawn upon before external resolution funds are considered.
- Powers to attach enforceable conditions to any support provided in a bank resolution.
- Powers to levy banks to the extent that the government does not fully recover the amount of disbursements, including interest, in net-present-value terms.

52. **In giving consideration to this matter, the BoB and the MFDP should think about possible statutory triggers for the provision of funding and financial support for bank resolution.** These might appropriately include:

- The provision of funding is considered by the MFDP and the BoB to be necessary for preserving financial system stability and other statutory resolution objectives.
- The government is satisfied, on the advice of the BoB and the MFDP, that all assessed losses have been absorbed by the shareholders and creditors—other than insured deposits—of the failed bank, except when the BoB believes it would be contrary to the resolution objectives to impose losses on certain categories of creditors.
- The government is satisfied, on the advice of the MFDP and the BoB, that funding or financial support can be structured in a manner consistent with maximizing the probability of recovering the full NPV of funding outlays, to the extent practicable, over time, or of recovering losses through levies on the banking industry.
- The minister, the MFDP, and the BoB are satisfied that funding or financial support can be provided on terms that enable all material risks associated with providing support to be prudently managed.

### **K. Domestic Coordination**

53. **It is essential that there be close coordination between the BoB, the MFDP, and the NBFIRA in responding to a bank’s distress or failure situation.** In order to facilitate this coordination, it is suggested that the three agencies establish a multilateral Memorandum of Understanding (MoU) that sets out their respective responsibilities in responding to a banking crisis, particularly in the case of a systemic bank. The MoU might appropriately include the respective agencies’ responsibilities for, and cooperation and coordination in relation to:

- the assessment of the systemic and wider economic impact of a bank in distress;

- the assessment of the financial position of the bank, including its capital position, solvency and liquidity;
- the options for resolution, assuming that recovery is not feasible, and the assessment of each option;
- the matters on which each agency should coordinate with their respective foreign counterparts, where applicable;
- the options for facilitating capitalization of the bank or recapitalization of a bridge bank;
- the possible need for resolution funding or other forms of government financial support; and
- the key stakeholders with whom each agency should take responsibility for communicating, and the coordination thereof.

54. **It is also suggested that the authorities establish an FSC or similar body to coordinate and oversee the monitoring of financial stability, and to facilitate coordination of bank resolution and other financial sector stability issues.** The FSC would comprise senior-level representatives of all of the government agencies with responsibilities relating to financial system stability, regulation, and resolution. It should have a written mandate that is published on the authorities' respective websites, setting out the functions of the FSC, including with respect to cooperation and coordination of bank resolution and crisis management. The FSC should not have regulatory or resolution powers; those powers should reside with each member agency in relation to their respective areas of responsibility. Rather, the FSC should solely be a body to facilitate information sharing, cooperation, and coordination. It would appropriately meet at regular intervals (e.g., quarterly) to exchange information and assessments on financial stability and regulatory issues, and to facilitate cooperation and coordination. During a banking crisis, it would meet as necessary to ensure that all resolution actions are coordinated among the authorities. The FSC could be chaired either by the BoB governor or on a rotating basis.

55. **Working groups or sub-committees of the FSC could be established from time to time to develop more detailed cooperation and coordination arrangements in relation to particular subject areas.** This is especially important in the case of bank resolution and crisis management, where a working group reporting to the FSC would be an appropriate forum within which the detailed cooperation and coordination arrangements of bank resolution and crisis management could be developed and maintained. It is therefore suggested that an FSC permanent sub-committee be established, chaired by the BoB and comprising senior staff from all member agencies, that would be responsible for coordinating

policies, processes, and procedures relating to bank resolution and financial crisis management

#### **L. Cross-Border Coordination**

56. **Because the Botswana financial system is dominated by foreign-owned banks, cross-border cooperation and coordination is essential.** Currently, there is no substantive cross-border coordination arrangement in place to facilitate effective bank recovery and resolution. There are some MoUs between the BoB and their supervisory counterparts in other countries, and proposals to develop others. However, these are basic information exchange agreements, and they only include brief provisions on bank crisis resolution. It is therefore suggested that the BoB seeks to establish MoUs on bank recovery and resolution with their counterparts in the parent-bank home jurisdictions, particularly in respect of the systemically important banks. The MoUs would, desirably, include provisions to facilitate cooperation and coordination in relation to:

- the assessment of the capital and liquidity position of the parent bank and subsidiary;
- recovery planning, resolvability assessments and resolution planning;
- guidance on implementation of resolution options, identifying the respective responsibilities and areas of coordination of the home and host authorities. This would include guidance on how SPE and MPE forms of resolution could be implemented;
- to the extent practicable, burden-sharing arrangements between the parent authorities and the Botswana authorities (e.g., where the parent recapitalizes the subsidiary, but the parent authorities expect a contribution from the Botswana authorities for this); and
- the key stakeholders with whom each agency should take responsibility for communicating, and the coordination thereof.

57. **In addition to developing more specific cross-border MOUs, it is also recommended that the BoB seeks to participate in supervisory colleges and crisis management groups of foreign banks with a systemically important presence in Botswana.** Where full participation in supervisory colleges and crisis management groups is not possible, given the relatively small significance of the Botswana operations in the global banking groups, it is suggested that the BoB seeks to establish a lower level of participation to at least keep itself informed of supervisory developments that are affecting the banks in question and of recovery and resolution planning.



### M. Capacity Building

**58. It is important to build capacity across all agencies on bank crisis resolution.**

This is especially the case with the BoB. It is suggested that the BoB and the MFDP, in liaison with the NBFIRA, develop capacity-building initiatives to strengthen their ability to respond to a range of possible bank-crisis scenarios. Three types of capacity-building initiative could be considered:

- High-level workshops involving the senior management of the agencies could be held on a regular basis to assess different resolution strategies. These will assist in the development of greater understanding at senior management levels of the resolution options and the contingency plan, to help refine the plan.
- In-house and cross-agency training could be held on crisis resolution issues as an ongoing capacity building. Annual training could be held for all supervision and resolution staff, and those staff involved in liquidity support, payment system, and financial stability issues, as well as relevant staff in the MFDP and the NBFIRA.
- Periodical crisis exercises to test the ability of the agencies to respond to simulated financial crises. In some cases, these exercises could be held within the BoB only to test different aspects of its resolution functions. In addition, cross-agency crisis simulation exercises could usefully be held every two to three years, involving the BoB, the MFDP, and the NBFIRA. Possibilities should also be explored for holding cross-border exercises with the applicable parent authorities.

### III. DEVELOPING A FRAMEWORK FOR EMERGENCY LIQUIDITY ASSISTANCE

**59. This section reviews the legal powers and liquidity providing frameworks operated by the BoB and provides recommendations for the establishment of a new ELA framework.** The first sub-section reviews the existing legal powers relating to ELA and considers the proposed enhancements to these powers contained in the draft amendments to the BoBA. In addition, the current liquidity providing operations are briefly considered in terms of how the system's overall liquidity management capabilities, including the proposed ELA framework, can sit together in a consistent and complementary manner. The second sub-section reviews the governance and decision-making processes to be considered when commencing the ELA process. The third sub-section examines the key ELA principles, guidelines, and criteria that should be explored to ensure the application of best-practice terms and conditions surrounding ELA provision. The fourth sub-section provides guidance to operationalizing ELA provisions, while the fifth (and last) sub-section highlights a number of areas that require ongoing and additional monitoring and decision making in the interim period.

## A. ELA Provision in the Context of Existing Powers and Open Market Operations

60. **While the existing BoBA contains provisions that allow ELA to be extended to banks, some of these provisions are somewhat too general and allow the BoB to extend such credits without the receipt of adequate collateral.**<sup>4</sup> While this provision may be intended to allow maximum flexibility to react to critical situations, the BoB should not be empowered to provide credit without suitable collateral.

61. **At the same time, the existing BoB Act contains some provisions that are too specific and may unduly curtail the BoB's ability to provide emergency liquidity in certain valid circumstances.** Specifically, Section 38 indicates that credit can be provided up to a maximum of 92 days. It also links the eligibility of collateral to sub-section 2 of the same Section 38, which restricts the eligibility of certain securities as collateral to those maturing within 184 days.

62. **The new draft BoBA contains a new section specifically relating to lender of last resort,<sup>5</sup> which appears to tighten up some of the more general provisions relating to the provision of ELA.**<sup>6</sup> In particular, it makes it explicit that the BoB can only provide ELA to a licensed bank where the recipient is solvent and can provide adequate collateral and is based on the need to improve liquidity (i.e., it is not intended to improve solvency). These new provisions are necessary. The draft revised BoBA also incorporates additional references to the objectives of the BoB<sup>7</sup> and the inclusion therein of a reference to stability of the financial system is useful in order to clarify the purpose and decision making behind ELA.

63. **Some of the new proposed BoBA provisions relating to ELA may be overly explicit.** They may, ex ante, curtail the BoB from providing liquidity support in certain circumstances that may constitute legitimate and valid performance of its function as lender of last resort. For example, the new proposed provision stipulates ex ante that, in all cases, the provision of ELA may not exceed 184 calendar days; but, for example, a credible recapitalization plan may require a little longer, and ELA could then be justified beyond the time frame. In addition, the new proposed provision explicitly limits the provision of ELA to licensed banks only—thereby excluding the possibility of liquidity support to other systemically important financial entities in the country.

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<sup>4</sup> The BoBA 1996, Part VII, Section 38 'Operations with account holders' specifically sub-sections 3(a) and (b).

<sup>5</sup> Throughout this report, the terms Emergency Liquidity Assistance (ELA) and Lender of Last Resort (LOLR) are used interchangeably.

<sup>6</sup> The BoBA Revision 4 of 2015, June 16 2015, Part IX, Section 47 'Lender of last resort.'

<sup>7</sup> The BoBA Revision 4 of 2015, June 16 2015, Part II, Section 4 'Objectives of the Bank.'

64. **The draft BoBA Revision 4 provisions contain a requirement that a guarantee will be sought from the minister to ensure that the amounts owing to the BoB under ELA will be guaranteed.** While such a guarantee is recommended in the majority of cases and should be sought, there may be occasion when the BoB might be adequately collateralized, but a government guarantee could negatively affect the sovereign rating and create further instability. However, this should only be considered once there is no ambiguity around the distribution of the BoB’s realized profits, along with the creation and maintenance of adequate realized capital reserves.<sup>8</sup> Otherwise, if the BoB should request a guarantee for ELA, which is not forthcoming, then other resolution avenues should be examined.

65. **It is recommended to consider amending the draft BoBA<sup>9</sup> to remove the *ex ante* restriction on provision of ELA to licensed banks only, the provision on curtailing the provision of liquidity support to no more than 184 days in all cases, and the provision on requiring a guarantee from the government.** While a central bank should have good governance procedures and rules surrounding the provision of ELA, it may not always be advantageous to be quite so explicit regarding some of the terms in the central bank law. The BoB may find itself in situations where—subject to following internal procedures and ELA principles and guidelines to be discussed in later sections—it might be necessary for financial stability considerations to provide ELA in circumstances that would otherwise be prohibited by these particular rules. However, should BoB grant ELA to any entities outside of licensed banks, (i) these entities should be either directly or indirectly regulated by the BoB; and (ii) the BoB should fully understand the underlying liquidity need and should put in place measures to prevent (re)occurrences of regulatory arbitrage.

66. **The issues that these three proposed provisions are attempting to address could be better dealt with in an alternative manner.** For example, they could be outlined in a comprehensive internal BoB ELA decision and framework policy document or in an accompanying ELA guideline that is approved by the BoB’s Board and the governor. The policy documents would include a range of ELA policy issues, including eligible ELA

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<sup>8</sup> These assessments did not form part of the work of this TA mission.

<sup>9</sup> A Draft Banking Act for the Bank of Botswana, dated July 2015, was also supplied to the mission team for review. The Draft Banking Act does not explicitly refer to ELA. However, there are two items that could potentially have an impact on ELA and liquidity. Part III, Section 24—Liquidity management in banks—sub-section (3) requires banks to prepare and submit to the BoB monthly liquidity reports. While other provisions may allow the BoB to request further data, it is suggested that, to avoid potential ambiguity or conflict in the Banking Act, wording along the lines of ‘or at higher frequency as may be directed by the central bank from time to time,’ be inserted after the word ‘monthly.’ In addition, Section 24, sub-section (6) requires that a bank shall not pledge or encumber any portion of its liquid assets without prior authorization of the central bank. The motivation behind (and implications of) this clause should be explained more clearly. For example, is this intended to only apply to the 10 percent liquid assets ratio that the banks are required to hold for regulatory purposes? If it applies to all liquid assets, even where banks hold in excess of their regulatory requirement, then the reason for the BoB’s authorization should be clarified, as this will otherwise provide a hindrance to banks being able to easily mobilize liquid assets as collateral on the interbank market, for example.

recipient entities and duration of provision of ELA, but also issues such as collateral eligibility and risk criteria, oversight, and other policy decisions. This mechanism of documenting the more granular policy decisions relating to ELA provision is widely used in other countries and would facilitate the amendment of these criteria in a timely manner, should circumstances necessitate.

**67. While it is outside the terms of reference of this mission to deal comprehensively with the effectiveness of the existing suite of monetary policy operations, the functionality of these operations must be considered in the context of their ability to act as an initial shock-absorber to liquidity stress and their compatibility with the creation of an ELA framework.** The compatibility of existing monetary policy operations with an ELA operation is important, as ELA is a liquidity providing operation and should not conflict with, or add ambiguity to the role of, existing monetary operations. Indeed, should such ambiguity exist, or should there be overlap between the role of normal liquidity providing monetary operations and an ELA operation, the transmission of monetary policy could be impaired.

**68. The BoB conducts monetary policy in an excess liquidity environment, whereby interbank market rates are close to the interest rates paid by the BoB through the absorption of liquidity from the market.** The BoB's main operation is to offer 14-day liquidity absorption auctions on a weekly basis.<sup>10</sup> A reference rate is set by the Monetary Policy Committee (MPC) and a maximum absorption amount is specified.<sup>11</sup> If excess liquidity remains in the system on a daily basis, an overnight fine-tuning absorption operation—reverse repo—mops up the remaining liquidity.

**69. The primary mechanism currently available for banks to obtain liquidity from the BoB in a relatively straightforward manner is on an overnight basis.** A bank can borrow overnight under a repo operation against a narrow list of collateral offered by the BoB when there is less liquidity in the system than was forecast previously. Subsequently, after closing of the settlement system, a bank can automatically access the overnight credit facility subject to having sufficient eligible collateral and up to one-third of the bank's agreed quote (150 percent of core capital) at a rate of the Bank Rate plus a margin.<sup>12</sup> A bank can borrow in excess of this, subject to having sufficient collateral and subject to a threshold of

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<sup>10</sup> Ninety-one-day paper is also auctioned once a month.

<sup>11</sup> Although, in practice, the BoB has absorbed larger amounts than the maximum limit specified for the tender. See Paragraph 3.6 in the latest Bank of Botswana 2016 Monetary Policy Statement, released on February 25, 2016.

<sup>12</sup> At time of writing, the repo rate is 5.5 percent, the Bank Rate is 6 percent, and the CF margin is 6 percent, equating to an overnight credit facility rate of 12 percent.

its agreed quote specified by the BoB, but at a much more penal interest rate—which is analogous to an ELA facility.<sup>13</sup>

70. **Furthermore, there is growing indication that the interbank market in Botswana is becoming increasingly fragmented as liquidity tightens.** Big banks and smaller banks do not easily transact with each other on the interbank market and there is unwillingness to document agreed credit lines between banks.<sup>14</sup> Part of the lack of banks’ willingness to transact with each other is due to counterparty credit risk concerns, but also because of banks’ desire to purchase the BoBCs in order to meet their liquid asset regulatory requirements. This latter reason is a key factor why the interbank rate is currently low and close to the BoB liquidity absorption rates, yet banks are placing money with the BoB (in the BoBCs) at a little over 1 percent, while their average cost of funding is closer to, or above, the bank rate (6 percent).<sup>15</sup>

71. **Previous TA reports have identified some of these issues, which are important in the context of this mission report, as they contribute to the overall liquidity management in the system and should act as an initial shock-absorber of stress and crisis scenarios.** Among a number of relevant issues identified in the 2007 FSAP, it noted in particular that “The shallowness of the interbank money market has constrained efficient systemic liquidity management. A small margin between the reverse repo rate and the BoBC rates has discouraged banks with excess reserves from placing funds in the interbank market, conducting reverse repos with the BoB instead. Also, despite the existence of a primary dealer system, a secondary market for the BoBCs has not emerged because banks are not allowed to sell the BoBCs to nonbanks, including pension funds.”

72. **Vulnerabilities in the wider system’s liquidity management framework were identified in the 2012 TA report.**<sup>16</sup> In particular, the report noted that “The interbank market is two-tiered. Since the interbank market has excess liquidity, the number of transactions and volume in the interbank market is low. Most transactions take place overnight. However, even if the system on an aggregated level is long, individual banks can still be short in the overnight market, since liquidity can be unevenly spread among the banks. Large banks appear to be trading interbank (repos and unsecured) between them, but they do not trade with the small banks frequently. Hence, a small bank can be forced to go to the Secured

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<sup>13</sup> At the time of writing, the penal interest rate for borrowing under the extended credit facility in excess of one-third of the bank-specific limit, known as special repo or secured lending facility, is 50 percent.

<sup>14</sup> Also, life insurance companies hold large amounts of the cash in the system.

<sup>15</sup> In addition to this apparent fragmentation and the effect that the need for liquid assets appears to be having in distorting the money market cost of funding, the banks do not understand how the markets function exactly and cannot fully explain why there is excess liquidity, yet their average cost of funding is much higher than the interbank rates and the rates at which funds are placed with the BoB.

<sup>16</sup> TA Report “Strengthening the Financial Stability Framework at the Bank of Botswana,” July 2012.

Lending Facility (SLF), even if the system is in excess liquidity and the small bank has collateral that could be used in a repo transaction with another banks The large banks are large enough to take a corner of the interbank market and force smaller participants to the BoB's facility.”

73. **The bank rate is the interest rate that signals the BoB's monetary policy stance; however, there is no regular liquidity providing operation available for banks to access funding at the bank rate.** Banks use the indicative bank rate as the starting point to determine the prime rate for lending and to subsequently determine mortgage interest rates. There is a mechanism within the BoB that enables banks to obtain funding at the bank rate, but the facility is viewed as analogous to a lender-of-last-resort operation. The facility is not documented and has no detailed framework but is one under which liquidity can be provided—in theory—for up to three months at Bank Rate unsecured. It requires application from a bank to the governor for release of funds at the Bank Rate.

74. **It might be considered whether a secured term credit providing operation could be offered simultaneously to active term liquidity absorbing operations to help ease a situations of tight liquidity.** For example, it could be considered whether there would be merit in offering a 14-day liquidity providing tender at the same time as carrying out the main 14-day BoBC issuance tender operation.<sup>17</sup> This effectively formalizes the operation of a two-sided term market operation, but consistent with monetary policy objectives. While the BoB conducts monetary policy in an environment of excess liquidity and wants to encourage banks to transact on the interbank market lacks a mechanism for banks to obtain central bank funding beyond an overnight basis function. The interest rate set for liquidity providing repos beyond overnight term vis-à-vis the liquidity absorption interest rates for similar term should be structured to ensure that banks have financial incentives to transact with each other in the interbank market. Consideration could thus be given to whether the Bank Rate should become the minimum bid rate for such longer-term liquidity providing repo operations—thereby anchoring the policy rate to the main liquidity providing operation.

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<sup>17</sup> A detailed examination of the monetary policy framework was outside the scope of this mission. The suggestion of a 14-day secured credit providing operation is made here as it would complement the main 14-day liquidity absorption operation implemented by the BoB and having a two-sided main open market operation is recommended. However, secured credit providing facilities of different durations could be considered in accordance with the financial and monetary conditions experienced at a point in time—for example, many central banks have announced liquidity providing operations of various maturities in response to the recent financial crisis and subsequent low inflation environment (e.g., see [https://www.ecb.europa.eu/press/pr/date/2011/html/pr111208\\_1.en.html](https://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html) and [https://www.ecb.europa.eu/press/pr/date/2016/html/pr160310\\_1.en.html](https://www.ecb.europa.eu/press/pr/date/2016/html/pr160310_1.en.html)).

75. **It is advisable that banks have access to a certain amount of central bank liquidity in the normal course of business, prior to reaching the need for ELA.**<sup>18</sup> There could generally be access for banks to liquidity providing monetary policy and overnight operations, subject to tender limits consistent with the monetary policy stance and availability of eligible collateral. Only then should ELA funding be considered against a broader set of collateral<sup>19</sup> for a solvent bank that is unable to source other market funding to meet its normal business liabilities. A 14-day liquidity providing operation should, therefore, not conflict with the need to absorb liquidity from the system when more active sterilization operations are required. It should be seen as a mechanism for banks, which are short liquidity due to the inefficient allocation of excess liquidity on the interbank market to obtain liquidity using high-quality eligible collateral.

76. **However, the BoB would need to adjust its liquidity forecasts and absorption operations accordingly, so that this more active sterilization produces overall liquidity conditions that remain consistent with monetary policy objectives.** Indeed, a desire to have such a facility available was expressed by some of the banks that the TA team met with during the mission. The BoB is most likely concerned about the associated cost of absorbing the appropriate amount of excess liquidity, hence the low supply of (and high demand for) its sterilization instruments. This, along with some market confusion about the BoB's precise policy stance, suggests a need for TA in the area of monetary policy implementation.

77. **It is necessary to examine the limits and rates attached to the overnight liquidity providing standing facilities as well as the theoretical operation available at Bank Rate, as they appear to overlap with the rationale and disincentives associated with ELA.** The existing overnight liquidity providing standing facilities (Credit Facility and Secured Lending Facility) have strict limits and penal interest rates that make them analogous to an ELA facility, so consideration will need to be given to easing the terms of the overnight facility if an ELA facility is made available as well. Furthermore, while there is no documented operation behind the Bank Rate, it is possible for the BoB to provide unsecured funding to banks for up to three months under bilateral request to the governor. It should be assessed whether that operation could be subsumed by an ELA facility.

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<sup>18</sup> See Appendix III for a stylized illustration of how liquidity providing monetary policy operations may sit alongside ELA and offer banks a path of access to liquidity with escalating restrictions and criteria.

<sup>19</sup> The list of collateral eligible for liquidity providing open market operations and overnight standing facilities are usually high-quality collateral. Other assets on a banks' balance sheet could be considered for ELA collateral subject to adequate risk management. These options are illustrated in a stylized manner in Appendix IV.

78. **The issues just discussed point toward vulnerabilities in the system, if liquidity conditions become tight.** The interbank money market is fragmented and the existing low willingness of banks to engage in it would be amplified in a stress scenario where the market would be unlikely to function well. Furthermore, the ability for banks to access funding from the BoB for normal liquidity management purposes is limited to an overnight basis.

79. **It is therefore suggested to examine and enhance the existing liquidity management framework, including the interbank market and the BoB liquidity providing operations, with an ELA framework then being available as a final option for banks to deal with large idiosyncratic liquidity shocks.** However, given the vulnerabilities identified, it is recommended that the necessary steps to prepare an ELA framework and the capacity to take additional types of collateral commence as soon as possible.

80. **The suggestion to consider the optimality of the BoB's current one-sided term liquidity operation in a time of liquidity stress, and the limits attached to the overnight credit facilities, interacts with other issues outside the terms of reference for this TA mission.** The interaction of monetary policy with forex management may also need to be considered. Further TA that examines the overall monetary policy framework in more detail and in conjunction with the functioning of the money market, forex policy, and consistency with the provision of ELA should be considered.<sup>20</sup> The remainder of this TA report will provide a framework for ELA, notwithstanding the issues raised here regarding the consistency with existing liquidity providing mechanisms operated by the BoB.

## **B. ELA Governance and Executive Decision Making**

81. **The BoB should establish an ELA framework to respond to idiosyncratic liquidity needs of banks, where one or more banks may require liquidity support.** Under an ELA framework, temporary liquidity may be provided at the initiative of the counterparty, and at a penalty rate, in order to ensure that financial stability can be maintained. The funding should be provided at the BoB's discretion and should be distinct from the monetary policy framework, which has a specific monetary policy target. ELA may be provided to a number of banks in a systemic liquidity shortage, but it can also be considered as separate to a central bank responding to broad systemic liquidity shortages for monetary policy purposes, as many

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<sup>20</sup> The suggestions regarding examination of the BoB's existing market operations are made in the context of assessing the consistency and suitability of the BoB liquidity providing operations alongside a proposal to introduce an ELA framework. There are other issues that could be examined in the context of a deeper analysis of the monetary policy framework and its interaction with interbank activity. For example, the BoBA limits certain eligible collateral for monetary policy operations to that which matures within 184 days of purchase. Collateral with longer maturities could be considered with various pricing and haircut categories devised to address the risks.



central banks did during the recent financial crisis.<sup>21</sup> The purpose and justification of the ELA function of a central bank, whereby it provides ELA, should be clearly understood by all parties.<sup>22</sup>

**82. Internal BoB ELA governance and authorization procedures should be clearly set out.** It is important that the initial decision as to whether or not to provide ELA to a requesting entity is taken by the correct authority; this may be the Board, or the Board may delegate the power to the governor. Whatever governance decision is made by the BoB in this regard, it should be able to be implemented quickly in the case of an emergency request.

**83. It is recommended that an internal BoB Financial Stability Committee (FSCOM) be established.**<sup>23 24</sup> This committee would meet at least once a month to discuss information from across the BoB relevant to financial stability. Upon a request for ELA, the governor should be adequately informed of the views and key information available at BoB's relevant departments. In such circumstance, a meeting of the FSCOM would be convened to bring the relevant information to the governor, so that an informed decision can be made as to whether to provide ELA.<sup>25</sup>

**84. Clear criteria as to when and why to provide ELA funding to a bank should be set out, including reliable solvency, viability, and capital assessments to enable correct ELA decisions.**<sup>26</sup> One key criterion behind the provision of LOLR funding is that it is temporary in nature and not open-ended. Therefore, it should be provided to solvent entities only where they cannot obtain market funding to meet their critical liability obligations, and should only be provided for as long as the liquidity shortage exists, subject to adherence to other criteria.

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<sup>21</sup> For example, the ECB offered LTRO funding for a number of years. See Appendix V for a high level overview of central bank liquidity responses.

<sup>22</sup> These include objectives, transaction terms, and other disincentives and are outlined in Appendix VIII.

<sup>23</sup> If an additional internal committee is not desired, the existing Regulatory Committee could be expanded into a Financial Stability Committee and be attended by senior representatives from regulation, financial stability, financial markets, monetary policy and risk and legal management where they exist.

<sup>24</sup> This is different from the idea of a high level cross-organisational Financial Stability Council (FSC). Previous IMF TA reports (e.g., 2012 report on 'Strengthening the Financial Stability Framework at the Bank of Botswana' and 2014 report 'Toward Financial Stability Analysis and Reporting') have called for the establishment of an FSC and the need for such a forum is emphasized in this TA report also. It is recommended that the FSC comprises senior personnel from the BoB, the MFDP, the NBFIRA and potentially any other national authority with responsibility for parts of the financial sector. The FSCOM would discuss key issues of financial stability for Botswana that arise and would agree co-ordinated approaches to issues of importance.

<sup>25</sup> An example of ELA governance and decision making procedures is illustrated in Appendix VI.

<sup>26</sup> See Appendix VII for an example of a stylized type of central bank lending decision system that could be applied to banks of different levels of strength.

85. **LOLR resources can only be provided to temporarily illiquid but solvent institutions.** It should not be the role of a central bank to support insolvent institutions. Doing so would induce banks to take on excessive risks in under the expectation that the central bank will always support them. Moreover, such an expectation could destabilize medium-term inflation expectations. ELA support should in no way be seen as a substitute for the resolution of problem banks.

86. **It is not always easy to distinguish liquidity support from capital support.** Given the often tight timeline around the provision of ELA, it may not always be possible to clearly distinguish solvent from insolvent banks at the time of an ELA request. Best efforts should be made in using the information available at the time of the request. In such circumstances, strict short-term conditions and deadlines should be set and adhered to. Ideally, advance planning and diligence will have been carried out in anticipation of banks applying for ELA, so that a need to opine on solvency will not be unexpected.

87. **Some indicators may be useful to signal potential insolvency.** Having a positive level of capital in itself is not sufficient to fulfill capital adequacy requirements and may introduce moral hazard issues. Instead, compliance with prescribed supervisory ratios should be required. Approved recapitalization and/or restructuring plans should be required for institutions that have levels of capital below minimum prescribed levels and are in need of, or are drawing down, ELA. A timeframe can be defined to restore the capital ratios to the regulatory requirement, but missed targets within set timelines should push the lender toward making a decision as to whether the borrower is non-viable and likely insolvent.<sup>27</sup>

88. **The correct application of ELA implies that banks that are insolvent, not viable, or have no prospect of reaching sound and sustainable capital levels should be wound down rather than funded through ELA.** Adoption of an ELA framework will be complemented by a comprehensive resolution regime for banks to liquidate or merge them and create bridge and wind-down entities where necessary.

89. **ELA can be provided to entities that are systemically important.** While ELA should be provided only to systemically important banks, the definition of ‘systemically important’ may be dependent on an assessment of the circumstances at each point in time. ELA access is often limited to financial institutions that hold reserve accounts at the central bank (typically commercial banks), but some countries allow access to systemically important entities or institutions whose default would cause contagion across the system.<sup>28</sup>

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<sup>27</sup> Compliance with regulatory liquidity ratios can guide a liquidity assessment, but other qualitative elements are needed in the assessment, such as counterparty quotes obtained in the market and the supervisors’ and market participants’ assessment of the counterparty. In addition, the (prolonged) length of the liquidity need may indicate that there are more fundamental problems behind the scenes (e.g., bad business management).

<sup>28</sup>In some circumstances entities other than banks can be considered for ELA. See IMF Working Paper, “The Lender of Last Resort Function after the Global Financial Crisis,” WP/16/10, for further discussion.

Systemically important can usually be considered in the context of the direct impact on the financial stability if the entity were to be refused support and perhaps allowed to fail. However, the concept of systemic importance can also be considered in a wider manner, such as whether public confidence or sentiment in the financial system would deteriorate substantially if support were to be refused, leading to financial instability.

90. **Provisions of ELA to subsidiaries of foreign parent banks carries additional complications.** This issue is particularly relevant for the BoB, given that most banks in Botswana are subsidiaries of foreign-owned banks. Additional risks relating to ELA exist in such circumstance, including the risk that the local bank may upstream funds to the parent and the risk that the parent may no longer support the local subsidiary.

91. **While solvency and systemic importance remain the key initial criteria, further steps should be sought to give comfort to the BoB before deciding to provide ELA to subsidiaries of foreign-owned parents.** These include (i) evidence from the parent that alternative funding cannot be sourced from other parts of the banking group or from the parent's central bank; and (ii) an MoU between the home and host central banks (or supervisory authority) for the sharing of prudential information, so that the financial position of the local entity and the group can be assessed.<sup>29</sup>

### C. ELA Principles, Guidelines, and Criteria

92. **While solvency and systemic importance are key initial considerations to provide ELA to an entity, there are several other principles, guidelines, and criteria to be followed to ensure that the BoB is adequately collateralized and not unduly exposed to potential losses.** Internally, the BoB should document and duly authorize the ELA principles, guidelines and criteria to be followed. Clear ELA principles and guidelines are necessary to ensure that ELA is provided in the correct manner and that adequate risk management considerations are in place and followed. Collateral adequacy, collateral recoverability, and length of ELA provision are all important factors to be considered. A more detailed description of the key concepts surrounding ELA is contained in Appendix VIII.

93. **The duration that ELA can legitimately provide (i.e., for the correct LOLR reasons) may be longer during a systemic liquidity crisis than during normal times, when only one bank has suffered a liquidity shock.** The duration of ELA provision in a systemic liquidity crisis should still be viewed as temporary, and a total of one year of continuous (rolling) ELA provision would be considered as the outer limits in most cases. Also, in restricted circumstances, a central bank may be willing to continue to provide ELA for an extended period to a bank that is being wound down after having received ELA. This

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<sup>29</sup> See IMF Working Paper "The Lender of Last Resort Function after the Global Financial Crisis," WP/16/10, for further discussion.

might be particularly relevant where the central bank is the sole creditor on the basis that it is necessary to prevent instability and, given the alternative, inability of the government to find funding. Central bank controls in such cases may need to be extensive in order to ensure proper wind-down, with transfer to a resolution vehicle and the use of a deposit guarantee fund advisable where possible.

94. **The BoB may wish to identify its risk-tolerance level, explicit or implicit, in order to guide the extent of risk it is willing to take when providing ELA.** While it is necessary to monitor collateral and carry out legal due diligence on collateral, an explicit or implicit level of risk tolerance may assist overall levels of exposure per institution. This risk tolerance measure could be implicit (such that if a bank is likely to become insolvent or will not be able to restore its capital ratios, or does not have a viable business plan, it should be removed from funding) or explicit, such as based on a Value at Risk (VaR) measure.

95. **A detailed and robust collateral assessment and valuation approach surrounding the provision of ELA is necessary.** A detailed assessment of a range of potential collateral, assets underlying loans and debtors should be carried out by the BoB. In particular, a detailed approach to pricing and haircut methodologies is necessary, and the BoB should adopt rigorous valuation techniques and benchmark themselves against other central banks (Appendix IX).

96. **The BoB should typically seek to obtain a direct indemnity from the MFDP that it will make good any losses incurred by the BoB in the course of an ELA operation, so that the government's obligations to the BoB rank at least *pari passu* with other government obligations.** The proposed draft amendments to the BoBA<sup>30</sup> contain a proposal that “the minister has issued to the bank a guarantee in writing on behalf of the government securing the repayment of the loan” (although as noted earlier, it could be considered whether this needs to be explicitly stated in the BoBA).<sup>31</sup> Furthermore, in some circumstances where a bank has no adequate collateral available, an additional specific guarantee from the minister may be sought to cover the advancement of agreed amounts of ELA to that bank as replacement for the mobilization of collateral from the bank.

97. **Given that every commercial bank in Botswana is predominantly foreign owned, the central bank may consider taking collateral from the foreign parent banks of subsidiary banks located in the host jurisdiction.** Firstly, the host central bank will look to the parent bank to provide liquidity support to the subsidiary bank. In a situation where the parent bank is also suffering a liquidity shock and cannot provide liquidity support to the subsidiary, the central bank may consider taking collateral from the parent in return for

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<sup>30</sup> The BoBA Revision 4 of 2015, June 16 2015, Part IX, Section 47, ‘Lender of last resort.’

<sup>31</sup> See IMF Working Paper, “The Lender of Last Resort Function after the Global Financial Crisis,” WP/16/10, for further discussion on this issue.

providing ELA to the (solvent and systemically important) subsidiary. Collateral from the subsidiary will usually be preferable, but if it does not have adequate collateral, then the parent may have more suitable collateral to be considered.<sup>32</sup>

98. **Consideration of collateral from a foreign parent bank requires additional due diligence and legal oversight.** It may not always be legally possible to take charge over collateral located in a foreign parent bank, and legal advice will be needed as to whether a charge or repo agreement can be implemented between the central bank and the foreign parent bank, what legal jurisdiction it falls under, and what the cross-border implications are in the event of a default. It may be the case that only tradable securities can be considered ELA collateral from foreign parent banks, as collateral such as residential mortgages or claims over real estate or commercial assets may not be enforceable or chargeable on a cross-border basis. Collateral that can be mobilized from the parent bank may require additional risk-control measures, i.e., pricing and haircuts, if additional risks exist compared to domestic equivalent collateral.

#### **D. Operationalizing the Provision of ELA**

99. **The ownership of the ELA process, in terms of preparation, collateral, policy, and implementation should rest with the Financial Markets Department (FMD) of the BoB.** To date, the Banking Supervision Department (BSD) appears to have led the process of enhancing the ELA provisions in the draft revisions to the BoBA. Close cooperation between the FMD and the BSD is essential for a correct decision making with regard to the initial and ongoing provision of ELA. In addition, close interaction with Financial Stability, Monetary Policy and Payments, as well as Legal<sup>33</sup> and Risk Management<sup>34</sup> units if they are developed in time, would be important.

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<sup>32</sup> An unsecured guarantee from the parent bank will usually not suffice as collateral for lending to a subsidiary, as it offers no recourse to tangible assets in the event of default and would likely be worthless if the liquidity issues being experienced by the subsidiary were to spread to the parent or group and result in default.

<sup>33</sup> The role of legal counsel and assessments during the ELA planning, preparation, drafting and implementation stages should not be underestimated. Often there will be a need to quickly translate policy requirements into legal text and vice versa. There could be significant legal work required in examining what types of assets can legally be mobilized from banks' balance sheets and preparing legal agreements to allow them to be taken as collateral. It is advisable that strong consideration be given to the BoB's employing lawyers to assist the timely implementation of this work, and to assist in legal work relating to normal monetary policy agreements and the resolution and crisis management legal requirements.

<sup>34</sup> Some central banks have designated risk management or middle office departments or units. If the BoB does not follow such a route, it may nonetheless be useful to task a particular FMD staff member, or as many as is required, to perform the risk management duties outlined in this report, which are distinct from the front office lending duties.

100. **Detailed ELA organizational and workflow plans are recommended.** These should include enhanced ELA preparation and planning, including a designated liquidity analysis team in FMD to carry out analysis of banks' funding flows and potential ELA drawdown requirements.

101. **Enhanced monitoring by FMD of its counterparties' liquidity needs and projections would commence after a BoB early warning indicator is triggered or based on information provided by the counterparty.** Based on these detailed counterparty projections, and more accurate knowledge of banks' likely ELA requirements in immediate advance of transactions, this team could advise the ELA requirements to the FMD colleagues, who calculate the system's reserves and liquidity forecast to ensure that the correct adjustments are made to the provision or withdrawal of liquidity to/from the system in accordance with the monetary policy stance. ELA deals should generally be provided on a T+1 basis (especially where the decision to provide ELA has already been made by the governor in response to the initial request).

102. **Clear procedures and contact details should be agreed between the BoB staff involved in the provision of ELA and the relevant counterparties.** Communication channels should be outlined, transaction procedures agreed, and authorized signatories exchanged in advance of ELA transactions. In this regard, it is useful for the BoB and relevant counterparties to carry out ELA trial runs or simulation exercises (both for the smooth running of ELA operations but in some cases also as part of broader crisis simulation exercises). However, such trial-runs should be clearly understood as not representing a pre-commitment by the BoB to provide ELA to any particular counterparty.

#### **E. Ongoing Oversight of ELA Provision**

103. **It is important that adequate oversight and conditionality is applied to monitoring ELA recipient entities and the collateral taken to secure the lending.** Incentives and oversight must be strong so as to encourage the bank to obtain alternative market funding where at all possible (see Appendix XI). Strong conditionality may also be necessary alongside the provision of ELA in order to protect the balance sheet of the BoB—with a dedicated risk management view (perhaps even from a risk management team) focusing on, and monitoring compliance with, the established conditions.

104. **Clear trigger points and metrics should be developed against which the provision of funding by the BoB to a counterparty can be assessed on an ongoing basis.** This requires the development of a number of key indicators (both real time and forward looking) that can be relied upon to inform the decision as to whether the BoB ELA funding should be provided, and continue to be provided, or whether the counterparty is not viable and should be wound down or placed in some form of resolution mechanism.

105. **In addition to the governor’s initial decision on whether to provide ELA, ongoing continuous assessment of the ELA criteria should be made—when important developments occur or at least monthly.** The assessment should be prepared jointly by an ELA working group, involving each of the relevant departments, and submitted to the relevant decision makers (such as the governor chairing an FSCOM meeting). Supervision will be responsible for providing solvency assessment, whereas the early warning indicators and opinion on viability will be prepared jointly by market operations, supervision, and financial stability.

106. **Ex post monitoring of the use of funds, business practices, transactions carried out, and any additional conditionality imposed on ELA borrowers should be carried out.** This could be done by the Supervision Inspection Department, though consultation with legal personnel may be required. Risk-management-task staff will typically have responsibility for oversight and monitoring of collateral and related documentation, and for any terms and conditions in this regard that were contained in the legal or side agreements.

107. **Non-adherence by banks to ELA conditions and compliance targets, such as inaccurate certification or data, or undue delay in updating their internal data or credit rating systems, should result in removal of that collateral from ELA operations and reduction of ELA provision, if necessary.** For example, where ELA has to be provided quickly without fully completing due diligence carried out on the collateral loans or property, the BoB should check the progress of the retrospective due diligence that the borrowing banks committed to undertake. Strong and robust enforcement powers and actions from the BoB will help create a disincentive for banks to ignore such conditionality. Non-compliance with conditions or due diligence regarding collateral should mean that the collateral concerned is not eligible for ELA operations and should be withdrawn. If no suitable substitute collateral is available, or the entity cannot repay ELA within a short time frame, then the situation should be treated as equivalent to an initial ELA request from an entity without any eligible ELA collateral—either (i) a government guarantee would be required to substitute the collateral; or (ii) an alternative source of funding would be required to repay the ELA amount being recalled—which will presumably come from either an injection of capital/investment from the government or from a resolution/recovery process.

## **APPENDIX I. SUGGESTED IMPROVEMENTS TO THE PROPOSALS FOR LEGISLATIVE AMENDMENTS**

1. This appendix sets out suggestions for improvements to the proposed amendments to the BoBA and BA. They are not expressed in legal drafting terms; rather, they focus on the policy substance of the issues in question. As recommended in the body of this report, it is recommended that the BoB engage appropriately qualified legal advisers to review the draft proposed amendments to the Acts and develop appropriate revisions, having regard to the points raised in this report.

### ***Issues in relation to the Bank of Botswana Act***

#### *Section 4. Objectives of the Bank*

2. In subsection 2, the current draft wording is: “Subject to that [the primary objective of price stability], to contribute to the stability of the financial system, and to foster and maintain a stable and competitive market-based financial system.” It is suggested that consideration be given to the following matters:

- Whether the objective of financial stability should rank equally with (rather than being subordinated to) the price stability objective, given the fundamental importance of financial system stability and the complementarity with price stability.
- To strengthen the focus on financial stability by replacing “contributing to the stability of the financial system” to “promoting the stability of the financial system.”

#### *Section 5. Functions of the Bank*

3. It is suggested that this section be further amended to explicitly designate the BoB as the resolution authority by stating that one of its functions is to facilitate the resolution of banks. In addition, it would be desirable to include reference to the BoB’s function to undertake corrective actions to seek to restore a bank to financial soundness.

4. The BoBA would also appropriately be amended to include a requirement for the governor/Board to ensure that the bank supervision and resolution functions are established in a manner that avoids conflicts of interest between the two functions, and that there is robust accountability for the management of both functions.

### ***Financial Stability Committee***

5. In order to oversee coordination of all functions relating to financial stability (including licensing, bank regulation and supervision, resolution, ELA, and financial stability



surveillance and policy), it is recommended that the BoBA be amended to establish a Financial Stability Committee (FSCOM). The provisions could be modeled broadly on those in draft sections 25 and 26 in relation to the MPC, with appropriate changes to set out the functions of the FSCOM. Membership of the FSCOM would appropriately be determined by the governor, and could include external members.

### *Financial stability report*

6. In order to provide focus to the financial stability functions of the BoB and to enhance its transparency and accountability, it is suggested that a new provision be included in the BoBA to require the BoB to publish a report, at least every six months, that sets out its analysis of the stability of the financial system, summarizes relevant policy developments relating to financial stability, and provides a range of metrics with which the effectiveness of financial stability policies and actions can be assessed.

### *Section 12. Establishment, powers, and functions of the Board*

7. It is recommended that this section be amended to include reference to the Board's functions in relation to the proposed FSCOM in a manner that is broadly consistent with the Board's functions as they relate to the Monetary Policy Committee (but modified to reflect the functions of the FSCOM).

8. It would be desirable to amend draft section 12 to make it clear what the Board's powers are (vis-à-vis the governor's powers) in relation to all financial stability functions (and especially functions related to dealing with bank distress and failure). It is essential that there be absolute clarity and certainty as to who is empowered to exercise the BoB's powers in relation to bank corrective actions and resolution; i.e., the Board, the governor, or the proposed FSCOM). It is also important to ensure that the Board is able to formally delegate powers in these areas, within appropriate safeguards, to the governor, and for the governor to sub-delegate those powers to enable the BoB to act swiftly in exercising its bank corrective action and resolution responsibilities.

### *Section 18. Powers and functions of the governor*

9. It is recommended that this draft section be further amended to include reference to the proposed FSCOM, with clarity as to whether the committee would be a decision-making body in relation to all financial stability matters or a body charged with advising the governor, such that the decision-making authority is vested in the governor.

### *Section 43. Supervisory functions*

10. It is suggested that this section be amended to include reference to the BoB's functions in relation to bank corrective actions and resolution. In that regard, the title of the section could be changed to 'Supervisory, remedial and resolution functions.'

*Section 46. Operations with account holders*

11. It is suggested that the provision in sub-section 2(a) that limits the dealing in certain collateral to those maturing within 184 days from the date of acquisition be considered as to whether or not it is necessary and whether longer dated collateral could be acceptable alongside additional risk control measures such as pricing and haircuts.

*Section 47. Lender of last resort*

12. It is suggested that some of the more explicit criteria included in section 47 could be removed and, instead, included as best practice principles in an accompanying ELA guideline or ELA policy document that could be approved by the BoB's Board or the governor. It is recommended that this section be amended to remove (i) the *ex ante* restriction on provision of ELA to licensed banks, only so that consideration can be given to providing ELA to other financial entities of systemic importance; (ii) the restriction on the provision of liquidity support to no more than 184 days in all cases, as it may unduly restrict the BoB to providing liquidity support in certain justified circumstances; and (iii) the stipulation that the minister has issued to the bank a guarantee securing the repayment of the loan. Each of these are important principles to be followed, but it should be considered whether explicitly stating it in the BoBA may unduly restrict the BoB in providing ELA in a range of circumstances.

*Section 53. Cooperation with the government and other authorities*

13. In subsection 2 of this section, it is suggested that reference be made to the financial stability functions of the BoB, such that the governor must hold meetings at least biannually with the minister of financial stability matters. On this basis, the subsection could be reworded as follows: "The governor shall hold regular meetings, and at least on a biannual basis, with the minister to consider monetary, financial stability and fiscal policies, and other matters of common interest."

*Section 71. Legal protection*

14. Given that the BoB, in its capacity as resolution authority, may need to take actions of a potentially high-risk nature, it is suggested that consideration be given to including a provision in this section that exempts the BoB from liability arising from the exercise of its powers relating to bank corrective action and resolution, provided that the powers are not exercised in bad faith (i.e., fraudulently).

## ***Issues in relation to the Banking Act***

### *Power to take actions in relation a banking group*

15. The powers provided for in the proposed draft BA are generally expressed as being exercisable in relation only to banks; e.g., as with corrective action and resolution powers. It is suggested that the draft BA be amended to enable the BoB to exercise its powers for corrective action and resolution in relation to banks and banking groups (where banking groups include bank holding companies and bank subsidiaries).

### *Section 24. Liquidity management in banks*

16. Sub-section (3) requires banks to prepare and submit monthly liquidity reports to the BoB. While other provisions may allow the BoB to request further data, it is suggested that, to avoid potential ambiguity or conflict in the Banking Act, that wording along the lines of ‘or at higher frequency as may be directed by the central bank from time to time,’ be inserted after the word ‘monthly.’

17. Sub-section (6) requires that a bank shall not pledge or encumber any portion of its liquid assets without prior authorization of the central bank. The motivation behind this clause should be better understood or defined more clearly. For example, is this intended to only apply to the 10 percent liquid assets ratio that the banks are required to hold for regulatory purposes? If it applies to all liquid assets, even where banks hold in excess of their regulatory requirement, then the reason for requiring BoB authorization should be clarified as it will otherwise provide a hindrance to banks being able to easily mobilize liquid assets as collateral on the interbank market, for example.

### *Section 49. Corrective measures, administrative penalties and other enforcement actions*

18. It is suggested that this section be amended so that the powers included in it can be exercised in relation to banks and banking groups.

19. In subsection 1, there would be merit in expanding the grounds on which the powers in the section can be exercised, so that they enable the BoB to act before a bank or banking group has breached the Act or prudential requirements, and before the ‘unsafe or unsound’ trigger has been breached. This recognizes that corrective actions are best undertaken at an early stage before a bank’s condition becomes unsafe or unsound. On this basis, the triggers could be expanded to enable corrective action powers to be taken where the BoB has concerns that a bank or banking group may conduct business in a manner which could, if left unchecked, lead to an unsafe or unsound situation arising.

20. In addition to the powers set out in the proposed section, it is suggested that the following powers be included:

- The power for the BoB to remove and replace a director or senior officer of a bank and any member of the banking group where the BoB is of the view that this is necessary to implement timely and effective corrective action. (We note that the draft changes to the BA make provision for this power to be exercised only in relation to a bank; it should be extended to all entities in the regulated banking group).
- A general power for the BoB to issue directions to a bank or any member of the banking group to take actions or cease to take actions specified by the BoB where the BoB is of the view that such directions will assist in achieving timely and effective corrective action.

***Requirement to establish a contingency plan***

21. It is suggested that a new provision be included in the draft BA to require the BoB to establish and maintain a contingency plan that sets out its policies and practices for undertaking corrective actions, including guidance on the triggers for particular actions and guidance on the nature of potential actions. In this context, we suggest that the BoB have regard for guidance provided by the BCBS in the Core Principles and Guidelines for Identifying and Dealing with Weak Banks when developing its contingency plan and internal guidance, building on the BoB's existing use of international guidelines.

***Section 51. Commencement of official administration***

22. It is suggested that, in addition to the triggers set out in the draft section 51, a further trigger be included which enables the BoB to appoint an administrator if it believes that a bank or any member of a banking group is non-viable, and that the bank or member of the banking group cannot restore itself to viability within the timeframe regarded as necessary by the BoB.

23. As noted earlier, we suggest that the BoBA be amended to empower the BoB to appoint an administrator to any member of a banking group.

***Non-viability***

24. We suggest that a new section be drafted to require the BoB to establish and publish guidance on how it interprets 'non-viability' for the purpose of this being a trigger for appointing an administrator and undertaking resolution actions.

***Section 52. Objectives and tasks under official administration***

25. The provisions in this draft section are generally satisfactory as regards the objectives of resolution. However, greater clarity of objectives would be achieved if there was closer alignment to the Key Attributes, particularly as regards the following objectives and principles set out in the Key Attributes:

- ensuring continuity of systemically important financial services;
- protecting depositors in accordance with deposit insurance arrangements;
- allocating losses to shareholders and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;
- avoiding reliance on public solvency support;
- avoiding unnecessary destruction of value;
- providing for speed, transparency, and predictability through legal and procedural clarity and advanced planning for orderly resolution;
- promoting effective domestic and cross-border coordination; and
- facilitating market-based solutions where practicable.

*Section 53. Appointment of an administrator*

26. It is suggested that consideration be given to the following possible amendments to this section:

- Enabling the BoB to appoint an administrator for a longer period than stated in the draft; e.g., for an initial term of up to one year, and the capacity to extend the term for a further year in recognition that there may be situations where administration needs to continue for a substantial period.
- Enabling the BoB to replace an administrator.
- Empowering the BoB to issue binding directions to an administrator on any matters relating to the powers exercisable by the administrator, and obliging the administrator to comply with those directions.

*Section 55. Inventory of assets and liabilities and plan of action*

27. It is suggested that section 55 be substantially deleted in its current form. As drafted, it requires the administrator to submit to the BoB a restructuring plan or proposal for the

bank's liquidation within 60 days, and gives the BoB a further 10 days to approve or modify the plan or order the bank to be placed into liquidation. This is unnecessarily restrictive, particularly as regards the process and timing. In most situations where an administrator has been appointed to a bank, there will be a need to determine the resolution actions within, at most, a few days of appointing the administrator, given the need to avoid disruption to the financial system and to minimize adverse market reactions. A long period of uncertainty over the bank's status and its operations would arise from the proposed timeframe allowed for in the draft section.

28. If this section is retained, it should be drafted so that the administrator delivers any reports required by the BoB within the timeframe specified by the BoB and empowers the administrator to make recommendations for resolution or liquidation to the BoB. The timeframe referred to the section should be removed. The section should empower the BoB to issue directions to the administrator to implement specified resolution actions any time from the commencement of the administration.

#### *Section 56. Resolution measures*

29. This section should be amended to enable any of the resolution actions listed in the section, and those in section 54, to be implemented at the direction of the BoB at any time following the commencement of administration, regardless of whether the administrator has made recommendations to the BoB. In a bank resolution, time is of the essence; resolution actions generally need to be implemented very quickly and with certainty and clarity. Therefore, the BoB should be empowered to determine the resolution actions without waiting for reports or recommendations from the administrator.

#### ***Bail-in***

30. The bail-in provision in section 54 is narrow in scope, given that it applies only to a bank's bonds and notes. It is suggested that the bail-in power be exercisable in relation to any unsecured liability (other than deposits covered by deposit insurance) of the bank in administration, either through conversion to equity or some other form of eligible capital instrument (of a loss-absorbing nature), or through write-down.

#### ***Bridge bank***

31. Section 56(6) makes provision for the administrator to establish a bridge bank with the approval of the BoB, and to be owned by the BoB. It is suggested that this provision be amended to align with more conventional practice with respect to bridge banks, such that:

- The bridge bank is established by the BoB (and not by the administrator).

- The bridge bank may continue in existence beyond the proposed two-year period where the BoB considers this to be necessary in order to transition the bridge bank to new, permanent ownership or merger or liquidation.
- The bridge bank is not owned by the BoB (as is proposed in the draft law), but rather is owned either by shareholders and/or bailed-in creditors of the bank in resolution, or by the government or a resolution fund if the government or a resolution fund has provided equity funding. This recognizes the principle that central banks should not provide equity funding/solvency support to banks, or be owners of banks. If funding from the existing shareholders and creditors of the bank in resolution is insufficient to capitalize the bridge bank, then the government or a resolution fund should provide the equity needed to capitalize the bridge bank.
- The initial Board of the bridge bank should be appointed by the BoB, pending the establishment of a standard governance arrangement under the control of the shareholders of the bank.

*Section 57. Moratoria during official administration*

32. This section provides for an open-ended moratorium upon the appointment of an administrator. As drafted, it creates an inference that the administrator could suspend financial obligations of the bank (including deposit repayment, payments under committed credit facilities and payments under derivatives contracts) for an unlimited period. The only exception to that is for retail deposits, where the option to suspend payment is capped at 10 days.

33. We suggest that the moratorium provision be amended to more closely align with the moratoria guidance in the Key Attributes, with a view to placing a relatively short maximum limit on the period during which payment obligations on certain categories of liability can be suspended. For example, in the case of derivatives obligations, current international thinking is for a moratorium that prohibits counterparties from exercising rights under events of default clauses for a period of just two to three days. This recognizes that open-ended moratoria create major risks of disruption to financial markets and could lead to counterparties withdrawing from markets where open-ended moratoria provisions exist.

*Section 58. Creditor safeguards*

34. We suggest that the section be amended so that creditor safeguards apply to all resolution actions. As drafted, it appears to be limited to transfers of assets and liabilities. It should apply to any resolution actions, including the bail-in of liabilities (either through conversion to equity or write-down), transfers of assets and liabilities, and restructuring of capital.

35. The section would also benefit from further clarity on the process for determining compensation. For example, it needs to be made clear whether the independent valuer is appointed by the BoB or by a court on application by the BoB. The latter might be a better option, given that it would be more transparent and enable stakeholders to challenge the proposed appointment of the valuer through the court system, leaving it to the court to ultimately determine who the valuer is (subject to a requirement that valuer meet defined requirements in relation to qualifications, experience and independence). It is especially important that the valuer be completely independent of the BoB.

36. Other aspects of compensation processes that require clarification include:

- the need for the valuer to report their findings to the court in a manner that is transparent to all stakeholders;
- the need to specify a maximum period within which the valuer must report to the court;
- the need for the valuation report to comprehensively set out the valuation methodology and assumptions (which should be open to challenge through the court process);
- the rights of stakeholders to challenge the valuation findings and compensation recommendations through the court process; and
- the court's ability to require the report and recommendations to be reviewed by a third party.

37. The section should make it clear that, once the court has ruled on the valuation and compensation, the decisions are final (subject to whether an appeals process is allowed). It also needs to make it clear that the court is not empowered to reverse or amend any resolution action; its sole function is to ensure that the valuation process is fair and soundly based, and to rule on compensation recommendations.

38. The section should specify the source of funding for compensation. In this regard, compensation would appropriately be funded from the bank's assets in resolution, with any shortfall being funded via either a resolution fund or by the government (with the capacity for the government to recover from the banking industry through levies on banks).

39. We suggest that the creditor safeguards provisions be modeled closely on the Key Attributes and international best practice, such as the EU Bank Recovery and Resolution Directive (BRRD).



40. The above points are also pertinent to section 59 – Shareholder safeguards.

*Section 75. Cross-border cooperation*

41. It is suggested that the section be amended to:

- ensure that any actions taken by the administrator to implement in Botswana the resolution proposed by the home resolution authority (where the bank in Botswana is a subsidiary of a foreign bank) are under the strict control and oversight of the BoB;
- require the BoB to be satisfied that the implementation in Botswana of resolution actions proposed by the home authorities is consistent with maintaining the financial stability of Botswana, and with all other resolution objectives in the BA before directing the administrator or allowing the administrator to give legal recognition to or facilitate implementation of the home authority resolution proposals in Botswana;
- empower the BoB to enter into crisis resolution MOUs with foreign supervisory and resolution authorities, and other agencies relevant to cross-border resolution; and
- empower the BoB to participate in (rather than necessarily establish) supervisory colleges and/or crisis management groups for the purpose of facilitating bank-specific resolution planning, resolvability assessments, resolution pre-positioning, and implementation of resolution.

*Section 76. Funding of bank resolution*

42. We suggest that this section be fundamentally reviewed, with close regard to the resolution funding guidance in the Key Attributes, and other FSB publications and international practice (such as in the EU BRRD). In this regard, it will be appropriate to assess whether Botswana should establish a resolution fund for the purpose of facilitating bank resolution (beyond deposit insurance), where this would be funded via levies on banks. Given the small size of the banking system and the need to establish deposit insurance (and associated levies on banks), our inclination is to suggest that consideration of a resolution fund might best be deferred until the resolution laws have been established, resolution policies are in place, and deposit insurance has been established and a target fund achieved. Once that has been done, it would be desirable to consider whether a sound case exists to establish a resolution fund and, if so, what its purposes would be, its governance arrangements, preconditions for drawing on the fund, calibration of the size of the fund, levy arrangements, and many other factors.

43. In the meantime, however, there will still need to be a mechanism for funding bank resolution in situations where there is inadequate scope to fund a bank resolution from the shareholders and creditors of the bank. To that end, we suggest that a resolution funding mechanism be incorporated into the BA under which the government would, as a last resort only, be the source of resolution funding, subject to the following requirements:

- Clearly defined objectives for which government funding may be provided; e.g., to maintain the stability of the financial system and the continuity of critical banking functions;
- Preconditions on which the minister must be satisfied before agreeing to the provision of funding—such as shareholders and subordinated creditors of the bank in resolution have absorbed losses to the full extent of their claims, other creditors have been bailed in to the extent practicable and consistent with financial stability objectives, and all market-based sources of funding have been exhausted;
- Ministerial power to impose terms and conditions on which any funding will be provided, with a view to ensuring that the risks to the government are appropriately managed and compensated, including in respect of fees, charges, interest rates, dividends, monitoring arrangements, restrictions on the bank’s activities, control over the appointment of directors and senior officers, etc.; and
- Ministerial power to levy the banking industry to recover any funding outlays (in net present value terms) that are not able to be recovered from the assets of the bank in resolution.

***Provision for bank recovery plans***

44. A new section should be drafted to empower the BoB to require banks to develop and maintain plans to facilitate their recovery from adverse events and to restore themselves to financial soundness. The section should empower the BoB to:

- specify the requirements in relation to recovery plans, including matters to be covered and responsibility for sign-off of the plans (e.g., at Board level);
- require recovery plans to be subject to regular testing in a manner specified by the BoB;
- require recovery plans to be subject to review or audit by an independent party approved by the BoB where the BoB considers this to be beneficial;
- require banks to make specified changes to their recovery plans; and

- require banks to undertake specified pre-positioning actions to enable recovery plans to be readily implemented if triggers for recovery are reached.

### ***Resolvability assessments***

45. A new section should be drafted to require the BoB to undertake resolvability assessments of banks; to require banks to provide the BoB with specified information for the purpose of undertaking such assessments; and to require such information be audited or reviewed by an independent party approved by the BoB where the BoB considers this to be desirable.

### ***Resolution planning***

46. A new section should be drafted to require the BoB to prepare resolution plans for each bank considered by the BoB to be systemically important, and to enable the BoB to prepare resolution plans for other banks. The section should empower the BoB to:

- require banks to provide specified information to enable resolution plans to be prepared;
- require such information to be audited or reviewed by an independent party approved by the BoB where the BoB considers this to be desirable; and
- require banks to make specified changes to their operating arrangements and structure to facilitate resolution in accordance with resolution plans.

## APPENDIX II. GUIDANCE ON THE DEVELOPMENT OF A RESOLUTION TOOLKIT

1. This appendix provides indicative guidance on the development of a resolution toolkit to facilitate the resolution of banks. Its purpose is to assist the BoB in the development of a resolution toolkit in coordination with the MFDP and NBFIRA.
2. The purpose of a resolution toolkit is to provide guidance for the resolution authority (the BoB in the case of Botswana) on the activation of resolution, selection of the resolution strategy, implementation of the resolution, and communication. A resolution toolkit also provides guidance on the coordination of resolution actions between domestic agencies and, in the case of foreign-owned banks or domestic banks with foreign operations, cross-border coordination. It needs to be supplemented by bank-specific resolution plans that set out the details of how particular resolution options could be implemented for individual banks.
3. The key elements of a bank resolution toolkit are set out below, including:
  - crisis diagnostics—solvency assessment and systemic impact assessment;
  - resolution strategies, criteria to assist in selecting which strategy might be appropriate in particular circumstances and implementation steps; and
  - cross-border crisis resolution.

### **Crisis diagnostics**

#### ***Solvency and financial soundness assessment***

4. In a period of emerging stress, any bank considered to be potentially vulnerable should be assessed by the supervisory authority to assess the bank's:
  - solvency (i.e., surplus of assets over liabilities);
  - common equity tier 1 capital position;
  - total tier 1 capital position;
  - total capital position;
  - exposure to shareholders and other related parties;
  - level of NPLs;
  - level of specific provisions in relation to NPLs; and
  - expected loss on NPLs.

5. The analysis would appropriately include an estimation of a range of capital values for the bank, from best case to worst case, with assets estimated at expected recoverable values net of realization expenses. Valuations of assets should be undertaken on a 'going concern' basis, unless there is an expectation that the bank will be closed; in which case, valuations would be on a 'gone concern' basis.
6. The analysis would also include an assessment of the bank's liquidity position and a stress-tested assessment of how vulnerable the bank is to wholesale and retail liquidity withdrawals. Liquidity assessment would include analysis of, among other matters:
  - the amount and quality of liquid assets;
  - access to parent or other shareholder liquidity (where applicable);
  - access to committed standby facilities with other banks;
  - amount and nature of assets capable of being used for collateral to obtain liquidity from the BoB or other sources;
  - maturity profile of liabilities, both using contractual and behavioral maturities, under assumed stress conditions;
  - schedule of projected payment and settlement obligations for a defined period (e.g., next one, two weeks, month, etc.); and
  - stress testing of liquidity by estimating the bank's capacity to meet payment and settlement obligations, including deposit withdrawals, under a range of plausible stress scenarios.
7. Where a bank has subsidiaries that perform essential functions for the bank, there should also be a solvency and liquidity assessment of the relevant subsidiaries.
8. It would be desirable for the supervisory authority to develop the capacity to undertake solvency assessments, capital adequacy assessments and liquidity assessments under acute time pressure (e.g., within 24 hours), and undertake periodic testing of that capacity.

### ***Systemic impact assessment***

9. The resolution toolkit should include guidance on undertaking an assessment by the BoB, in liaison with the MFDP and NBFIRA, of the systemic impact of the bank in distress. This would be based on the BoB's framework for determining systemically important banks, but the assessment would need to take into account the particular circumstances of the bank

and financial system at the time of the distress event. In that regard, it is important to remember that the potential systemic impact of a bank varies over time, and on the fragility of the financial system. In a period of financial system stability, small- to medium-sized banks might be assessed as having a low systemic impact, whereas in periods of financial system instability, the failure of the same banks might have a significant impact on the financial system, given the potential for contagion and confidence effects. Accordingly, it is essential that the systemic impact assessment is made at the time of distress and that it factors in the then prevailing circumstances affecting financial system stability.

10. Systemic impact assessments would appropriately draw on the criteria applied in the D-SIB framework developed by the BCBS. The analysis would therefore take into account:

- the market shares of each bank in each of the key lending sectors;
- the market shares of each bank in the deposit market (differentiating between retail and wholesale deposits);
- the share of payments services, differentiated by payment system and payments product;
- the share of lending to economic and social infrastructure providers;
- inter-connectedness (including intra-group and between banks);
- potential for the bank to cause contagion (drawing on the contagion analysis referred to earlier);
- substitutability of systemically important financial functions (including considerations related to the concentrated nature of the banking sector); and
- complexity (including any complexities arising from group structures and the location of essential banking functions in subsidiaries, and cross-border activity).

11. The systemic impact assessment should be undertaken not just for the bank on a solo entity basis, but also on a banking group basis (i.e., taking into account the systemic impact of the failure of subsidiaries of the bank), where banks have significant business in subsidiaries.

12. As part of the systemic impact assessment, contagion risk should be assessed. The analysis would appropriately include an assessment of:

- contagion via inter-bank exposures;

- contagion arising from related party exposures, such as credit exposures to parent banks and other substantial shareholders;
- credit rating downgrade risks associated with parent bank stress;
- reputation impacts associated with parent bank or other major shareholder distress;
- contagion risks associated with functional dependencies between banks with common shareholdings;
- contagion via banks having common credit exposures (e.g., syndicated lending, where the failure of one bank to meet commitments under a syndicated loan could impact the other banks in the syndicate);
- the contagion impact of bank defaults on interest rate and foreign currency derivatives (i.e., requiring other banks to replace interest rate and currency contracts they had with the failed bank, and the potential difficulty in doing so under stressed conditions, possibly leaving them with unhedged exposures); and
- confidence-linked contagion risks and the potential for a generalized depositor run on banks.

13. The systemic impact assessment undertaken by the BoB, in liaison with the MFDP and NBFIRA, will significantly influence the type of resolution strategy to be adopted. In the case of a small bank with little or no systemic impact, and where recovery is not possible, then closure and prompt pay-out of insured depositors or deposit account transfer to another bank via a purchase and assumption transaction would be the likely resolution option. In the case of a systemically important bank, a form of ‘open resolution,’ where the bank’s core banking functions are kept open, would be the likely resolution option.

### **Resolution strategies and implementation of resolution**

14. The resolution toolkit should identify the main resolution strategies and options to deal with banks which cannot restore themselves to financial soundness, and the criteria for determining which option would be appropriate in the circumstances. The plan should also identify the procedures required to implement particular resolution options. The stylized resolution options can then be refined into bank-specific resolution plans for each bank, by category of bank (e.g., domestically owned systemically important banks, foreign-owned systemically important banks, medium-sized banks, and small banks).

15. An important part of the resolution toolkit is establishing guidance on systemically important functions—i.e., those functions that need to be continued, either in the recapitalized bank, a bridge bank, or other acquiring bank, in order to minimize adverse impacts on the financial system and economy. The toolkit would set out the generic functions that would normally be regarded as critical functions required for systemic stability. It would also include guidance on what quantitative thresholds might appropriately be applied by the BoB in determining, as part of bank-specific resolution plans, whether particular banks have sufficient critical functionality so as to warrant a form of resolution that maintains the continuity of these functions (i.e., an ‘open resolution,’ in essence).

16. Systemically important functions would generally include, as a minimum:

- transaction-capable deposit facilities;
- committed credit facilities;
- payment system interface and payments execution functions;
- inter-bank settlement functions;
- settlement functions performed for other financial institutions on an agency basis;
- currency and interest rate derivatives functions; and
- IT support, risk management, and other back-office arrangements required for systemically important functions.

17. Resolution options which could be considered in developing the resolution toolkit (and on which resolution plans would be based) are likely to include the following:

- ***Option 1. Closure of a bank and pay-out of insured deposits followed by liquidation of the bank.*** This would involve the appointment of an administrator to the bank and withdrawal of the bank from all payment channels. Eligible deposit balances would be calculated on the basis of end-of-day positions. The deposit insurance agency (once established) would confirm the amount to be paid to each depositor, capped at the level of the deposit insurance cover per depositor. Payments would then be made to depositors, presumably via a bank that is appointed as the paying agent, funded by the deposit insurance fund. Payments should be made as soon as practicable following the bank’s closure and, desirably, within seven days.



Option 1 might be appropriate where:

- a. The bank is insolvent (i.e., negative equity) or close to insolvent, or otherwise very substantially below minimum capital requirements.
  - b. The bank cannot recover; i.e., there is no prospect of shareholder support or external financial private sector support in the required timeframe.
  - c. No other bank is prepared to acquire equity in the failing bank or to assume all deposit liabilities or even just insured deposit liabilities and acquire assets from the failing bank.
  - d. Closure of the bank would not have a significant adverse impact on the stability of the financial system or economy.
  - e. Closure and pay-out is a lower cost option than the alternative closed resolution options.
- ***Option 2. Closure of a bank and transfer of insured deposit accounts to a receiving bank (either an existing bank or a bridge bank).*** This would involve the appointment of an administrator to the bank and withdrawal of the bank from all payment channels. Eligible deposit balances would be calculated on the basis of end-of-day positions. The deposit insurance agency (once established) would confirm the amount to which each depositor is entitled, capped at the level of the deposit insurance cover per depositor. The deposit accounts (together with associated IT systems) would be transferred to an acquiring bank that is willing to assume the deposit liabilities or to a bridge bank established for the purpose. The acquiring bank/bridge bank would administer the failed bank's IT systems required to operate the deposit accounts. The deposit accounts would operate as usual, with no change of account numbers once transferred to the receiving bank. The receiving bank would purchase assets from the failed bank at market value, if it wished to do so. The net cost to the acquiring bank of assuming the insured deposit liabilities would be funded by the deposit insurance agency. The failed bank would then be wound up through the insolvency law arrangements and the deposit insurance agency would have a subrogated claim of the insured depositors on the assets of the bank in liquidation.

Option 2 might be appropriate where:

- a. The bank is insolvent (i.e., negative equity) or close to insolvent, or otherwise very substantially below minimum capital requirements.

- b. The bank cannot recover; i.e., there is no prospect of shareholder support or external financial private sector support in the required timeframe.
  - c. No other bank is prepared to acquire equity in the failing bank or to assume all deposit liabilities and acquire assets from the failing bank.
  - d. One or more banks are willing to assume the insured deposits, funded either fully by the deposit insurance agency or funded through a combination of deposit insurance funding and assets transferred to the acquiring bank. If there is sufficient time available, the deposit insurance agency would seek competitive bids from banks which the BoB regards as being in a sufficiently sound financial condition to acquire the insured deposits of the failed bank.
  - e. Closure of the bank would not have a significant adverse impact on the stability of the financial system or economy.
  - f. Closure and transfer of insured deposits are assessed as being a lower cost option than the alternative closed resolution options.
- ***Option 3. Transfer of some or all of the failed bank's assets, liabilities, and business functions to another existing bank or a bridge bank.*** This would involve the appointment of an administrator to the bank and withdrawal of the bank from the payment systems. An assessment would be of the systemically important and otherwise viable business that is to be transferred to either an existing bank willing to acquire this business and associated functionality, or to a bridge bank established for the purpose. The business to be transferred (most likely including all critical functions and performing assets) would be valued and transferred at the assessed market value.

If the assets (including estimated franchise value) to be transferred equal, at least, the liabilities to be assumed by the acquiring bank, then no resolution funding would be required. A surplus of assets relative to liabilities transferred would entail payment of the net amount to the account of the bankruptcy estate of the failed bank. A deficiency in assets relative to liabilities transferred would require funding from either the bail-in of liabilities, the deposit insurance agency or the government (as a last resort only). The deposit insurance agency's funding would be capped at the amount it would have paid (net of recoveries) under a least-cost deposit insurance pay-out or insured deposit account transfer.

The failed bank would be closed and its residual business would be wound up under insolvency law. Ex post compensation would be paid to shareholders and creditors, respectively, to the extent they were rendered worse off than under a conventional

winding up had the bank been retained whole and wound up, applying the statutory ranking of claims in winding up.

NPLs could either be retained in the failed bank or transferred to an asset management company established by the BoB for the purpose, or to an existing private sector entity in the business of acquiring and working out impaired assets.

Option 3 might be appropriate where:

- a. The bank is still solvent (i.e., has positive equity), at least with respect to deposit liabilities and possibly other senior unsecured debt.
  - b. The bank cannot recover—i.e., there is no prospect of shareholder support in the required timeframe.
  - c. The closure of the bank would have a significant adverse impact on the stability of the financial system.
  - d. At least one suitably capitalized bank is able and willing to acquire the systemically important business of the bank or a bridge bank could be established to acquire the relevant business. (The latter would be an option where no existing bank is willing or able to acquire the systemic business of the failed bank or where market concentration factors would make it undesirable for the business to be transferred to an existing bank).
- **Option 4. Sale of the bank to another bank.** This would involve placing the bank into administration and selling a majority shareholding position to an acquiring bank. This could be done by cancelling existing shares (assuming the powers were in place to do this), with compensation to shareholders for the assessed value of the shares and issuing new shares to the acquiring bank. Alternatively, it could be achieved by issuing new shares to an acquiring bank and diluting existing shares to their assessed market value, resulting in the acquiring bank assuming a controlling shareholding. In either case, the distressed bank would be recapitalized to the appropriate target level (i.e., sufficient to comfortably exceed the regulatory requirements and to maintain an acceptable credit rating and maintain depositor and investor confidence).

Option 4 might be appropriate where:

- a. The bank is still solvent (i.e., has positive equity), at least with respect to deposit liabilities and, possibly, other senior unsecured debt.

- b. The bank cannot recover; i.e., there is no prospect of shareholder support in the required timeframe.
  - c. The bank's closure would have a significantly adverse impact on the stability of the financial system.
  - d. At least one suitably capitalized bank is able and willing to acquire either 100 percent or a majority shareholding in the bank that is sufficient to recapitalize the bank to the required target level.
  - e. The acquisition of the failed bank by the acquiring bank would not lead to excessive market concentration or systemic risk.
- ***Option 5. Recapitalization of the bank through bail-in.*** This would involve appointing an administrator to the bank, assessing the worst-case capital position of the bank (taking into account the need for any capital support to essential subsidiaries), and determining the amount of capital required to meet a target capital ratio that is sufficient to comply with capital requirements and maintain market confidence and credit ratings. Bail-in could be implemented via a number of routes, including by write-down of the liabilities or conversion of liabilities to an equity instrument that ranks equal to diluted equity of existing shareholders or converted to preference shares that rank above existing equity. Liabilities would be bailed in in the inverse order of their ranking in a winding-up; i.e., the lowest ranking liabilities (such as subordinated debt) would be bailed in first, followed by senior unsecured bonds, followed by uninsured deposits, etc. Insured deposits would either be exempted from bail-in or the deposit insurance agency would bear the bail-in cost if it were applied to insured deposits. Some other liabilities might also be exempted from bail-in, potentially including liabilities payable to suppliers of essential services and liabilities in relation to derivatives required to maintain balance sheet hedges.

Bail-in can be achieved through different mechanisms, as discussed later in this note.

Option 5 might be appropriate where:

- a. The bank cannot recover; i.e., there is no prospect of shareholder support in the required timeframe.
- b. The bank has sufficient subordinated debt and senior unsecured debt (excluding insured deposits) to be a source for recapitalization, either through conversion to equity or other eligible capital instrument or write-down, after first writing down existing equity.

- c. The closure of the bank would have a significant adverse impact on the stability of the financial system.
  - d. Bail-in would not trigger contagion or other systemic disruption on a significant scale. Bail-in is more likely to be a viable solution for an idiosyncratic bank failure, where the other banks in the financial system are in a prudentially sound condition and market confidence in the banking system as a whole is reasonably strong. Bail-in is less likely to be an attractive option in the case of multiple bank distress and where the bail-in of one bank could trigger a contagious run on other banks.
- ***Option 6. Recapitalization of the bank through bail-out via public funds.*** This is a last-resort option and would only be used where the other options are considered to be impracticable, and that some form of government-funded bail-out is required for the purpose of meeting resolution objectives. It should be applied with robust safeguards, as discussed below.

This would involve appointing an administrator to the bank, assessing the worst-case capital position of the bank (taking into account the need for any capital support to essential subsidiaries), and determining the amount of capital required to meet a target capital ratio that is sufficient to comply with capital requirements and for maintaining market confidence and credit ratings. Recapitalization would be implemented by the issuance of shares to the government (either directly or via a government-owned entity) sufficient to achieve the target capital ratio. This would be a last-resort option where all other options (including bail-in) have been assessed and found to be non-viable or systemically destabilizing. Government-funded recapitalization should occur only after existing shareholders have been fully bailed in, such that their shares are either cancelled (if of no value or of very little value) or diluted to the assessed market value. Subordinated debt should also be bailed in.

The government's shareholding could either take the form of ordinary shares with full voting rights or preference shares with full or limited voting rights (where existing shareholders and bailed-in creditors hold a substantial proportion of total equity). In either case, the government should ensure that it prices the shares it holds, and any other support it provides (e.g., guarantees or indemnities), at appropriate commercial pricing to ensure that taxpayers are compensated for the risks involved. It should also ensure that it has sufficient control of the bank to manage all risks arising from its equity stake and other forms of support it provides.

Option 6 might be appropriate where:

- a. The bank cannot recover; i.e., there is no prospect of shareholder support in the required timeframe;
- b. The bank does not have sufficient subordinated debt and senior unsecured debt (excluding insured deposits) to be a source for full recapitalization, either through conversion to equity or other eligible capital instrument or write-down, after first writing down existing equity;
- c. The bank's closure would have a significantly adverse impact on the stability of the financial system;
- d. Bail-in would likely trigger contagion or other systemic disruption on a significant scale; and
- e. The government ensures that existing shareholders and subordinated creditors are required to absorb all losses to the extent of their holdings before any government-funded support is provided.

The principle of “no creditor or shareholder left worse off than under whole-of-bank liquidation” should be applied, such that shareholders and creditors are compensated to the extent that the resolution option chosen left them worse off than had the bank been retained whole and liquidated under conventional insolvency law.

In the case of recapitalization of an existing bank or transfer of business to a bridge bank, the following issues would need to be considered:

- ***Nature of directions to the bank.*** For example, if there is a likely need to recapitalize the bank or to transfer some or all of the bank's business and functionality to another entity, the BoB may need to issue directions to the bank to undertake the required pre-positioning; e.g., preparation of specific documentation for capital issuance, IT changes to facilitate the transfer of some parts of the undertaking to another entity, etc. There may also need to be directions to remove directors and management to the extent they are thought to be obstacles to resolution and not required for the resolution process.
- ***New directors and management.*** If the BoB believes new directors and management are needed before the appointment of an administrator or as an alternative to administration, they should pre-identify candidates for the appointments, potentially including senior staff from the NBS or from suitable foreign banks. For example, the replacement of directors and senior management might be required ahead of the

appointment of an administrator in situations where the BoB wants to pre-position the bank for an expected resolution—e.g., to restructure the bank, curtail new lending, etc., and where they do not have confidence in some of the existing directors or management team to undertake pre-positioning for resolution.

- ***Administration.*** It is suggested that the BoB document the process required to appoint an administrator if that becomes necessary, and maintain a list of possible appointees for administrator (e.g., senior staff from the BoB or another government agency, or possibly a seconded senior executive from a bank or parent bank with a sound understanding of the Botswana banking system). The administrator might need to be supported by advisers to bring market credibility and assist in the management of technical aspects of the resolution process. The toolkit should desirably include a list of potential firms and individuals for this purpose, and updated regularly. It should also include draft terms of reference and documentation for appointment.
- ***Directions to an administrator.*** The BoB would also need to identify the directions to give to an administrator; i.e., as to the particular business functions to keep open (e.g., deposit-taking, payments functions, meeting commitments on derivatives, meeting commitments under committed credit facilities, etc.) and which ones to be suspended. Directions would also extend to what actions should be taken to keep subsidiaries functioning where this is necessary for the bank’s functioning. The toolkit should also identify the particular pre-positioning directions to an administrator applicable to each type of resolution.
- ***Public and other stakeholder communications.*** The toolkit should include guidance on public and other stakeholder communications for each type of resolution. For example, if, in an open resolution, most or all of the bank’s business is to be maintained, the BoB needs to be ready to publicly announce at the time an administrator is appointed the intended scope of the bank’s business under administration, and which obligations will be continued and which will be suspended. Clarity and certainty is crucial for counterparties, depositors, and other stakeholders. The communications strategy should include an identification of the information to be conveyed by each agency to each category of stakeholder, the timing of each communication in the resolution process, and the channels used for communications. Key stakeholders will include:
  - a. depositors of the bank being resolved;
  - b. depositors in other banks;
  - c. other creditors of the bank being resolved;

- d. borrowers of the bank being resolved, especially those with overdraft and other committed credit facilities;
  - e. the management of other banks;
  - f. the financial institutions which meet their payment obligations through the bank being resolved;
  - g. foreign regulators (e.g., of the foreign banks operating in the country);
  - h. the financial news media and general news media;
  - i. social media; and
  - j. the general public.
- ***Determination of the capital requirement for the recapitalized bank or bridge bank.*** the BoB would need to determine an appropriate capital ratio and, therefore, capital injection, required to restore the distressed bank to financial soundness or to capitalize a bridge bank. The capital ratio would need, at the least, to be around the same level as for other banks in the peer group and sufficient to obtain a credit rating similar to the rating that applied before the bank became distressed. In order to restore market confidence and enable the bank to resume normal funding, the target capital ratio is likely to be higher than it was pre-distress, based on a target credit rating (e.g., at least investment grade and likely higher for any major bank). The capital ratio will also be influenced by whether the government is providing an interim guarantee of the bank's liabilities and, if so, the terms of the guarantee. If there is a guarantee, the required capital ratio would be lower than in the absence of a guarantee. However, given the desire to avoid open-ended commitments by the government, such as those arising under a guarantee, it would generally be better to set the capital ratio at a level where the bank can operate without a guarantee.
  - ***Capital support by the government.*** If the distressed bank is to be recapitalized by the government, or a bridge bank is to be capitalized by the government, it is essential that this is done as a last resort (i.e., failing any other sources of capital) and on commercial terms. It is also essential that the existing shareholders are either removed from the recapitalized bank (e.g., by using a bridge bank and leaving shareholders in the failed bank) or diluted in accordance with the assessed value of shareholders' funds immediately pre-resolution. If the government does need to provide capital support, the MFDP will need to develop guidance on the following matters:



- a. whether capital provided by the government is in the form of preference shares (which would rank ahead of ordinary shares and therefore reduce the risk of the government) or ordinary shares ranking equally with existing ordinary shares;
  - b. the pricing of the shares paid for by the government, based on a conservative valuation of the bank immediately pre-resolution;
  - c. the voting rights on preference shares if that form of capital is used;
  - d. the other forms of control which the government may wish to exercise (either via voting rights on shares or through another means, such as a deed poll entered into by the bank), such as:
    - the right to appoint directors in proportion to the share of the capital the government holds;
    - veto rights over the appointment of directors by other shareholders (if they are minority shareholders);
    - the right to appoint (or veto the appointment of) the CEO, CFO, and CRO;
    - the right to approve (or veto) key transactions, such as lending to related parties, large exposures, disposal of business, acquisition of new business, etc.;
    - the right to determine the risk appetite and nature of business strategy adopted by the bank; and
    - the nature of the exit arrangements, such as eventual sale of the government's shares to another party (subject to the approval of the RA).
- ***Government underwriting of a rights issue to capitalize a bank.*** If the capital injection takes the form of a rights issue to existing shareholders, this should be priced on the basis of the estimated value of the bank (on a conservative basis) pre-resolution. Such a rights issue would probably need to be underwritten by the government in order to provide certainty of the capital being raised; i.e., any rights not taken up by the existing shareholders would be taken up by the government via its underwriting obligations. On this basis, the MFDP should develop guidance on the indicative terms for a government-provided underwriting of a rights issue. This should be priced commercially and enable the government to acquire additional shares if necessary to ensure that it has appropriate control of the bank to protect the government's risks. See above for the types of control the government might wish to

have. The contingency plan should include indicative documentation and terms sheets for a government underwriting agreement.

- ***Establishment of a bridge bank.*** If a bridge bank is to be used, the contingency plan should identify the steps required for the BoB to establish the legal entity. It is suggested that the contingency plan include pre-prepared documentation for the establishment of a bridge bank, including a company constitution, governance structure, management structure, etc. It will also be necessary to maintain updated lists of potential directors and senior management for a bridge bank. The toolkit should also include guidance on the steps required for fast-tracking bank licensing and other consent processes, as appropriate.
- ***Government guarantee of a bridge bank.*** It may be necessary for the government to provide a guarantee of a resolved bank's liabilities for a period until the bank has been stabilized. This should be avoided unless absolutely necessary. If this is considered necessary, the guarantee should be on commercial terms where practicable, such that the government charges a fee for the provision of the guarantee. The guarantee documentation may also need to include covenants which confer specific powers on the government to control the bank while the guarantee is in place, such as the need for specific business transactions to be approved by the government, the need for director and management appointments and removals to be approved by the government, etc. The contingency plan should include preparation of an indicative terms sheet for a government guarantee, together with draft documentation. These are matters for which the MFDP needs to take responsibility.
- ***Business transfer to a bridge bank.*** Consideration needs to be given to what assets and liabilities are transferred to the bridge bank; i.e., only systemically important business or the entire business, and whether impaired assets are retained in the failed bank, transferred to the new bank, or (if substantial) transferred to an asset management vehicle established for the purpose. Consideration is also needed to identify the risks of counterparty defaults as a result of business transfers occurring and how these can be avoided where possible; e.g., assurances or guarantees that the contracts in question will continue to be met by the new bank. At a minimum, one would expect the plan to provide for all systemically important business and performing assets to be transferred to the bridge bank, including deposit liabilities, payments functionality, committed credit facilities, risk hedges, relevant IT infrastructure to maintain all transferred functions and performing assets.
- ***Bail-in.*** In order to minimize the need for government funding and risks to the taxpayer, consideration should be given to the possibility of achieving some form of bail-in of existing bank debt; e.g., subordinated debt and possibly senior unsecured bonds. Bail-in could potentially be achieved by any of the following mechanisms:

- a. Requiring banks, as part of recovery planning requirements, to have a tranche of debt capable of being contractually converted to eligible capital instruments or written down upon defined triggers (such as the capital ratio falling below a trigger level).
- b. Using statutory powers in the BA to bail-in any unsecured debt instrument by converting it to an eligible capital instrument or write it down. The bail-in would apply to debt in a manner consistent with the ranking of claims in a winding up; i.e., lower-ranked debt in a winding up would be bailed-in before higher-ranked debt.
- c. Implementing a bail-in using business transfer powers, whereby a tranche of debt is retained in the failed bank, such that the reduced level of debt transferred to a bridge bank provides the funding for capital in a bridge bank. A similar option would be to assess whether tranches of debt could be transferred out of the failed bank to a special entity established for the purpose if the decision were made to recapitalize the failed bank rather than establish a bridge bank. The creditors of the debt retained in the failed bank or transferred to the special entity, as the case may be, would be compensated ex post to the extent that they are left worse off than if the bank had been liquidated in its entirety (on the basis of the ranking of claims in winding up).

### **Communications and coordination**

18. Communications and coordination are essential in a crisis. For each resolution strategy, the toolkit needs to identify what communications need to be made to each category of stakeholder (including depositors, the wider public, banks, other financial institutions, foreign counterparties, foreign regulators, rating agencies, news media, and social media). The toolkit should identify the key information to be conveyed to each category of stakeholder and which agency has responsibility for each element of this. It should also include the development of checklists for the issues to be considered by each agency in preparing media statements and other forms of communication.

### **Cross-border coordination and cooperation**

19. The toolkit needs to include guidance on cross-border coordination and cooperation.
20. Matters that should be covered in this area include the following:
  - A clear delineation of resolution responsibilities between the parent authorities (the prudential supervisor/resolution authority) and the Ministries of Finance in the home

and host countries. These should be documented in either a multilateral MoU (for all agencies) or bilateral MoUs.

- Identification of information exchange arrangements between the respective agencies, based on the above-mentioned MoU(s).
- Coordination of the development and enforcement of recovery plans, resolvability assessments and resolution plans, such that the recovery plans and resolution plans for the subsidiary banks in the host country are informed by, and not materially inconsistent with, the parent bank recovery and resolution plans.
- Processes for coordinating the solvency/capital assessment and liquidity assessment for the parent banking group and subsidiaries in the host country.
- Process for coordinating the identification and assessment of resolution options. This is especially important for recapitalization options for the subsidiary, drawing on the two generic models for group-based recapitalization: Single Point of Entry (SPE) and Multiple Points of Entry (MPE). Under an SPE model, the recapitalization of the subsidiary in a host country would be performed by the parent bank, either via bail-in of liabilities in the parent bank, bail-in of liabilities in the subsidiary (in exchange for shares in the parent bank) or external injection of capital into the parent bank, with the capital being cascaded to the subsidiary in the host country. Under an MPE model, the recapitalization of the subsidiary in the host country would be performed at the level of the subsidiary, either by bail-in of liabilities of the subsidiary or injection of capital into the subsidiary by the government or another party approved by the BoB. Under an SPE approach, the parent bank remains the shareholder of the subsidiary. However, under the MPE approach, the subsidiary might cease to be a member of the parent banking group, reflecting its new shareholding arrangements. In that event, it would be necessary to ensure that contractual arrangements are entered into between the subsidiary and parent bank for all essential functional support provided by the parent bank to be continued (on commercial terms) until alternative arrangements can be made.

**APPENDIX III. STYLIZED ILLUSTRATION OF LIQUIDITY PROVIDING OPERATIONS BY CENTRAL BANKS**

**Liquidity Providing Operations to Solvent Banks**

**Normal Market Operations**      **ELA**

**OMO Tenders**      **Overnight Facility**      **Short-term funding to address liquidity shortages**

High quality collateral

Can be from one-week to three-month duration - but should match liquidity absorption OMOs (14 days for BoB)

Some central banks have provided long term refinancing operations in response to liquidity shortages during the global financial crisis (e.g., one to four year ECB LTROs)

Short-term operations are typically at a rate linked to the monetary policy rate; longer-term operations are usually at a market rate, or indexed to the prevailing policy rate

**OMO**

High quality collateral

Interest rate at OMO rate plus a spread

Designed to allow borrowing on an overnight basis or until the next OMO tender

Can be used to meet sudden liquidity shock

Offered in addition to overnight liquidity absorption

**Overnight Facility**

Provided in response to request from a bank that has no other source of funding

Short term liquidity provision as lender of last resort

Interest rate at a penalty - usually Overnight Facility plus a margin

Separate list of eligible collateral, subject to risk control

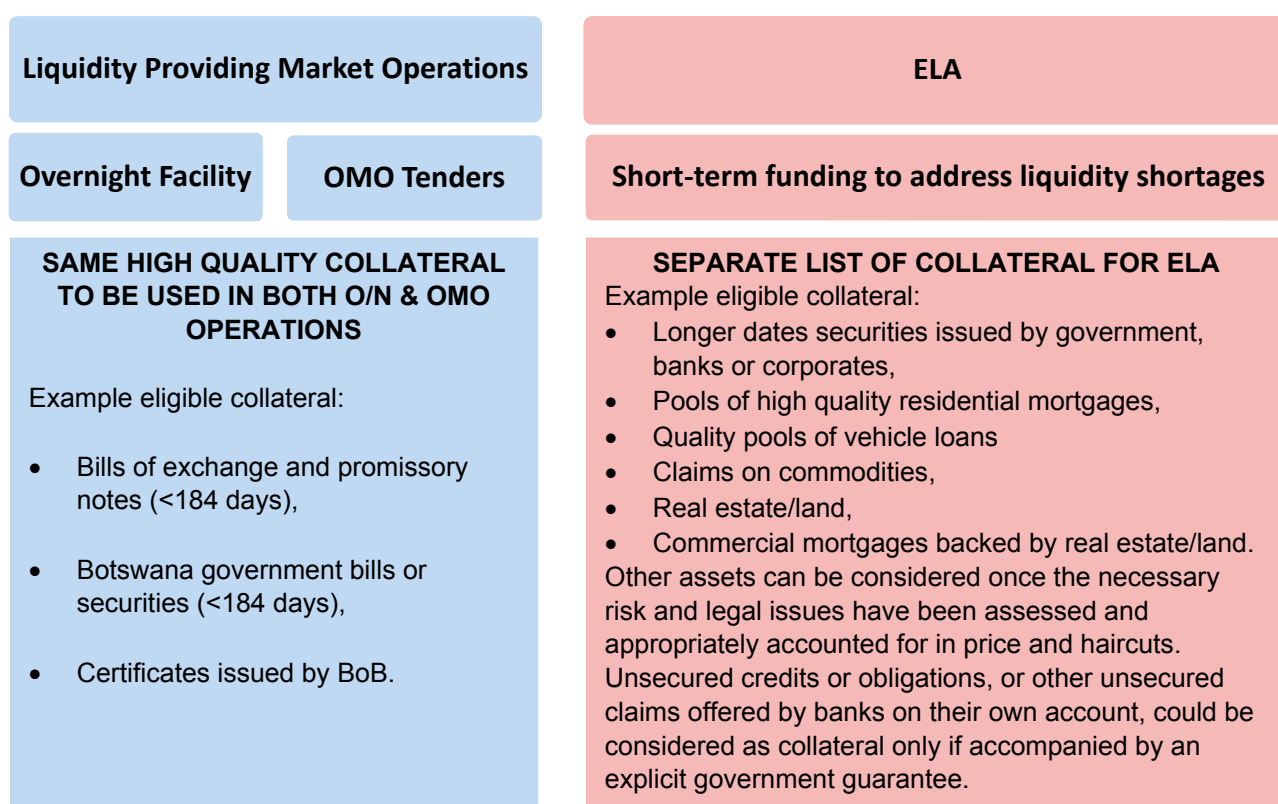
Enhanced criteria and conditionality

**ELA**

## APPENDIX IV. STYLIZED ILLUSTRATION OF POTENTIAL COLLATERAL ELIGIBILITY PER OPERATION<sup>1</sup>

1. Currently, the BoB has a relatively narrow list of eligible collateral for use in normal liquidity providing monetary policy operations. The list of collateral eligible for normal monetary operations should always be driven by the extent of liquidity that needs to be provided according to the monetary policy stance. Often, where low levels of liquidity need to be provided to the system as a whole, such as the current situation in Botswana, a narrow list of eligible collateral for normal operations is sufficient.

### Appendix Figure 1. Botswana: A Narrow List of Eligible Collateral for Normal Market Operations



<sup>1</sup>See ECB list of eligible collateral for normal monetary operations <https://www.ecb.europa.eu/paym/coll/standards/marketable/html/index.en.html>. The list of collateral that is eligible for normal monetary operations is determined by the monetary policy stance and the degree to which banks have sufficient collateral to access normal operations. ELA collateral will be determined by what other assets are left after monetary policy eligible collateral has been used, subject to additional risk control measures.

In particular, consideration needs to be given to whether the counterpart banks have sufficient quality collateral when the central bank needs to inject reserves into the system in order for the central bank to achieve its desired inflation target. If the BoB wishes to retain the existing narrow list of collateral eligible for normal market operations, then the remaining assets on banks' balance sheets would be considered as potential ELA collateral, subject to the necessary risk control measures being taken.

### Appendix Figure 2. Botswana: A Broader List of Eligible Collateral for Normal Market Operations

Liquidity Providing Market Operations		ELA
Overnight Facility	OMO Tenders	Short-term funding to address liquidity shortages
<p><b>SAME HIGH QUALITY COLLATERAL TO BE USED IN BOTH O/N &amp; OMO OPERATIONS</b></p> <p>Example eligible collateral:</p> <ul style="list-style-type: none"> <li>• Bills of exchange and promissory notes drawn of made for commercial, industrial or agricultural purposes (&lt;184 days is proposed in BoBA Revision 4, but longer maturities could be considered),</li> <li>• Botswana government bills or securities,</li> <li>• Certificates issued by BoB.</li> </ul> <p>Plus, if broader collateral base required, other assets such as pools of very high quality mortgages.</p>		<p><b>SEPARATE LIST OF COLLATERAL FOR ELA</b></p> <p>Example eligible collateral:</p> <ul style="list-style-type: none"> <li>• Certain credit claims backed by government guarantee,</li> <li>• Pools of high quality residential mortgages not eligible for O/N or OMO,</li> <li>• Quality pools of vehicle loans,</li> <li>• Claims on commodities,</li> <li>• Real estate/land,</li> <li>• Commercial mortgages backed by real estate/land.</li> </ul> <p>Other assets can be considered once the necessary risk and legal issues have been assessed and are appropriately accounted for in price and haircuts.</p> <p>Unsecured credits or obligations, or other unsecured claims offered by banks on their own account, could be considered as collateral only if accompanied by an explicit individual government guarantee.</p>

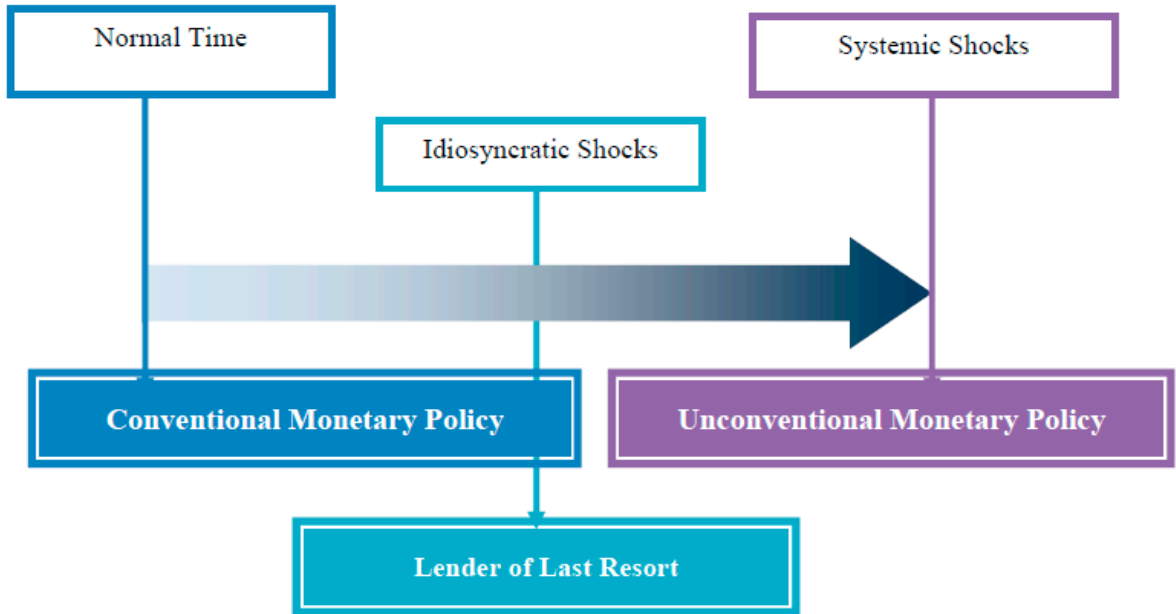
2. Some central banks (e.g., the ECB and the Bank of England) have expanded the list of collateral eligible for normal liquidity providing monetary operations in response to the financial crisis, where larger amounts of liquidity needed to be injected into the wider banking system in order to achieve the required monetary stance. This is usually implemented in response to a systemic monetary and liquidity shock.
3. Expansion of such collateral eligibility for normal market operations is subject to the collateral being of sufficiently high quality and should not be confused with providing ELA liquidity to support individual banks. Therefore, if the BoB were to consider at any stage that banks should be able to borrow more funds through normal market operations in order to meet the monetary policy target, or if banks could not obtain sufficient quantities of assets on the existing narrow list of eligible collateral, then consideration could be given to expanding the list of eligible collateral for normal market operations. The remaining collateral would potentially be eligible for ELA.
4. For example, the proposed amendments to the BoBA in Part IX Section 46, subsection 2(b), envisage that the BoB may take government securities, with no time to maturity restrictions, as collateral—whereas these are currently restricted to <184 days. Any expanded list of collateral for normal operations should be comprised of assets that are generally available to banks across the system.<sup>2</sup> Collateral for ELA would be chosen from suitable assets remaining on bank's balance sheets.

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<sup>2</sup> The Bank of England applies a price tiering in some of its Sterling Monetary Framework operations in order to encourage the market to hold higher quality assets.



**APPENDIX V. HIGH LEVEL OVERVIEW OF CENTRAL BANK LIQUIDITY RESPONSES**



**APPENDIX VI. ELA GOVERNANCE AND HIGH-LEVEL PROCEDURES**

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*Authority to approve ELA is often delegated to the governor. Generally, the decision whether to provide ELA or not resides with the Board of the central bank. However, it is not always possible to convene a Board meeting at short notice and, therefore, responsibility for the decision of the provision of ELA might be delegated to the governor.*

*The governor/Board will make the decision regarding the provision of ELA in accordance with BoB powers and the objectives of financial stability, solvency, and systemic importance of the bank, stipulating that ELA advancements should be against approved collateral adequacy, and taking the monetary policy stance into consideration.*

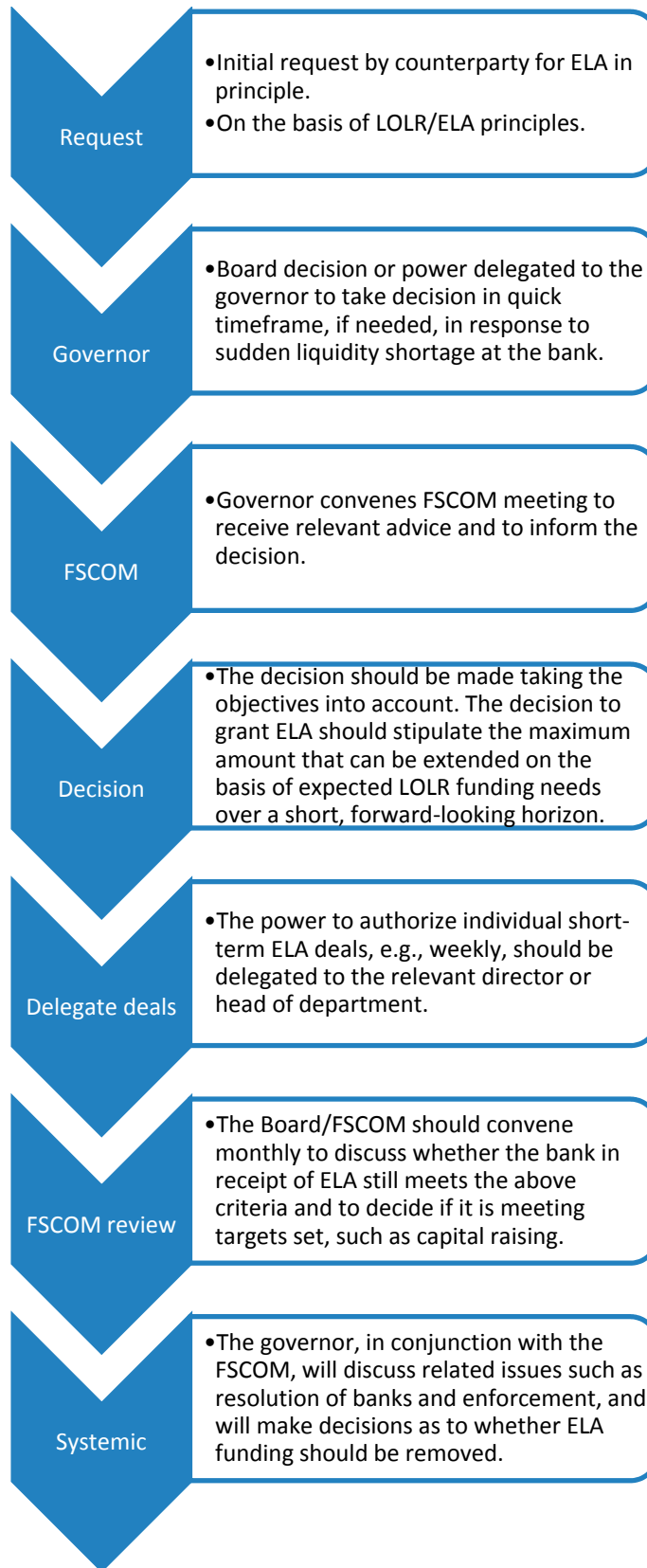
*A meeting of a FSCOM could be convened. This should be chaired by the governor and include the relevant directors and heads of department. They will advise on bank solvency, systemic importance, monetary policy, BoB risk management, and on market and bank-specific liquidity and flows developments.*

*A decision in principle to grant ELA should stipulate that funding up to a certain amount can be provided on a short-term basis over a specified period; e.g., to cover expected cash outflows over the **next one month**.*

*Approval could be given to provide ELA within these limits specified and subject to adequate collateral, as per risk specifications agreed by the Board. Shorter-term, one- or two-week ELA deals carried out within that month could be authorized by the director or at the department level.*

*Each month, the FSCOM/Board should meet to discuss the bank's solvency, its progress to restore itself to normal market funding and exit out of ELA, the continued systemic importance of the bank, monetary policy consistency and its success in meeting targets, such as capital raising. Should important developments arise, ad hoc FSCOM meetings should be called urgently.*

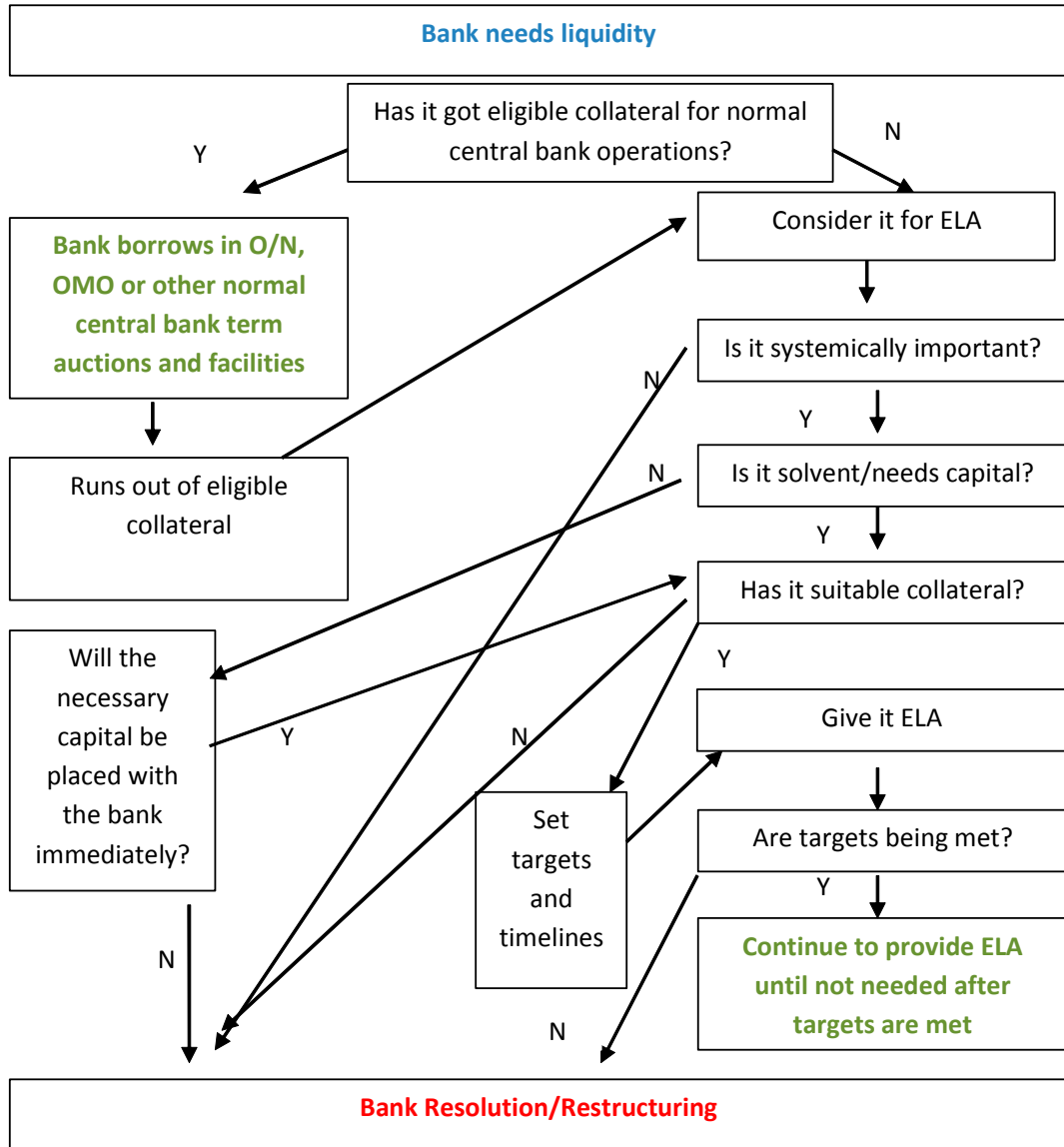
*The governor/Board, in conjunction with the FSCOM, will discuss related issues such as resolution of banks and enforcement, and will make decisions as to whether a bank should be removed from ELA funding. These issues will require close cooperation with other national authorities to manage the processes and maintain*



### **High-Level Steps When a Counterparty First Requests ELA**

- A written request from the chairman (or similar level) of the financial institution to the governor requesting ELA to be provided. This letter should detail the reason behind this request.
- Consideration of the request by the governor/Board (advised by Financial Stability Committee) on the basis of detailed supporting information provided by the Financial Stability, Supervision, And Markets Departments (and risk management and legal, where applicable).
- Approval of the request and acknowledgement of the financial stability grounds behind this provision of liquidity. Confirming the term and rate of the transaction and agreeing that once all the necessary documentation and collateral details are in order, to advance the funds to the institution.
- The governor/Board formally writes to the requesting institution approving the provision of ELA (electronically with hard copy to follow). In this letter, the governor should outline that BoB will liaise with the financial institution in relation to the collateral and associated haircuts that will secure the ELA and also requests the following:
  - A list of authorized signatures for personnel authorized by the institution to carry out ELA transactions;
  - Minutes of the institution's Board meeting where ELA was agreed.
- Confirmation should be sought from the prudential area of BoB specifying that the requesting financial institution is solvent or if it is currently below its capital ratios that is in compliance with, or has, an agreed restructuring plan.
- Confirmation sought from BoB's legal/relevant area that the associated legal documentation is prepared and ready for execution.
- Given the implication for reserves within the system, inform the monetary policy area of the pending provision of ELA, amounts, and duration.
- A written request is sent from the governor/Board to the minister requesting the provision of an indemnity in the name of BoB to cover the full value of the ELA to be provided.
- Provision of ELA funding T+1 (aim for maximum of cash delivery one day after the application, both after initial application and for ELA roll-over deals).

**APPENDIX VII. STYLIZED CENTRAL BANK LENDING DECISION TREE**



## APPENDIX VIII. KEY CONCEPTS OF LENDER-OF-LAST-RESORT FUNDING<sup>1</sup>

1. **An appropriate monetary policy framework forms a good basis for an effective ELA framework.** Monetary policy frameworks should have clear counterparty and collateral eligibility criteria, ensuring that only solvent counterparties can access these operations and that counterparties with capital or management difficulties are not supported. Monetary policy collateral frameworks should be confined to a limited set of liquid assets with clear eligibility criteria. Having clearly defined monetary policy and ELA frameworks ensures that both operations have separate monetary policy and financial stability objectives.
  
2. **Central banks have a number of liquidity provision tools available.** Through implementation of its monetary policy during normal times, central banks, at their initiative, can provide reserve money on a multilateral basis to the market, or at an institution's initiative—and on a bilateral basis—to support the payment system. The objective of a central bank's open market operations under conventional monetary policy is generally to steer short-term market rates. Central banks can also respond to idiosyncratic emergency needs or a market/systemic shock when normal market functioning is disrupted.
  
3. **The emergency response role is one of the most important functions of a central bank.** In a closed system of reserves supply, the central bank is the last lender an institution can resort to after exhausting all other funding options available to them. The demand for idiosyncratic lending may stem from a single bank, or a small group of banks, encountering immediate problems.
  - **Systemic, multilateral lending at the central bank's initiative:** aggregate systemic liquidity needs can change the terms on which OMOs lending is provided; e.g., lengthening the tenure (e.g., the ECB's three-year, long-term operations) where central banks focus on specific market issues rather than on a desired interest rate target. This may be to inject the necessary liquidity into the system in order to ensure market functioning, efficacy of the monetary transmission mechanism and, ultimately, to enhance the monetary base to enable the real economy to function *so as to achieve the central bank's inflation target*.
  - **Idiosyncratic, bilateral lending at the counterparty's initiative:** the provision of this liquidity is generally performed under the central bank's financial stability mandate, with the aim of avoiding the institution's default and therefore preventing disruption to the payments system. In such circumstances, the central bank is said to be acting in the capacity of 'Lender of Last Resort.' This provision of ELA is strictly in response to a solvent and systemically important institution facing an urgent need

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<sup>1</sup> See ECB's ELA high level principles at <https://www.ecb.europa.eu/mopo/ela/html/index.en.html>.

for liquidity that cannot be sourced from anywhere else other than from the central bank.

4. **LOLR is provided to temporarily illiquid but solvent institutions.** It should not be the role of a central bank to support insolvent institutions. By doing so, it could lead to banks taking on excessive risks in the knowledge that the central bank will always be there to support them. Moreover, such an expectation could de-anchor medium-term price stability expectations. ELA should in no way be seen as a substitute for the resolution of problem banks.

5. **Before ELA can be provided by a central bank, the central bank must first have the legal power to provide such liquidity.** Legal acts generally stipulate that the central bank can lend in exceptional circumstances for financial stability purposes or to perform a lender-of-last-resort function.

6. **LOLR practices vary across countries, but the key principles remain the same:**

*Solvency of counterparty:* in order to avoid the banking system taking on excessive risks (creation of moral hazard risks). If a central bank is to use public funds and provide credit against non-standard collateral (which may be hard to value), it should be satisfied as far as possible that the bank in question is solvent.

*Viability of the counterparty:* While an institution is solvent, it may not have a viable business model or could be subject to liquidation in the near future. It is prudent for the central bank not to lend to such non-viable entities, as there is little chance the monies lent will be recouped. A viability assessment should be forward looking.<sup>2</sup>

*Counterparty access:* ELA access is generally limited to financial institutions that hold reserve accounts at the central bank (typically commercial banks), but some countries restrict or allow access to systemically important institutions whose default would cause contagion across the system.

*Supervisory intrusion and conditionality:* The provision of ELA should only be temporary and, therefore, institutions in receipt of ELA should be subject to enhanced supervision and conditionality, so that the central bank is always comfortable that the monies lent can be repaid and that the funding is being used for appropriate purposes. Moreover, any potential moral hazard associated with the potential weakening of

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<sup>2</sup> "... the prudential supervisor's assessment, over the short and medium term, of the liquidity position and solvency of the institution receiving the ELA, including the criteria used to come to a positive conclusion with respect to solvency" (ECB ELA Procedures, Updated February 2014, [https://www.ecb.europa.eu/pub/pdf/other/201402\\_elaprocedures.en.pdf?10cc0e926699a1984161dc21722ca841](https://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf?10cc0e926699a1984161dc21722ca841))

market discipline is minimized through increased supervisory intrusion and even conditionality.

***Collateral criteria:*** As institutions should always have explored all other options for funding, including the use of eligible collateral in normal monetary policy operations, it is generally expected that the ELA collateral will be less liquid. In the majority of cases, ELA lending is backed by loan collateral or securities that are not eligible for monetary policy operations, with the approach taken being very much dependent on what collateral is unencumbered on the institution's balance sheet at the time of the liquidity need. This is always subject to the risk-control measures and risk limits that the central bank is willing to accept in consideration of its protecting its own capital levels.

***Interest rate:*** ELA should apply a penalty interest rate in order to dissuade unnecessary market access. Central banks have different practices, but, in general, central banks should try to strike a balance between the incentives for a distressed institution to seek alternative funding and the issue of moral hazard. The upper bound should be considered in the context of whether the rate is too penal, so as to make repayment impractical, yet the rate should always be above the market-available rates.

***Maturity:*** LOLR involves the temporary provision of liquidity and should not be provided for longer than absolutely necessary; i.e., long enough to address the underlying liquidity difficulty that has been caused due to a temporary shock. Should the liquidity need be prolonged, it could indicate more acute difficulties, such as insolvency or non-viability. There is no international consensus for how long ELA should remain outstanding. Generally, 90 days is an appropriate target, but in some circumstances it may need to be longer, even up to one year, such as where there is a broader shock to money markets or deep levels of market fragmentation. ELA must nonetheless only be provided where the bank is suffering from a liquidity shock relating to those conditions only, and not in response to non-viability, poor cash management, or mismanagement.

***ELA is not an open facility:*** ELA should only be accessed in exceptional circumstances at the discretion of the central bank. Therefore, ELA is not an open facility. By not being "an open facility," the perception (moral hazard) that the central bank always stands ready to support the institution is avoided. Where the central bank agrees in principle to provide ELA, it may decide to do so for a defined period initially, e.g., one-month, and review this decision each month. Individual ELA deals may be transacted for shorter periods within that month if collateral values are subject to volatility or as a tool to illustrate to the borrower that behavior that is susceptible to moral hazard will not be accepted by the central bank. In such circumstance,



agreement to provide ELA for a specified period, in the form of a committed facility subject to adherence to the eligibility criteria and conditionality of the central bank, should not be confused with ELA being an ‘open facility.’ Furthermore, the carrying out of ELA trial runs or the incorporation of ELA into crisis-management exercises should not be viewed as a pre-commitment to providing ELA in response to a future request.

***Exit plans are a key requirement:*** ELA should always be a temporary bridge to more stable funding, and a funding plan prepared by the bank should be detailed prior to receipt of ELA funds, detailing how the entity will exit ELA. Due to the time involved, it is not always possible to complete these in advance of ELA drawdown, and in such circumstances they should be completed not long after the ELA drawdown. From this plan it should be evident that the institution is able to repay the funding, or that additional liquidity needs will arise due to the continuation of the liquidity shock. In the case of doubt, conditionality should be enforced, such as limiting the institution’s exposure to certain risks, payment of dividends or staff bonuses, etc.<sup>3</sup> Conditionality permits outlining key targets to ensure funding gaps are met and therefore ensuring long-run viability and the repayment of ELA.

***Internal understanding and co-ordination is a necessary prerequisite:*** The provision of ELA involves a number of key areas, including banking, operations, legal, financial stability, and there is a reliance on key areas for input into the process. In general, the central bank should establish an internal working group to facilitate the sharing of information which should ensure all parties involved have a clear understanding of their respective roles.

7. **In order to anticipate the need for ELA liquidity, the central bank should actively monitor liquidity flows.** In general, a central bank should not be taken by surprise by an institution’s need for ELA and should actively monitor recent liquidity developments across individual counterparties and carry out liquidity projections under different specified stress assumptions. Such an exercise involves the input of the market operations area—given their proximity to market developments and the supervisory area—as they are best positioned to assess asset and liability management. Daily phone calls should be held with banks that are ‘on-watch’ for liquidity difficulties, so that most up-to-date figures on funding flows are available. Reports should be circulated daily within the BoB to inform key stakeholders. Weekly liquidity projections and analysis of the available collateral buffer of relevant banks should be compiled and circulated within the BoB, using specified data requests to the banks where necessary.

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<sup>3</sup> It is up to the local central bank to decide on the extent of stipulations necessary—reflecting its perception of the risks involved in lending activities of the banks in question.

8. **Central bank ELA support is a key component of the financial safety net, supported by strong supervision, enforcement and resolution frameworks, and is only provided after private sector solutions are first explored.** The provision of ELA by the central bank is one of the main components of the crisis management framework. In order for the ELA framework to be effective, close cooperation is needed between the central bank and the government in the case that indemnities from the government are required and to plan coordinated actions such as restructuring or resolution of problem banks.

**APPENDIX IX. EVALUATING COLLATERAL FOR EMERGENCY LIQUIDITY ASSISTANCE****Current BoB collateral eligibility**

1. Current provisions in the BoBA (PART VII Relations with Financial Institutions (ss 36-43)) allow that:

38. Operations with account holders

(2) The Bank may, on such terms and conditions as the Board may from time to time determine:

(a) purchase from, sell to, discount and rediscount for account holders, bills of exchange and promissory notes drawn or made for commercial, industrial or agricultural purposes, bearing two or more good signatures, of which at least one shall be that of a bank, and maturing within 184 days from the date of their acquisition by the bank;

(b) purchase from, sell to, discount and rediscount for account holders any treasury bills or other securities issued or guaranteed by government, forming part of a public issue and maturing within 184 days of the date of their acquisition by the bank; and

(c) sell to, purchase from, discount and rediscount for account holders any securities issued by the BoB.

(3) The bank may, on such terms and conditions as the Board may determine from time to time, grant to account holders loans and advances for periods not exceeding 92 days

(a) secured by:

(i) instruments specified in paragraph (a), (b) or (c) of subsection (2);

(ii) other securities issued or guaranteed by government and forming part of a public issue;

(iii) warehouse receipts and documents of title issued in respect of staple commodities or other goods duly insured; or

(iv) holdings of any assets which the bank is permitted to buy, sell or deal in under section 31; or

(b) unsecured or secured by such other assets, on such special terms and conditions as the Board shall determine when, in its opinion, such a loan or advance is exceptionally necessary to meet the liquidity requirements of the borrower.

**BoB Collateral Eligibility Proposed in BoBA Revision 4.**

## 2. Part IX, S. 47 Lender of Last Resort

(1)(b) “The licensed bank... provides adequate collateral...”

(2) “The Bank shall determine the maximum percentage of the value of the surety deposited to guarantee each of the credit operations set forth in the previous subsection.”

**Current risk control measures advised by the BoB**

3. The bank accepts the BoBCs and government paper (184 days to maturity and below) as collateral for the credit facility (CF). The CF quota itself comprises up to 150 percent of core capital. Currently the facility is very short term (Intra-Day and Overnight).

4. The BoB states that the collateral carries almost zero-default risk, as the bulk of it is the BoBCs, and that the BoBCs and government notes are marked-to-market on an ongoing basis. It is important that accurate and up-to-date valuations are applied to tradable securities taken as collateral—particularly where the central bank believes the cash/nominal value of the asset to be 100 percent due to its being a government obligation.

5. Collateral in the form of the BoBCs, bonds, and treasury bills sit with the bank as the custodian. Furthermore, upon lending, the collateral is transferred to the entity that has lent out money to further reduce the default risk. In this way, the BoB notes that it has direct and immediate control of the collateral.

6. The bank is also the settlement agent and custodian of the BoBCs and government notes. Accordingly, the BoB believes that the requirement to apply haircuts does not arise, given that the facility is for central bank operations. However, the risk rests with the potential default of the issuer of the securities, and good practice would be to apply some form of haircut to even government-issued debt.

7. Nonetheless, the BoB states that the issue of haircut and pricing would apply in the event that a wide range of instruments is allowed. This is imperative to prudent lending and to ensuring the soundness of the BoB’s balance sheet. In particular, taking longer-term sovereign bonds, for example, should require a more detailed pricing and haircut framework than is applied currently to shorter-term treasury instruments.

## Example of ECB OMO Eligible Collateral Haircuts<sup>1</sup>

**Appendix Table 1. Botswana: Haircut Categories for Eligible Marketable Assets Based on the Type of Issuer and/or Type of Asset**

Category I	Category II	Category III	Category IV	Category V
debt instruments issued by central governments ECB debt certificates debt certificates issued by NCBs prior to the date of adoption of the euro in their respective Member State	debt instruments issued by local and regional governments debt instruments issued by entities classified as agencies by the Eurosystem debt instruments issued by multilateral development banks and international organisations jumbo covered bonds	traditional covered bonds and other covered bonds debt instruments issued by non-financial corporations	unsecured debt instruments issued by credit institutions unsecured debt instruments issued by financial corporations other than credit institutions	asset-backed securities

<sup>1</sup> See “Guideline (EU) 2016/65 of the European Central Bank” of November 18, 2015 on the valuation haircuts applied in the implementation of the Eurosystem monetary policy framework (ECB/2015/35) at [http://www.ecb.europa.eu/ecb/legal/pdf/oj\\_jol\\_2016\\_014\\_r\\_0006\\_en\\_txt.pdf](http://www.ecb.europa.eu/ecb/legal/pdf/oj_jol_2016_014_r_0006_en_txt.pdf). Note that this is intended as a guideline to the schedule of haircuts that could be applied and it does not refer to collateral used by National Central Banks of the euro area in ELA operations, as collateral for such operations and their risk control measures are not published. See also temporary measures at [http://www.ecb.europa.eu/ecb/legal/pdf/oj\\_jol\\_2014\\_240\\_r\\_0012\\_en\\_txt.pdf](http://www.ecb.europa.eu/ecb/legal/pdf/oj_jol_2014_240_r_0012_en_txt.pdf).

**Appendix Table 2. Botswana: Levels of Valuation Haircuts Applied to Eligible Marketable Assets**

		Haircut categories								
Credit quality	Residual maturity (years) (*)	Category I		Category II		Category III		Category IV		Category V
		fixed coupon	zero coupon	fixed coupon	zero coupon	fixed coupon	zero coupon	fixed coupon	zero coupon	
Steps 1 and 2	[0-1)	0,5	0,5	1,0	1,0	1,0	1,0	6,5	6,5	10,0
	[1-3)	1,0	2,0	1,5	2,5	2,0	3,0	8,5	9,0	
	[3-5)	1,5	2,5	2,5	3,5	3,0	4,5	11,0	11,5	
	[5-7)	2,0	3,0	3,5	4,5	4,5	6,0	12,5	13,5	
	[7-10)	3,0	4,0	4,5	6,5	6,0	8,0	14,0	15,5	
	[10, ∞)	5,0	7,0	8,0	10,5	9,0	13,0	17,0	22,5	
		Haircut categories								
Credit quality	Residual maturity (years) (*)	Category I		Category II		Category III		Category IV		Category V
		fixed coupon	zero coupon	fixed coupon	zero coupon	fixed coupon	zero coupon	fixed coupon	zero coupon	
Step 3	[0-1)	6,0	6,0	7,0	7,0	8,0	8,0	13,0	13,0	not eligible
	[1-3)	7,0	8,0	10,0	14,5	15,0	16,5	24,5	26,5	
	[3-5)	9,0	10,0	15,5	20,5	22,5	25,0	32,5	36,5	
	[5-7)	10,0	11,5	16,0	22,0	26,0	30,0	36,0	40,0	
	[7-10)	11,5	13,0	18,5	27,5	27,0	32,5	37,0	42,5	
	[10, ∞)	13,0	16,0	22,5	33,0	27,5	35,0	37,5	44,0	

(\*) i.e. [0-1) residual maturity less than one year, [1-3) residual maturity equal to or greater than one year and less than three years, etc.

**Appendix Table 3. Botswana: Example of Levels of ECB Valuation Haircuts Applied to Credit Claims with Fixed Interest Payments**

		Valuation methodology	
Credit quality	Residual maturity (years) (*)	Fixed interest payment and a valuation based on a theoretical price assigned by the NCB	Fixed interest payment and a valuation according to the outstanding amount assigned by the NCB
steps 1 and 2	[0-1)	10,0	12,0
	[1-3)	12,0	16,0
	[3-5)	14,0	21,0
	[5-7)	17,0	27,0
	[7-10)	22,0	35,0
	[10, ∞)	30,0	45,0
		Valuation methodology	
Credit quality	Residual maturity (years) (*)	Fixed interest payment and a valuation based on a theoretical price assigned by the NCB	Fixed interest payment and a valuation according to the outstanding amount assigned by the NCB
step 3	[0-1)	17,0	19,0
	[1-3)	29,0	34,0
	[3-5)	37,0	46,0
	[5-7)	39,0	52,0
	[7-10)	40,0	58,0
	[10, ∞)	42,0	65,0

(\*) i.e. [0-1) residual maturity less than one year, [1-3) residual maturity equal to or greater than one year and less than three years, etc.

### Collateral haircut and pricing<sup>2</sup> principles

- Use market or theoretical (rather than nominal or book) values for assets and securities. This may require theoretical valuations, using extrapolation or interpolation techniques, and, where relevant, in reference to comparably rated and performing sovereign bonds of another country.
- Establish a differentiated schedule of haircuts to equalize the market, credit, maturity, and liquidity risks across asset classes consistent with the risk tolerance of the BoB.
- Limits on the quantum use of certain types of collateral could be considered sometimes in order to reduce concentration risk of exposure to that collateral from a particular bank.
- Up-to-date valuations of properties presented as collateral, or backing loan obligations that are presented as collateral, should be provided. These can be updated

<sup>2</sup> See also Title VI - Risk Control and Valuation Framework of Marketable and Non-Marketable Assets – in Guideline (EU) 2015/510 of the European Central Bank of December 19, 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60) (recast) ([http://www.ecb.europa.eu/ecb/legal/pdf/oj\\_jol\\_2015\\_091\\_r\\_0002\\_en\\_txt.pdf](http://www.ecb.europa.eu/ecb/legal/pdf/oj_jol_2015_091_r_0002_en_txt.pdf)).

according to a schedule set by the BoB, if they are already held as collateral in the BoB's funding operations.

- There is no *a priori* checklist of collateral that should or shouldn't be eligible for use in ELA operations, but collateral should only be accepted subject to appropriate risk controls and where the central bank is reasonably assured that it will recover its money in a situation where the counterparty might default.
- Loans accepted as collateral should be graded into buckets according to credit quality, and this should ideally be visible on banks' internal ratings-based systems. Ideally, they should be rated with deference to probability of default and loss-given-default, if available.
- Haircut schedules for real estate may vary according to the type of property, region/location, and cash flow of the property when it is a rental property.
- Haircut schedules for loan obligations backed by property could also vary in a similar manner.
- Ideally, loans should be bundled into pools, incorporating some over-collateralization. Market-type structures such as securitization and their related structural requirements, as stipulated by rating agencies, offer better protection to the lender. However, such detailed structures may not always be feasible and pools of loans may have to be accepted.
- Stipulations should be made regarding the performance of the loans, such as, for example, excluding loans that are > 65/90 days in arrears and grouping other performance levels into buckets.
- Loans should have capped levels of loan-to-value (LTV) ratios, e.g., capped at 80 percent, so that any loan with a higher LTV would recognize a maximum of 80 percent of the value of the loan when calculating the nominal amount before haircut.
- Terms and conditions may refer to transactions relating to the loans or the underlying collateral, or performance characteristics of securities, which would trigger an event of default and obligate the reporting of the event to the BoB in order to decide upon action.



- Loan-by-loan level data requirements and provision as per timelines stipulated by the BoB.<sup>3</sup>

**Example of selection criteria for inclusion of a loan secured by a mortgage in a pool for ELA collateral**

- 1) Such loans shall be secured by a first legal mortgage.
- 2) The LTV ratio shall be no more than 80 percent, by reference to the last valuation of the property.
- 3) The consent of each mortgage borrower to permit a transfer of or creation of a charge over the mortgage shall be contained in the standard documentation or shall have otherwise been given in writing.
- 4) No arrears of principal or interest on the loan shall be outstanding for more than 65/90 days.
- 5) Such loan (unless it is a ‘further advance’) shall have been advanced not less than 90 days prior to the segregation of the mortgage for inclusion in the collateral pool.
- 6) Mortgage is expected to be in annuity form.
- 7) The mortgage shall not be subject to any encumbrance.
- 8) Such loan shall not have a residual maturity greater than 40 years.
- 9) The income of the borrower has been verified by the bank prior to the granting of such loan.
- 10) The counterparty shall not, as a matter of policy, include any loan granted to a borrower against which (i) proceedings to obtain payment have been commenced; or (ii) an adverse court judgment has been issued during the three-year period immediately preceding the granting of the loan.

Note: Residential property for the purpose of this schedule does not include any commercial or nonresidential property, or any property (intended to be developed as residential property) which is not yet under development.

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<sup>3</sup> For example, see ECB loan level requirements in the context of asset-backed securities <https://www.ecb.europa.eu/mopo/assets/loanlevel/html/index.en.html>.

## APPENDIX X. EXAMPLE OF ELA OPERATIONAL STRUCTURES AND WORK FLOWS

### Key steps

1. **Ownership of the ELA process.** Once the decision has been made by the governor to provide ELA, it is recommended that FMD take ownership of the process instead of supervision. Supervision will have important roles in advising the process on solvency, general assessment of the bank, and the ongoing monitoring of bank data, conditions, and management practices.
2. **Establish a Liquidity Analysis Team.** The market operations area should establish a designated team to lead the preparation and planning for ELA and to then carry out ELA transactions when necessary.
3. **Establish a cross-departmental ELA working group (WG).** This should include all the departments that are to be involved in the ELA operational process, including market operations, payments/back office, and legal and risk management personnel where appointed. FMD should chair and lead the group's work, which will oversee end-to-end procedures and testing (trial-run operations). The procedures should include the description of ELA governance structure, including decision making and inter-departmental coordination policy.
4. **Establish regular dialogue with banking supervision.** The FMD (and risk management) should have regular dialogue with banking supervision to discuss the banks' capital and funding developments. Contact should be daily where issues arise, but meetings should be held at least weekly.
5. **Preparation of guidelines and criteria.** The necessary legal powers to enable a sound ELA framework should be prepared by legal staff and reflected in the BoBA. Further internal rules and guidelines should be approved by the Board or the governor and assessed by legal staff. Legal frameworks should be drafted to enable all potential and adequate forms of assets to be taken as collateral under ELA operations with the relevant banks/entities.
6. **Preparation of data base.** The WG should prepare counterparty eligibility criteria (the FMD, with assistance of the BSD and, perhaps, Financial Stability) by establishing a data set in the form of an early warning system comprising supervisory and market data.
7. **Collateral preparedness.** The WG should preemptively engage in collateral identification on each bank's balance sheet, establishment of haircuts, and risk control measures (operations and risk management, with assistance of supervisory area for balance sheet review, if necessary).

8. **Documentation preparedness.** Legal staff should be engaged by the FMD to ensure that the BoB understands the specific issues related to the collateral proposed and to ensure that the legal agreements to allow adequate mobilization of the collateral are effective, and to address any peculiarities in taking secured loans as collateral in particular.
9. **ELA transaction details.** The length of ELA operations and interest rate applicable should be outlined by the FMD. The rate should be agreed at the Board level at a margin over the O/N facility. However, the Liquidity Team performing the ELA operations, in conjunction with back office/payments, needs to consider how frequently it is feasible to carry out ELA deals; e.g., can they operationally handle transactions on a weekly basis.
10. **Operational flow.** The new Liquidity Team will be the primary interface with the banks and will receive the ELA deal request, and will process front office deal tickets and check that there are eligible collateral limits available. Risk management/middle office staff would normally check that the deal tickets correspond with agreed counterpart and collateral limits. Finally, back office/payments will receive any necessary signed collateral confirmations from the counterparty and will perform settlement of the deals.
11. **Automation.** The ad-hoc nature and checks required to authorize ELA necessitate that it remain a somewhat more manual operation than normal open market tenders. However, documents should be able to be signed in the respective institutions, scanned, and then emailed to each other in order to provide confirmation. Each party will have copies of other institutions' authorized signatories to check the signatures against. Within the BoB, use of facilities such as a SharePoint page for ELA might aid the process, flow, and storage of documents between the departments that are involved in the ELA operations. ELA deals should generally see money transferred at T+1 from day of request, both for rollover deals and for the first deal when the counterparty makes its first request for ELA and the governor's decision needs to be made.
12. **Monitoring of flows and liquidity developments.** The Liquidity Team shall set up liquidity flows monitoring based on daily phone calls and data returns from banks that are on watch for liquidity concerns, in order to prepare for likely ELA requests and to inform decision makers of developments. This should include:
  - (a) Daily calls with the institutions of concern to ascertain daily net flows in, e.g., retail and corporate deposits and collateral buffers. A daily report should be circulated to management showing these movements.
  - (b) Preparation of weekly projections, assuming institution-specific stress assumptions with regard to deposit retention and debt capital market rollover where applicable. The formulation of these assumptions should be done in close cooperation with the prudential area, and should include:

- projected net liquidity (out)flows (e.g., retail and corporates, debt capital markets, interbank and market repos);
- liquidity net flows related to collateral, such as fulfillment of margins in market repos;
- loss of collateral under stress assumptions; and
- projected cash buffer.

The net of (a) + (b) above should show anticipated recourse to monetary policy liquidity providing operations and, combined with the individual institutions' collateral buffers, would show any shortfall and, therefore, the potential for recourse to ELA going forward. A weekly report outlining these projections should be circulated to the BoB's senior management. Advance projections and exact T+1 ELA requirements should be advised to the FMD staff forming the liquidity forecasts for monetary targeting.

13. **Decision on whether an indemnity from the minister is necessary.** While it is sound practice for the BoB to seek a guarantee from the minister, there may be situations where the BoB is adequately collateralized and the guarantee is not required or could have negative consequences. The governor and Board should make the decision as to whether a guarantee from the minister is needed, on the basis of an assessment of projected funding requirements, the requesting bank's condition and an assessment of collateral risks.

14. **Communication and disclosure:** Consideration needs to be given to central bank ELA communication strategy and co-ordinate this with external stakeholders such as the banks and the Minister for Finance. While transparency gives confidence to the public that the BoB and the market is reliable and safe, ELA is lender of last resort and the provision of ELA to individual named banks is not normally publicized by the central bank. Often, the central bank may announce ELA provision to banks in aggregate in its annual report only where, after it is up to individual banks to announce to the market that they are in receipt of ELA, there are disclosure requirements necessary for their own market or accounting reporting. Staff within the BoB needs to be cognizant of the delicate nature of ELA provision and only staff involved in the relevant operations and work should know the details.

15. **Contingency:** The departments involved in transacting ELA deals should periodically review and test the internal process and incorporate improvements and efficiencies where they are identified. They should prepare contingency operational arrangements should the normal conditions or business site where ELA is carried out be unavailable. It is recommended that an alternative contingency site be available and equipped to facilitate ELA deals.

**Example of central bank operational duties regarding ELA transactions*****High-level steps:****Front Office (FMD Liquidity Analysis Team) duties*

- a. Following receipt of request for ELA, staff checks the liquidity need of the counterparty by cross-referencing the reserves balance, current collateral holdings, deposit and repo flows, and recent and forthcoming debt capital market maturities.
- b. Following receipt of confirmation of approval of the size, term, and rate applicable to ELA, the Front Office liaises with the Back Office to inform of collateral to be mobilized.
- c. Confirm with requesting institution the size, term, rate, and collateral for LOLR operation and request a written bid submission.
- d. Confirm that the signatories on the ELA request are those as per agreed authorized list.
- e. Check bid submitted for correctness and, once approved, forward to the Back Office.

*Middle Office (Risk Management) duties*

- a. Establish order of preference of collateral to be accepted for the ELA operation.
- b. Inform the Front Office of the maximum liquidity amount that can be provided per collateral type, specifying the nominal amount of the collateral, the valuation and haircut, and resultant maximum liquidity amount that can be provided.
- c. Confirm receipt of an acceptable indemnity from the Minister for Finance, specifying the maximum amount covered, where applicable.

*Back Office (Payments) duties*

- a. Receipt of checked counterparty bid from the Front Office.
- b. Management confirmation to pay funds to the requesting institution.
- c. Check that collateral exchange documents submitted contain correct authorized signatures and countersign any collateral exchange legal agreements where necessary.
- d. Payment of funds to the counterparty.

### **Example set of ELA counterparty procedures**

This section sets out the possible steps to be followed by a credit institution (the “Counterparty”) seeking ELA from the Bank of Botswana (the “Bank”). Failure by the counterparty to comply fully with these steps may result in delays or an inability of the bank to accommodate a counterparty request for ELA.

#### ***Initial high-level steps:***

1. **Request for ELA**—a senior official duly authorized by the Board of the counterparty seeking ELA sends a formal request to the bank addressed to the governor and copied to the relevant deputy governor with a scanned copy sent to the BoB’s designated ELA email account.
2. **Board minutes**—The counterparty must furnish the bank with evidence (e.g., the minutes of the relevant Board meeting) that the application for ELA was duly authorized in accordance with its internal corporate governance procedures.
3. **Other information**—The counterparty must provide any other information the bank may require before it makes a decision on whether to grant ELA, including any information required to confirm the solvency of the counterparty or information on available collateral to secure ELA.
4. **Receipt of letter approving ELA**—If the bank decides to grant ELA to the counterparty, the governor (or someone else duly authorized) will write to the counterparty confirming this decision (letter scanned and to follow by hard copy).
5. **List of authorized signatures**—The counterparty must send a list of signatories for personnel authorized to request and sign documentation relating to ELA transactions, along with evidence of appropriate signing authorities and a set of sample signatures. Contact details for the BoB personnel who are dealing with ELA transactions should be documented and provided to the counterparty.
6. **Collateral and haircuts**—The bank will liaise with the counterparty in relation to what collateral is available to secure ELA.
7. **Designated email addresses**—In advance of any ELA transactions, the counterparty must notify the bank of a designated email address for ELA communications. All email correspondence with the bank in regard to ELA transactions should be sent to the BoB’s designated ELA email account (accessible by front and back office staff).

***Sample steps for each ELA transaction subsequent to governor approval of initial request***

1. Counterparty requests an advance of ELA by phone (FMD Liquidity Analysis team).
2. Counterparty forecasts liquidity needs and trades within the ELA transaction calendar to be specified by the bank where ELA is being rolled over.
3. The bank (Liquidity Analysis Team) responds to the counterparty's ELA request by phone.
4. Once an ELA request is agreed by the bank, the counterparty will email a scanned copy of an ELA request form that has been signed by a duly authorized person or persons to the BoB's ELA email account. The original signed request should be immediately forwarded by the counterparty to the BoB's Liquidity Analysis Team.
5. The subject line of this email attaching the scan of the signed ELA request form should read [counterparty name], ELA request value dd/mm/yy.
6. Simultaneously, the counterparty will email details of the proposed ELA collateral for analysis to the BoB's ELA email account.
7. The bank's Back-Office team will contact the counterparty to identify specific collateral.
8. The bank will confirm to the counterparty when the transaction is complete via email from the Back Office to the counterparty's designated email address.
9. The counterparty shall confirm receipt of funds via email to the BoB's designated email address.

*Paragraphs 10 to 12 below apply where ELA is provided by way of repo (or other mechanism requiring countersigning of a legal agreement to mobilize collateral), subject to the provisions of the relevant (master repurchase) agreement.*

10. Where ELA is provided by way of repo, and, if required, by the relevant (master repurchase) agreement, the counterparty will send a scanned copy of a physically signed purchase confirmation to the BoB ELA email account. The subject line of this email attaching the scan of the signed purchase confirmation should read [counterparty name], Purchase Confirmation Form(s), ELA value dd/mm/yy.
11. If required by the relevant (master repurchase) agreement, the bank will arrange for any purchase confirmation to be countersigned on behalf of the bank and will send a scanned copy of same back to the counterparty.

12. Within three business days of an ELA repo transaction, the counterparty will deliver the original hard-copy version of any signed purchase confirmation to the bank (marked for the attention of a nominated person in the BoB's Payments Department).



## **APPENDIX XI. EXAMPLE OF COUNTERPARTY CONDITIONALITY THAT MAY BE ATTACHED TO ELA LENDING ARRANGEMENTS**

### **Main objectives**

1. Legal agreements between the BoB and the borrower could, where possible and allowable, contain the types of clauses, actions, and conditions that the BoB would expect to see in the prospectus of a (mortgage-backed) bond issued on the market. The conditions should reflect market standards both in terms of general criteria relating to details regarding the underlying collateral, but also expectations regarding the behavior of the counterparty in terms of handling cash flows and notification of certain events to the lender (in this case to the BoB).
2. The exact terms and conditions included in the agreement thereafter may be stronger or less onerous to reflect the circumstances and risks. This will depend on the collateral taken and the balance to be struck between the BoB's risk management, the need to advance liquidity, and the expected behavior of the borrowing bank's management. A clause could be inserted to allow the BoB to receive any information it deems necessary to assess the counterparty. Collaboration with the Banking Supervision Department to help monitor the conditions is important.
3. The key concept of lender of last resort is that ELA funding is only provided where a solvent bank suffers a liquidity shortage, it cannot obtain funding elsewhere, and it needs funding from the central bank in order to pay depositors or interbank or debt market funding. It may also be used to allow for the continuation of the bank's core functioning in its normal course of business, such as paying the bank's normally accrued utilities bills, paying normal staff wages (not bonuses, or new wage agreements struck at above market rate to extract money for personal use), etc.
4. General clauses should be inserted to stress that funding can only be used to maintain the bank functioning as normal until it obtains alternative funding to repay ELA. After ELA has been repaid, the bank can then go about its business and increase its balance sheet etc., if it wishes. The onus should always be on the borrowing bank to report any non-normal transactions to the BoB in advance and to obtain the BoB's agreement to carry out any transaction that is not clearly in the normal course of its business, and which would possibly reduce the ability of the BoB to recover its money.
5. The conditions may be inserted into each legal agreement relating to the exchange of each different type of collateral, or else the over-arching conditions relating to bank behavior could be signed as a separate undertaking by the borrowing bank at the time it initially applies for ELA. The latter case would see the CEO of the bank sign his personal undertaking that the bank will not engage in the stipulated, or other practices not specified, which could harm the central bank's position in relation to its lending. Guidelines regarding prohibited behavior and transactions to be carried out by the bank and its management could be important criteria where concerns may exist.

## **Overview of potential high-level commitments for any entity in receipt of ELA**

### **(i) ELA shall always be the recourse of last resort**

- (a) All requests for ELA funding should only be made when the requesting bank has explored and exhausted ALL other sources of funding. All market contacts should be tapped and all interbank lines should be explored before considering a request for ELA.
- (b) The cost of alternative market funding should not be considered as a factor in deciding whether or not ELA is a more attractive source of funding. ELA should always be a last resort, and, generally, irrespective of the price of alternative funding.

### **(ii) Compliance with reserve requirements**

- (a) The ELA recipient bank should ensure compliance with minimum reserve requirements as set out by the BoB. The use of the reserve account should be in accordance with standard operating procedures and an average reserve account balance in excess of the average requirement at the end of the maintenance period (so-called ‘burnt reserves’) should be avoided.
- (b) The bank should use the cash balance on its minimum reserve account in the event of small liquidity events, which can then be replenished before the end of the maintenance period.
- (c) ELA cannot be provided to ‘frontload’ the reserve account.

### **(iii) Limited use of deposit facilities**

The bank should only place funds in the BoB’s deposit/absorption facilities in exceptional circumstances, such as at the end of the maintenance period when the average reserve requirement has been met. The recipient bank’s liquidity position should be managed so as to ensure the minimum drawing of ELA, and excess funds available to the bank should be reflected in a reduced ELA balance. Proposed use of the deposit facility by a bank in receipt of ELA should be flagged to the Market Operations Department of the BoB no later than the morning of the intended placement.

### **(iv) Limited use of interbank deposit placements**

Interbank deposit placements should be very limited, as any surplus funds should be used to maintain the reserve requirement or to reduce ELA.

(v) **Overnight standing facility**

Where eligible collateral for liquidity providing standing facility and refinancing operations becomes available to the ELA recipient bank, this should be notified to the Market Operations Department of the BoB. In general, the recipient bank should aim to utilize all available collateral in normal the BoB market operations and, subsequently, access the O/N facility, where collateral is available, during the time until the next normal the BoB liquidity providing open market operation.<sup>1</sup> If necessary, the recipient bank may use the collateral for its intraday credit buffer (i.e., collateral placed with the central bank to give it credit with the central bank in order to allow it to process payments on its account during the day when the bank does not have matching inflows and outflows) in the O/N facility to be used to top up its minimum reserve account balance.

(vi) **Use of ELA funds—senior management commitment**

The Chairman or Chief Executive of the ELA recipient bank will provide a letter to the Market Operations Department of the BoB, stating that ELA will only be sought as a last resort and that all other sources of funding will constantly be explored with the aim to reduce ELA to the minimum level. It will also state that ELA funding will only be used to meet the recipient bank's commitments in the ordinary course of business and will outline the business areas for which it is intended to use ELA. These steps should be in accordance with the roadmap agreed with the BoB, and as outlined in the liquidity plans agreed therewith.

(vii) **Use of ELA funds—management of new and existing assets**

The recipient bank will carry out all regular banking activities subject to the terms set out in any agreed restructuring plan.

(viii) **Use of ELA funds—ban on acquisition**

The recipient bank will, in general, not be authorized to use ELA to acquire or take participations in any other firm. Prior notification of such an interest and consultation with the BoB is necessary to allow the circumstance to be evaluated.

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<sup>1</sup> This scenario is based on comments earlier in this report relating to the possible need for two-sided OMO and less penal access to overnight credit facilities so that counterparties can access liquidity from the BoB, in the normal course of liquidity management, before then having to request ELA for additional liquidity beyond a certain level.

(ix) **Use of ELA funds—subordinated debt and hybrid capital instruments**

- (a) The recipient bank will not pay coupons or exercise calls on subordinated debt instruments and hybrid capital instruments, unless it is legally obliged to do so.
- (b) The bank cannot use ELA for the purpose of a liability management exercise.

(x) **Use of ELA funds—notification to the BoB of non-standard activities**

There is an onus on the recipient bank to notify the BoB of any proposed activity that is not a regular occurrence or not considered to be a normal activity, or is one that is not generally carried out in the normal course of business. This may arise from an unexpected change in the terms and conditions of previous arrangements, e.g., requirement to place cash collateral, guarantee amounts, etc. Where these activities require funding and the bank is in receipt of ELA, such intended activities must be notified to the Market Operations Department in advance.

(xi) **Restrictions on payments to staff or related persons other than core wages**

There could be a restriction that no bonuses or any other type of non-essential payment can be made to senior staff, management, or related persons or parties. Distribution of cash, assets, dividends or any other item of value to persons, which is not necessary in the ordinary course of business and which worsens the central bank's position with regard to recovering its money at the earliest opportunity, should be disallowed. The obligation should be on the borrowing bank's management to seek approval from the BoB where it is unsure.

(xii) **Audits**

ELA recipient banks may be requested to have a report prepared by its own external auditors as to the bank's compliance with the guidelines issued for the use of ELA funds.