# Basis for decision

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# Policy for pricing of Emergency Liquidity Assistance

## Draft Executive Board decision

The Executive Board decides

- to adopt the proposed Policy for pricing of Emergency Liquidity Assistance.

The aim of the policy is to clarify in advance the principles for the pricing of Emergency Liquidity Assistance (ELA). If the Riksbank provides ELA, the interest rate charged will include a mark-up, the size of which is determined by the specific circumstances in each case.[1] The following principles shall apply when calculating the interest rate mark-up:

i. The interest rate shall be high enough to ensure that the institution receiving ELA does not gain an advantage from it in relation to other institutions. The interest rate shall hence be higher than the rate at which other comparable institutions can borrow on the market.[2]

ii. The interest rate shall compensate the Riksbank for the credit risk associated with the lending. The credit risk is determined based partly on the counterparty risk, i.e. the risk of the counterparty not being able to repay its debts and the risk of changes in the value of the collateral received by the Riksbank.

iii. The interest rate shall also reflect the type of event that has given rise to the ELA. In particular, the Riksbank shall consider how the risks in the institution's operations – for example credit risk, market and liquidity risk, as well as operational risk – have created the need for ELA. These

[1] In addition to the interest rate, the haircuts applied to the collateral received by the Riksbank can be changed.
[2] "Institution" refers here to a banking institution in accordance with Chapter 6, Article 1, first paragraph of the Sveriges Riksbank Act and to a Swedish company under the supervision of Finansinspektionen, see Chapter 6, Article 8 of the Sveriges Riksbank Act.

risks then form the basis of the assessment of the Riksbank's credit risk in conjunction with the ELA. Liquidity risks are of particular importance in this context. If the institution has historically had an insufficient Liquidity Coverage Ratio (LCR) in any significant currency or mismanaged its liquidity risks in some other way, the interest rate shall be set higher.[3] Insufficient liquidity coverage means an LCR level that has historically been below 100 per cent. This level is compatible with the minimum level according to the Basel Accord and the European regulatory framework.[4]

# Considerations

## Banks' maturity transformation is of benefit to society but poses risks

One of the main functions of a banking system is maturity transformation. It involves the bank's short-term liabilities, such as bank deposits or wholesale funding, being used to fund long-term assets, such as loans. Maturity transformation is of benefit to society as it transforms customers' short-term savings into long-term investments by e.g. making it possible for households to smooth out consumption over time.

However, maturity transformation is not a risk-free activity; if a bank's financiers wish to recuperate their money more quickly than the bank can convert its assets, the bank may find itself in a liquidity crisis. If the liquidity crisis continues unrestrained, it may turn into a solvency crisis. The banking system's basic functions such as credit supply, payment mediation and risk management may then be threatened, resulting in major costs to society. Liquidity problems in the banking sector can also disrupt the monetary policy transmission mechanism as a result of the negative effects on financial stability.

## Banks' liquidity risks are of particularly importance for the Riksbank

Swedish banks usually have major maturity mismatches between assets and liabilities. On the asset side of their balance sheets, for example, banks have a large proportion of mortgages with long maturities, while on the liabilities side, they have relatively short-term wholesale funding. The remaining average maturity for Swedish covered bonds is only around three years.[5] In addition, the banks obtain a large degree of their funding in foreign currency. Overall, they are exposed to both short-term and structural liquidity risks in different currencies.

These liquidity risks can be measured in many different ways. Banks themselves often use several measures to monitor and gauge their liquidity risks, and the authorities have also produced various regulatory measures. One such measure is the Liquidity Coverage

[3] A significant currency is a currency that comprises more than five per cent of a bank's total liabilities, according to the Basel Accord and European Commission Delegated Regulation (EU) 2015/61 on LCR. The proportion of funding in a specific currency can vary over time as can therefore the currencies classified as significant in accordance with this definition.
[4] See "Basel III. The Liquidity Coverage Ratio and liquidity risk monitoring tools", Basel Committee on Banking Supervision, January 2013 and "Commission Delegated Regulation 2015/61", October 2014.
[5] See http://www.ascb.se/statistics/

Ratio (LCR) which measures short-term liquidity risks, another is the Net Stable Funding Ratio (NSFR) which measures long-term, more structural liquidity risks.

For the Riksbank, banks' short-term liquidity risks are of particular interest. This is due to the Riksbank's role as Lender of Last Resort (LoLR) in the Swedish financial system. The LCR is hence of extra significance for the Riksbank. LCR measures a bank's resilience to short-term liquidity stress over 30 days. Put simply, an LCR of 100 per cent means that the bank can manage stressed cash outflows for 30 days.

Periodically, some of the major banks have very low LCR's in Swedish krona (SEK), sometimes below 30 per cent and on occasion as low as 10 per cent.[6] In simple terms, this means that the bank cannot cover its liquidity needs in SEK in a stressed situation for more than just a few days. Periodically, liquidity coverage ratios are also low in other significant currencies where there are no LCR requirements. These other significant currencies, including SEK, make up more than half of banks' liquidity outflows in a stress scenario.[7]

Banks first and foremost use euros (EUR) and US dollars (USD) to cover their liquidity requirements in Nordic currencies. They do this by utilising what are known as foreign exchange swaps, through which they exchange EUR and USD for Nordic currencies. However, problems may arise when this market functions less efficiently than normal, or when accessibility to it deteriorates for individual banks. This is what happened when the Riksbank's extraordinary loans matured in 2010, causing volatility in Swedish short-term market rates to increase. This also affected the foreign exchange swap market and it became both more expensive and more difficult to exchange USD and EUR for SEK. The opposite occurred during the global financial crisis of 2008-2009 when it became both expensive and difficult to exchange other currencies for USD. The Riksbank therefore considers there to be clear risks associated with relying too much on the foreign exchange swap market in order to manage liquidity in different currencies.

The Riksbank has recently decided to change the composition of currencies in its foreign exchange reserves to reflect the liquidity risks taken by banks. These changes involve a new composition as regards the existing currencies in the reserves – USD, EUR and British pounds (GBP). Moreover, two new currencies are being introduced; Danish krone (DKK) and Norwegian krone (NOK), as the banks have liquidity risks in these currencies. However, it is of the utmost importance that banks primarily manage their short-term liquidity risks in all significant currencies by themselves.

## The Riksbank needs to be clear about the terms and conditions for Emergency Liquidity Assistance

If one or more banks encounter liquidity problems and this poses a risk to stability in the financial system, the Riksbank can, under certain circumstances, act as LoLR and provide ELA. The purpose of such liquidity assistance is to avoid liquidity problems spreading and ultimately impairing the ability of the financial system to function. The Riksbank then takes over some of the funding of the bank when the capacity or risk appetite of the

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[6] The major banks refer here to Handelsbanken, Nordea, SEB and Swedbank.
[7] For examples of a stylised stress scenario, see Short-term liquidity risks in the major Swedish banks. Article in *Financial Stability Report 2017:2*. Sveriges Riksbank.

private sector wavers. As a result, the risk associated with the funding of the bank is transferred from the private sector to the Riksbank's balance sheet.

The interest charged on ELA shall compensate for the credit risk taken on by the Riksbank as a result of the lending. The assessment of credit risk includes both a forecast of the borrower's ability to repay and a valuation of the collateral offered to the Riksbank. The borrower's financial history is also important in this assessment. How the assistance seeking institution has managed, for example, liquidity risks under normal circumstances affects the likelihood of it having problems in the future, which in turn affects the credit risk for the institution's lender. To limit the Riksbank's credit risks, therefore, the Riksbank will also consider in its pricing how the institution has managed its liquidity risks in the past.

The pricing policy reduces the potentially distorting effects of ELA on competition between institutions. This is because the interest rate shall be set high enough to ensure that the institution receiving ELA does not gain an advantage from it in relation to other institutions. The interest rate shall hence be higher than the rate at which other comparable institutions can borrow on the market.

The Riksbank's policy clarifies in advance the principles for credit risk assessment when the Riksbank grants ELA and sets the interest rate. This can hence reduce the incentive of banks and other institutions to take large risks, as the policy states that if the institution has historically had an insufficient LCR in any significant currency or mismanaged its liquidity risks in some other way, the interest rate shall be set higher. Insufficient liquidity coverage means an LCR level that has historically been below 100 per cent. This level is compatible with the minimum level according to the Basel Accord and the European regulatory framework.

## Legal prerequisites

Under Chapter 6, Article 8 of the Sveriges Riksbank Act, the Riksbank may provide liquidity assistance on special terms and conditions to banks and certain other institutions under the supervision of Finansinspektionen. The terms and conditions of such assistance are determined by the Riksbank. Under Chapter 9, Article 1a of the Sveriges Riksbank Act, the Riksbank shall be economical with public finances. The policy is therefore deemed to be in line with the Riksbank's mandate and remit.