Comments on the FSB Consultative Paper

Effective resolution of systemically important financial institutions

South Africa appreciates the progress made in this regard. Being in process of strengthening our resolution regime, this docment provides valuable guidelines. However, we have some comments on areas where we don't agree with the proposals.

1.1 Key attributes of effective resolution regimes – Annexure 1

Our comments are mostly concerned with the funding of resolution. As a country that did not have to use any public funds to bail out banks during the globaf financial crisis (GFC), and even in past bank failures had to use very limited public funds in the resolution process, we have a concern about the (over)emphasis of the use of private funds for resolution. While we agree that the use of public funds should be a last resort and subject to tight control, there can also be circumstances in which the use of public funds may be less costly to the economy and financial system than excessively 'taxing' the banking system and investors, particularly in an emerging-market economy with various development needs.

More specifically, point 6.3 of Annexure 1 recommends that jurisdictions should have in place privately-funded deposit insurance or resolution funds or a funding mechanism for ex post recovery of costs from the industry. South Africa does not support this proposal as it may not be appropriate in all countries. South Africa does not currently have an explicit deposit insurance scheme (DIS) and, even if one is established in future, it is unlikely to be large enough to fully cover the cost of resolving a SIFI. South Africa has a very concentrated banking sector, and the costs (both in terms of direct and opportunity costs) to have a large enough deposit insurance fund set aside to resolve a failure of one of our large banks would be excessive. Deposit

insurance schemes have proven to be inadequate in preventing bank runs (e.g. Northern Rock), unless there is 100% coverage of deposits, and during the crisis various countries with a DIS had to issue public guarantees anyway to restore confidence. Also, wholesale deposits are generally not covered by deposit insurance funds, and it is these deposits that are withdrawn first when a bank has problems. It is, therefore, not clear why a DIS would be an absolute requirement within an effective resolution regime.

It is important that the resolution authorities should have *ex ante* funding arrangements in place, but in some jurisdictions it may be more appropriate to use a combination of public and private sector funding, or private sector funding combined with the possibility of government guarantees.

1.2 Bail-in requirements on liabilities – Annexure 2

Bail-in powers for resolution authorities introduce additional risk to investors in bank debt, and as such these investors will require a higher return. The consequence is likely to be an increase in bank funding, which will either be passed on to customers with effects on the real economy, or result in narrower margins and lower profitability for banks. Both could have negative effects for financial stability and the economy. These requirements come in addition to the Basel III liquidity requirements and the additional costs that those will imply for the banks. The cumulative impact of all these requirements may weigh heavily on the economy.

Furthermore, with these instruments being largely untested in a crisis situation, it is not clear how investors might react. It seems likely that, as the market/institution moves towards the point of conversion (into equity) in terms of the "bail-in" provision, the market volatility in these instruments could increase to such an extent that it could push the institution over the cliff during a period when stability is required.

There is also a risk that subordinated debt holders and/or unsecured creditors whose interests are about to be converted into equity by a resolution authority, as part of a proposed resolution plan, could approach the courts to protect their interests and to dispute the timing of, and/or the need for, the conversion at that stage, thereby largely reducing or hampering the expected or potential benefits of the bail-in provision.

Authorities will probably have to define specific points of coversion of bail-in instruments, for example the point at which public money will have to be injected to

restore solvency. Some international guidance and consensus in this regard will be useful.

1.3 Creditor hierarchy, depositor preference and depositor protection in resolution – Annexure 7

Past resolution processes of banks in South Africa was conducted on the basis of depositor preference, and in particular retail depositor preference. This was in line with the primary objective of microprudential supervision of banks with the primary aim of protecting depositors. Post GFC, systemic financial stability considerations play a more prominent role, and from a systemic risk perspective it is foreseeable that in certain specific circumstances some aspects of creditor preference and depositor protection could be affected. This possibility should be catered for in the resolution regime.

However, because it is so dependent on the specific jurisdiction and prevailing circumstances, it is difficult to foresee how greater cross-border consistency in creditor hierarchy and depositor preference could be achieved. At most, certain principles could be developed. Alternatively, a convergence of creditor and depositor hierarchies could be restricted to certain types of firms, or to globally significant firms.