ERSA Research Brief

February 2019

Can creditor bail-in trigger contagion? The experience of African Bank

By Roy Havemann

The economic costs of bank failures can be substantial, and the resulting reprioritisation of government resources has long-lasting economic, political and social costs. To reduce the cost of failures to taxpayers, recent global regulatory reforms have focused on `burden-sharing arrangements', which aim to share the costs of bank failures between creditors and government. These reforms include `creditor bail-in', a mechanism to write-down the claims of creditors during the bank resolution process. The unintended consequences of bail-in are largely unknown and there are few successful examples.

The successful bail-in of creditors in African Bank, a small South African monoline lender, provides a unique opportunity to study creditor bail-in. Using a data set that matches quarterly, daily and financial-instrument level data, the focus here is on the impact of the bail-in on mutual funds, particularly money-market funds, which experienced significant redemptions during the episode. The haircut triggered some financial contagion, through interlinkages between affected money-market funds and other banks. The contagion was limited by a clear and credible resolution strategy, a relatively small haircut and complementary interventions for money-market funds, including discretionary liquidity restrictions and market-making facilities. The spillover effects receded. As the bank recovered, bailed-in senior creditors recouped nearly all their losses, and ultimately the bail-in process facilitated a sustainable restructuring of the bank.

The paper exploits a unique data set, containing both daily and quarterly frequencies, including data down to mutual fund holdings at financial instrument level. Controlling for other factors which may influence redemption patterns, redemptions occurred disproportionately in money-market funds with African Bank exposure. There is evidence of financial contagion, albeit limited. A larger failure, or a poorly designed resolution, could have triggered broader spillovers with possible systemic consequences. The impact on money-market funds is compared to that of non-money market mutual funds. While these fund also saw outflows, the effect was dampened by their floating net asset value.

The paper exploits a unique data set, containing both daily and quarterly frequencies, including data down to mutual fund holdings at financial instrument level. Controlling for other factors which may influence redemption patterns, redemptions occurred disproportionately in money-market funds with African Bank exposure. There is evidence of financial contagion, albeit limited. A larger failure, or a poorly designed resolution, could have triggered broader spillovers with possible systemic consequences. The impact on money-market funds is compared to that of non-money market mutual funds. While these fund also saw outflows, the effect was dampened by their floating net asset value.

The findings suggest that creditor bail-in is a potentially useful resolution tool, but needs to be used carefully. Unexpected bail-in may precipitate spillovers throughout the financial system, and financial contagion may result. The systemic consequences can be reduced through a transparent and clear ex ante bail-in framework, supported by enhanced regulation of mutual funds, particularly money-market funds, to reduce their fragility. Regulatory reforms can reduce the systemic risk posed by money-market funds, e.g. phasing out fixed net asset value, allowing discretionary liquidity restrictions and introducing powers to suspend convertibility