

Joint Report: Progress Report on the Open Bank Resolution

Date:	21 December 2011	Report No:	T2011/2563
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Note recommendations	Friday, 23 December 2011

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Jo Hughes	Manager, Financial Markets, Treasury	917 6221	[Withheld under s9(2)(a)]
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Minister of Finance's Office Actions (if required)

None.

Enclosure: **No**

Joint Report: Progress Report on the Open Bank Resolution

Executive Summary

This report provides an update on implementing the Open Bank Resolution (OBR). It provides an update on the Reserve Bank's consultation with registered banks on systems changes and costs of pre-positioning. It then indicates further work that will be needed to support the use of OBR in practice.

Pre-Positioning

In March this year the Reserve Bank released a consultation paper and commenced a series of engagements with registered banks to outline the functionality required by OBR and to understand what changes were needed to banks' systems and the likely costs. No technical impediments to proceeding were identified by the banks or by the Reserve Bank.

Banks have taken some time to understand the functionality required. As a result the Reserve Bank put back the deadline for submissions to its consultation paper from 30 June 2011 to 30 September 2011. The Reserve Bank has also pushed back the deadline for banks to provide detailed implementation plans from 16 January 2012 to the end of February 2012. Formally, the deadline for full implementation remains the end of 2012, although the Reserve Bank previously indicated that a one-year implementation period would be allowed. This would imply a final implementation deadline of end February 2013. Discussions with banks have indicated that some, but not all, banks consider that they will be able to meet the original timelines, but that most banks have a technology 'lock-down' leading up to Christmas, so the industry generally prefers a February 2013 start date. Final decisions on timing will be made once implementation plans have been received from all banks.

Initial submissions provided only high-level information on the cost of pre-positioning and further detail was sought in the implementation plans. We have received one Implementation Plan, which includes a detailed cost assessment, from one systemic bank, suggesting that the total cost of pre-positioning will be a total of [REDACTED] spread across five years. The other systemic banks have indicated that the costs may range from \$3-\$5m up to \$10-\$20m, but they have not provided analysis to substantiate these costs. The costs for small banks are modest. More detailed cost estimates will be provided by the banks as part of the implementation plans at the end of February (although it is worth noting that none of the banks have raised costs as a particular concern). The Reserve Bank will prepare a full cost benefit analysis on the case for pre-positioning upon receipt of those plans. This will be included in a Cabinet paper, scheduled for March 2012 to seek agreement on a number of OBR-related matters (such as confirming Government support for OBR and high-level decisions on guarantees).

[s9(2)(b)(ii)]

The overall tone from the systemic banks' submissions was that they understood the rationale for OBR and will co-operate. They did stress the importance of ensuring the public and markets fully understood OBR, which we support. They also raised the need to harmonise OBR with the living wills being proposed in Australia. We held productive discussions with the Australian parent banks and the Australian authorities in December. They expressed similar sentiments to the New Zealand banks: they understand the policy and do not disagree with its intent, although they are anxious to see good communication about the policy to wholesale investors in particular.

Further work on the OBR

Current work is focussing specifically on the pre-positioning requirements to make OBR a live policy option. Alongside this process, there is further work that needs to be undertaken to make OBR a fully workable option and address communication needs. This includes a detailed and full understanding of the impacts that OBR might have on financial markets and the wider economy, the information needed to be able to recommend its use, the different ways a failed bank might be resolved once it was brought into OBR, and the further policy changes that might be needed to improve its credibility and effectiveness.

Following the global financial crisis, other countries are also grappling with these issues as they develop a range of options to deal with distressed financial institutions. Much of this work is being carried out with reference to the framework and principles proposed by the Financial Stability Board. We plan to map the OBR policy against this framework to identify areas of difference, and assess whether any of the overseas solutions suggest complementary changes that may enhance our failure management regime in New Zealand.

Recommended Action

We recommend that you:

- a **note** that banks have not identified any technical impediments to pre-positioning for open bank resolution
- b **note** that banks will be providing detailed costing information to allow a full cost benefit analysis on requiring banks to pre-position for open bank resolution as part of their implementation plans by the end of February
- c **note** that officials will report back and discuss with you in early March our recommendations on OBR based on the cost benefit analysis, the wider financial system impacts of OBR, and how it compares to emerging international practice, and
- d **note** if the cost benefit analysis supports proceeding with OBR that officials will prepare a paper for EGI in March 2012 to seek agreement on a number of OBR-related matters (such as confirming Government support for OBR and high-level decisions on guarantees).

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Hon Bill English
Minister of Finance

Treasury Report: Progress Report on the Open Bank Resolution

Purpose of Report

1. This report provides you with an update on the proposed implementation of the Open Bank Resolution (OBR) policy for registered banks in New Zealand. Specifically, it provides:
 - an update on the process to date
 - an outline of the banks' initial estimates of the costs associated with implementing the policy, and
 - an indication of the further work that would be needed to support the use of OBR in practice.

Analysis

Overview of the process to date

2. The Reserve Bank began developing the OBR policy in response to the 1997 Asian financial crisis. Since then significant work has been undertaken to ensure that the structures of financial institutions and the payments system in New Zealand are consistent with the implementation of the OBR, including major policies such as outsourcing, local incorporation and governance. The main technical impediment to implementing OBR is the pre-positioning of banks' internal systems.
3. In November 2010, EGI considered the OBR policy and noted that officials would do further work to understand the complete picture of the requirements to fully implement OBR. This included consulting with banks about the changes needed to their systems to implement OBR and the likely cost of these changes. EGI invited you to report back on the outcome of this work in the second half of 2011. The Reserve Bank released a consultation paper in March 2011, with an original deadline for responses by 30 June 2011, but this was extended to 30 September 2011 at the request of the industry.

Outcome of consultation

4. The Reserve Bank received 14 submissions to the consultation in total, eight from registered banks, and six from other interested parties. The overall tone of the submissions from the big four banks is that they understand the reasons for OBR, and will cooperate, but want more time to complete the implementation.
5. The submissions have not raised any technical impediments to proceeding with OBR. The nature of the technical discussion at this stage turns around some points for clarification with the clear message coming through that the IT task of pre-positioning is relatively straightforward, once there is clarity on a handful of issues. These issues include a definitive list of products to be pre-positioned; identifying the status of transactions (i.e. to be clear on whether it is pre- or post-statutory management); and the tax and interest treatment of term deposits. The main logistical issue seems to be the number of different products that will need to be pre-positioned.¹

¹ The Reserve Bank has received an implementation plan from one of the systemic banks, which indicated that the pre-positioning was feasible, and could be implemented within the timeframe proposed at reasonable cost. However, this bank had previously taken part in a pilot exercise. Close engagement will be needed with other banks to support their own development process.

6. The other main concerns raised by the major banks related to ensuring the public and markets properly understand the implications of OBR, and the desire for harmonisation with Australian proposals. The Reserve Bank recently published an article in its quarterly *Bulletin* which provides a description of the policy and its implications for various stakeholder groups. Further work is being undertaken to increase awareness and understanding of the policy as the process develops. This has included hosting an information forum for Australian parent banks and authorities in Sydney in early December. The Reserve Bank will be developing a detailed communications strategy to ensure all stakeholders are able to fully understand the nature of the OBR policy and its implications, including wholesale investors, depositors and ratings agencies.
7. The domestic banks that put in a submission or provided feedback [Withheld under s9(2)(b)(ii)] [redacted] are supportive of the policy, and see pre-positioning as straightforward and relatively inexpensive.
8. The Reserve Bank is continuing to engage with banks on the specification and planning for implementation. The next stage in this process is for banks to provide implementation plans to the Reserve Bank by 16 January 2012, with the expectation that full implementation would be achieved by the end of 2012. A number of banks expressed concerns about the timeframe, citing the complexity of the project and other pressures on resources. In light of these concerns, the Reserve Bank has extended the deadline for submitting implementation plans to the end of February 2012.
9. At this stage, no extension has been agreed for the deadline for full implementation. However, the Reserve Bank previously indicated that a one-year implementation period would be allowed. This would imply a final implementation deadline of end February 2013. Discussions with banks have indicated that some, but not all, banks consider that they will be able to meet the original timeframes, but that most banks have a technology 'lock-down' leading up to Christmas, so a February 2013 start date is preferred by industry.
10. Some of the systemic banks have argued that it will not be possible to meet the original deadline due to interactions with other major technology projects and general IT resource constraints. The Reserve Bank is working with banks to understand the challenges and assess the validity of the banks concerns, which will be described in detail in the implementation plans. Final decisions on deadlines will be taken once implementation plans have been received from all banks.

Cost of pre-positioning

11. One of the objectives of the consultation on pre-positioning was to extract detailed information on the likely costs that the industry would incur in implementing the OBR policy. In most cases, the information contained in the responses did not provide sufficient detail to form part of a robust cost benefit analysis. The Reserve Bank has been exploring possible cost implications with banks through bilateral discussions in November and December.
12. One of the systemic banks has already provided its implementation plan, and has estimated that the total cost of meeting the pre-positioning requirements will be [redacted] [s9(2)(b)(ii)] across five years. This figure is made up of design costs [redacted] build costs [redacted] implementation costs [redacted] and on-going testing and maintenance costs [redacted]

13. A number of the other large banks did provide high-level assumptions for the total cost of implementing the OBR as part of their consultation responses. These ranged from \$3m-\$5m, up to between \$10m and \$20m. However, none of these forecasts has been supported by any analysis at this stage, and the banks themselves have conceded that they are not based on any concrete assessments. Furthermore, none of the banks have raised costs as a particular concern.
14. These costs contrast with the initial views of the smaller domestic banks which assume costs ranging from \$20k at the lower end, up to between \$500k and \$750k at the higher end. This outcome is not unexpected given the difference in the scale and complexity of the operations undertaken by different banks.
15. The Reserve Bank will undertake a full cost benefit analysis once it has received detailed cost assessments from all banks as part of the implementation plans. However, whilst the assumed potential costs are not insignificant, it seems unlikely that they would be high enough to justify abandoning the OBR policy.

Planned work on other factors determining OBR's workability

16. The OBR is intended to provide the government with an option to quickly stabilise a failing entity by haircutting creditors and setting aside sufficient funds to meet expected losses to enable continued provision of core financial services. It aims to reduce the implicit guarantee by signalling that an entity could be stabilised by wiping out shareholders and imposing haircuts on creditors and with no recourse to public funds. This could strengthen the incentive for shareholders to provide support, which should be the lead option in the event of a bank getting into distress. OBR should also strengthen incentives of more sophisticated creditors to improve their monitoring.
17. If shareholder or third party support is not forthcoming then the Government would then need to determine whether it is appropriate to activate the OBR policy. This assessment will need to take account of many factors, such as the nature of the difficulty faced by the institution in question, the availability of alternative solutions, and the possible impact of activating OBR on the wider New Zealand financial system. This means that in specific circumstances government support could still be preferred to OBR.
18. While bank pre-positioning removes the main technical barriers to applying OBR, significant work is still needed to support its use in practice. This will include:
 - understanding the impacts on the financial system and economy from applying OBR, for example in terms of access to credit markets for other banks in the immediate aftermath and understanding the impact of invoking statutory management on the rights of various creditor classes
 - the information needed to be able to recommend its use and how to ensure this is available in a very timely manner
 - the different ways a failed bank might be resolved once it was brought into OBR such as sale to a third party, recapitalisation by creditors or the government or winding the bank down, and
 - whether further policy changes might be needed to improve its credibility and effectiveness, for example changes to the statutory management regime in the Reserve Bank Act.

19. It should be stressed that such issues are not unique to OBR and could arise from any approach that sought to impose losses on creditors. The global financial crisis has encouraged countries to propose new failure management tools that preserve essential financial functions while enabling authorities to impose losses on shareholders and creditors. This shift means the concept of imposing losses on creditors that underlies OBR is no longer unusual internationally. In fact, in February this year, senior unsecured and uninsured creditors in mid-sized Danish bank Amagerbanken suffered a 41% haircut as a result of the bank's failure.
20. However, other countries are starting with different regulatory frameworks in place, resulting in a range of options to deal with distressed or failing financial institutions, including various approaches to creditor loss sharing. Much of this work is being carried out with reference to the framework and principles proposed by the FSB. We plan to map the OBR policy against this framework to identify areas of difference, and assess whether any of the overseas solutions suggest complementary changes that may enhance our own failure management regime in New Zealand. This work will also form part of the communications strategy, by providing a vehicle for explaining the nature of the OBR policy to international wholesale investors.

Reconciling our approach with Australia

21. In submissions the systemic banks highlighted the need to coordinate our failure management approach with Australian authorities and to harmonise OBR with the recovery plans (or living wills) being proposed for the large Australian banks.

22. [Withheld under s6(b)(i)]

23. Our discussions with parent banks have indicated that the primary concern from a harmonisation perspective is the risk that a subsidiary will be placed under statutory management through the OBR policy at an early stage, undermining the assumptions contained within the parent's recovery plan. We have reiterated to the parent banks that the OBR is designed to be an option that is open to the government once hopes for a private sector solution have been extinguished. We believe that these discussions have mitigated their concerns in this area

- [Withheld under s6(b)(i)]

24. [Withheld under s6(b)(i)]

Next steps for bank pre-positioning

25. The implementation of OBR is expected to proceed according to the following timeline:
- Bilateral discussions with banks (December 2011 and January 2012)
 - Submission of implementation plans by banks to the Reserve Bank (end of February 2012)

- Discussion with you on our recommendations on OBR including a cost-benefit analysis, the wider financial system impacts of OBR, and how it compares to emerging international practice (early March 2012)
- Cabinet paper on implementation and government guarantees (March 2011), and
- Full implementation of OBR pre-positioning would be required as a condition of registration (from 1 January 2013 at the earliest).