

THE OPEN BANK RESOLUTION (OBR) POLICY

PROPOSAL

This paper informs Cabinet that officials intend to proceed with the next steps in making the Open Bank Resolution (OBR) a live option in the Government's crisis resolution toolkit. As a first step this involves the Reserve Bank requiring, as a condition of bank registration, all registered banks with retail deposits of more than \$1 billion make the necessary systems changes to be in a position to implement the OBR policy from 30 June 2013.

Secondly, the paper outlines the necessary supporting work that officials will be undertaking in parallel to ensure that OBR works more effectively in practice. This will involve improving certainty around the supporting legislative framework and improving our understanding of how it would be applied and its potential impacts.

EXECUTIVE SUMMARY

A key lesson to emerge from the global financial crisis was the enormous economic and fiscal costs of supporting troubled banks, particularly those that were deemed 'too big to fail'. Globally, the regulation and supervision of bank capital and liquidity proved to be inadequate, and countries were unable to protect the critical transactional functions provided by too-big-to-fail institutions without bailing them out in full. These government-funded bailouts reinforced perceptions of an implicit guarantee that public support for the largest banks will protect creditors from losses, reducing the incentives on sophisticated creditors to monitor and exert discipline on those entities. The bailouts also protected bank management who had contributed to the failures.

Our highly concentrated banking system means that the too-big-to-fail problem is a live issue for New Zealand. In November 2010 I informed Cabinet of the Reserve Bank's OBR policy. Broadly, OBR would give the Government the option to maintain access to a bank's core transactional functions while applying a 'haircut' across bank liabilities to ensure creditors bare the losses they were exposed to. OBR aims to limit the implicit guarantee by providing an alternative to a Government bailout, and make real the possibility that creditors could be exposed to losses.

Alongside OBR, which aims to reduce the economic and fiscal cost of any future bank failures, wider changes to prudential regulation are intended to reduce the probability of failure by improving banks' resilience to shocks. These include the Reserve Bank's liquidity regime, introduced in 2010, and the proposed Basel III capital requirements.

BACKGROUND

The Reserve Bank has been developing the OBR policy over many years and has already undertaken significant work to ensure that financial institution structures and the payment system are consistent with OBR.¹ Changes to banks' IT systems, to apply the haircut and restore access to core transactional functions, are a key component to making OBR a live policy option. The Reserve Bank has consulted with registered banks on the systems changes required and there are no impediments to prepositioning this functionality. The Reserve Bank has also completed a cost benefit analysis that supports requiring banks to make these changes.

COMMENT

Outline of OBR

OBR aims to keep open access to a failing bank's core transactional functions while losses are allocated and crystallised for creditors. Put simply, this would be done by putting the bank under statutory management and temporarily shutting access channels (overnight).² A 'haircut' would be applied across bank liabilities, freezing a portion of creditors' claims, and the bank would be re-opened the following day with customers given access to the 'un-haircut' portion of their transactional accounts. Other creditors would gain access to the un-haircut portion of their liabilities in due course.

The haircut process would preserve, as much as possible, the ranking of creditors that would apply in a conventional liquidation. In practice, secured creditors should not face a haircut (assuming their security is adequate) while subordinated creditors would be haircut in full. The haircut to senior creditors (including depositors) would apply in proportion to the remaining losses and buffer required.

To minimise potential for a run, and provide confidence for customers to continue to transact with the bank, a Government guarantee would be needed for the un-haircut portion of creditors' claims and new liabilities. The guarantee would set the maximum loss for creditors and prevent the haircut being increased. This may mitigate uncertainty about how creditors would be treated and the impact on access to international funding markets.

It should be noted that the OBR would not itself resolve the future of the bank nor allocate final losses (although it would cap the losses that the bank's creditors face). Rather, it is a mechanism that ensures core transactional functions continue to be provided whilst the Government determines the appropriate strategy. It also reduces the

1 For example, the outsourcing and local incorporation policies, and settlement before interchange payment rules.

2 The Statutory Manager would be appointed by the Governor General by Order In Council on a recommendation from the Minister of Finance following a recommendation from the Reserve Bank.

risk that urgent liquidity concerns dictate how losses are allocated between shareholders, creditors and the Government. Therefore, OBR would be consistent with a range of possible exit options, and the Government would retain an appropriate interest in the failed bank until such time as the guarantees and statutory manager are removed, which may take a number of years (although this may be true for other resolution approaches as well).

Implementation of OBR

Operational pre-positioning and consultation with banks

A key objective of OBR is to minimise the impact of a bank failure, and give the Government real alternatives to providing a bailout. It does this by reducing the economic impact of a bank failure by maintaining access to customer accounts to preserve liquidity whilst final decisions on the most appropriate resolution are determined. Ensuring that customers have rapid access to the un-haircut portion of their funds has been the core focus of consultation with banks and will require IT changes (the significance of which varies from bank to bank, although none is particularly significant). Specifically, banks' systems must be able to:

- determine creditor positions at the time of statutory management;
- freeze part of each transaction account balance before the start of the next banking day;
- provide access to the un-haircut account balance through the payments system on the next business day; and
- periodically release frozen funds to transaction accounts if available.

Following consultation throughout 2011 each registered bank has submitted an implementation plan to the Reserve Bank setting out how they will meet the required systems changes.

Rather than provide prescriptive rules, the Reserve Bank has outlined a series of core outcomes that banks will need to demonstrate they can meet. Banks have not raised any technical impediments to achieving this functionality.

The Reserve Bank had initially proposed a one year timeframe to complete the pre-positioning, from the beginning of 2012.

While most banks are able to meet the one year timeframe, several noted that a short extension should ensure that robust solutions are put in place. However, one large bank is unable to meet the deadline because of a major technology project. Furthermore, banks expressed concerns about potential implications for competitive neutrality in the event that some banks implement OBR ahead of others. In light of banks' concerns, there is a strong case for aligning the industry to the extent practicable. As a result, the Reserve Bank intends to require implementation for all banks by the end of June 2013, with sanctions to apply to any banks that are not able to comply. In the first instance it intends to incentivise banks to meet this deadline by putting in place, this year, a Condition of Registration requiring compliance with OBR requirements by the end of June next year.

The total cost for pre-positioning across the industry is estimated to be around \$20m, ranging from up to \$5m for some large banks to less than \$0.5m for some of the smaller banks. These costs are modest against the benefits of OBR (see appended Regulatory Impact Assessment).

While the haircut would apply across creditors, pre-positioning functionality applies to transactional (including term deposit) accounts, as it is early access to these accounts by depositors that help mitigate the economic costs of a bank failure compared to some other resolution options. Further work is being done on the application of a haircut to other creditor classes, such as how the Statutory Manager would treat these creditors, including the process for releasing the un-haircut portion of their funds. This may require new legislation to ensure that certain arrangements (such as swaps) cannot be terminated on the appointment of the statutory manager. This would be consistent with the Financial Stability Board (FSB) principles for effective resolution (as discussed below).

Benefits of OBR

If a private sector solution cannot be found to resolve a failed bank, OBR aims to provide the Government with an alternative to a taxpayer bailout. Even if OBR is not used, it still provides strong incentive benefits by:

- creating a real possibility that creditors might suffer loss from a bank failure, limiting the implicit guarantee and increasing the incentive for sophisticated creditors to monitor banks, which curbs excessive risk taking and reduces the probability of failure. Limiting the implicit guarantee should also reduce the expectation that the Crown will provide a taxpayer funded bailout in the future. Other things being equal, this should have a positive impact on market perceptions of Crown risk; and
- increasing the probability that shareholders will support a failing bank since OBR would wipe out shareholders, and in the case of the large four Australian owned banks mean that the parent bank lost control of the New Zealand subsidiary.

Creditors are likely to respond by pricing in this real possibility of loss, increasing bank funding costs. However, some rating agencies have already factored OBR in to revised credit ratings assessments for New Zealand banks, and there has been no directly observable impact on funding costs as a result of the announcement of the implementation of the policy.

The Reserve Bank has sought to quantify these costs and benefits. Whilst there is significant uncertainty and subjectivity in the assessment, the results indicate that there is a significant net present value benefit from having OBR as a live policy option. Further details are outlined in the attached Regulatory Impact Assessment.

Through the process of implementing OBR, banks and authorities will also develop much deeper knowledge about how to resolve a failing bank. Not only is this expected to improve the effectiveness of OBR and other resolution options, it will also help to reduce uncertainty involved in making decisions in a crisis.

Following the financial crisis there has been some convergence internationally as countries introduce creditor loss sharing approaches. The FSB has recently recommended principles, at this point for globally systemically important financial institutions, that require member countries to be able to resolve failed institutions without recourse to public funds³. This includes specific powers to impose losses on certain classes of creditors without needing to put the bank into liquidation.

In this light, the creditor loss sharing characteristics of OBR are consistent with emerging thinking on how to deal with financial institutions that are seen to be too-big-to-fail. In fact, in February last year, senior unsecured creditors and uninsured depositors of the mid-sized Danish bank Amagerbanken suffered a 41% haircut when authorities took control of the bank following its failure. Danish authorities transferred insured deposits with sufficient good assets to a 'good bank' which was reopened the following day, while other creditors were left in the bad bank to be liquidated. Through this restructuring process authorities were able to impose losses on uninsured creditors. The United States Federal Deposit Insurance Corporation takes a similar approach.

To help explain the OBR policy to international wholesale investors, the Reserve Bank has mapped it against the principles recommended by the FSB. This work demonstrates that OBR is broadly comparable with reforms being implemented internationally. The Reserve Bank plans to publish this assessment towards the middle of the year.

The shift in international focus should not understate the potential costs associated with activating OBR. Appointing a Statutory Manager and applying a haircut to creditors may cause significant disruption to financial markets.

Withheld under s6(b)(i)



OBR is only an option

It should be stressed that although there are downsides to using OBR, this is true for any resolution option (i.e. a taxpayer funded bailout). Whether OBR is the best resolution option will depend on the circumstances of the bank's distress and the economic and fiscal context at the time. But as noted above, OBR provides strong incentive effects by being a credible resolution option. Creditors would have a real expectation of loss strengthening incentives on them to monitor the bank. Incentives for shareholders to provide support would also be strengthened. Most importantly, it would mean the Government has a credible alternative to a taxpayer funded bailout, irrespective of whether it chooses to use it.

³ New Zealand is not a member of the Financial Stability Board so is not bound by its recommendations. Australia is a member and would be bound. However, at present none of the Trans-Tasman banks is included within the list of 29 globally systemically important financial institutions to which these principles would apply.

Next phase of work

Completion of bank pre-positioning will deliver the main technical capability required to implement OBR. Parallel to that process, officials will be undertaking further work to ensure that OBR will work more effectively in the event that the Government should choose to activate it. This work will include:

- the design of the guarantees required to support the ongoing operation of the failed bank and the specific form these will take. 
- aligning legislative provisions, including making necessary changes to the Reserve Bank Act to remove any legal uncertainty about the operation of OBR; 
- deepening understanding of the impacts on the financial system and economy from applying OBR, including access to credit markets for other banks and communicating the OBR to stakeholders;
- determining the information needed to be able to recommend the use of OBR and the information and reports that banks would need to be able to provide, in short order, to enable a decision to invoke OBR;
- determining the requirements to enable the Statutory Manager to effectively manage the bank once brought into OBR;
- determining the ongoing monitoring and assessment to ensure banks can carry out the necessary steps to implement OBR; and
- understanding the resolution options (exit) for a failed bank after it has been brought into OBR, such as sale to a third party, recapitalisation by creditors or the Government or winding the bank down, and requirements to support these options.

Such issues are not unique to OBR and could arise from any approach that sought to impose losses on creditors. We are monitoring international approaches to understand how other countries are addressing these issues.

Limitations/risks

Absence of deposit insurance is a point of difference

Many countries have started financial market reform with deposit insurance in place, and a few with depositor preference in place. This means that in most countries domestic retail depositors are at least partly protected from loss in a bank failure. This was the case for depositors in Amagerbanken, the banks resolved under FDIC in the US, and Bradford and Bingley and Northern Rock in the UK.

One of the key principles behind the design of the OBR policy is that the loss allocation should respect the priority of claims that would apply in liquidation. As a result, unsecured creditors (including depositors) would be subject to the same haircut.

Cabinet has previously considered the issue of deposit insurance and agreed that a permanent scheme should not be introduced in New Zealand (CAB MIN (10) 43/10). Activating OBR would therefore expose domestic depositors to a loss in the event that their bank was to fail. OBR would allow a *de minimis* to be applied, below which transactional accounts would not be haircut

IMPLEMENTATION TIMELINE

Once banks have made the necessary changes to their IT systems OBR will be an option in the technical sense. However, further work is needed on the details of OBR to ensure that it would work more effectively in practice. The main work streams and milestones for this next phase of work are outlined in Table 1 below:

Table 1: Key stages in implementation of OBR

Key Stage	Indicative timing
Report to Cabinet on changes to legislation for guarantees and powers under the Reserve Bank Act	By the end of September 2012
Reserve Bank require OBR systems prepositioning as a condition of registration for banks effective 30 June 2013	By end of 2012
Understand impacts of OBR and information needed to recommend its use	By end of 2012
Banks make changes to IT systems to make OBR live policy option	Through to end of June 2013
	June 2013
Develop specific OBR plans with each bank	2013

CONSULTATION

This paper was drafted by the Treasury and the Reserve Bank. The Ministry of Economic Development, the Ministry of Justice and the Financial Markets Authority were consulted, and the Department of Prime Minister and Cabinet was informed.

The Reserve Bank released a consultation document in March 2011 inviting submissions on the IT systems changes required to implement OBR. The Reserve Bank received submissions and implementation plans from each of the affected registered banks. The Reserve Bank has also consulted with Australian parent banks and Australian authorities including the Australian Treasury, the Australian Prudential Regulation Authority, the Reserve Bank of Australia and the Australian Securities and Investments Commission.

FINANCIAL IMPLICATIONS

This proposal does not have any direct financial implications for the Crown.

HUMAN RIGHTS

The proposals in this paper are not inconsistent with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

LEGISLATIVE IMPLICATIONS

Increasing legal certainty about the Statutory Manager's powers to implement OBR will require changes to the Reserve Bank Act 1989. Treasury is also assessing the merits of a framework guarantee in legislation in place of the existing provisions available through the Public Finance Act 1989. These changes to legislation are needed to improve the effective implementation of OBR and to manage the risk to the Crown. Officials will report back to Cabinet by the end of September 2012, outlining required changes to legislation.

REGULATORY IMPACT ANALYSIS


The Cabinet's Regulatory Impact Analysis requirements do not apply to this paper. The requirement for banks to pre-position for OBR will be achieved through a change to banks' conditions of registration, rather than changes to regulation. A separate RIA will be completed when policy decisions are sought on associated changes to the Reserve Bank Act 1989 and/or the Public Finance Act 1989.

The Reserve Bank has however produced an assessment of regulatory impacts under section 162AB of the Reserve Bank of New Zealand Act 1989. For policies that are more than minor or technical in nature, this assessment of regulatory impacts must be provided to the Minister of Finance and published. It is appended to this paper for Cabinet's information.

PUBLICITY

OBR has attracted limited comment to date, mainly from banks and financial market commentators. Publishing the Regulatory Impact Analysis and other material on OBR may attract comment from a wider audience. The rationale for OBR and the treatment of depositors may attract particular attention. The Reserve Bank has published articles and Q&A's on its website addressing key aspects of the OBR policy and will update these as necessary.

RECOMMENDATIONS

1. **Note** that the Reserve Bank will introduce a new condition of registration requiring all registered banks with retail deposits greater than \$1 billion to make the necessary systems changes to achieve the outcomes required by the OBR policy by 30 June 2013.
2. **Note** that changes to banks IT systems will mean OBR is a live option in a technical sense.
3. **Note** that, in parallel to banks making these systems changes, officials will undertake further work to support the OBR policy. This work will include:
 - a. the design and specific form of Government guarantees to support the ongoing operation of the failed bank;
 - b. making changes to the Reserve Bank Act to remove legal uncertainty around applying OBR;
 - c. 
[Withheld under s6(b)(i)]
 - d. deepening understanding of the impacts on the financial system and economy from applying OBR;
 - e. determining the information needed to be able to recommend OBR be activated;
 - f. determining the requirements to enable the Statutory Manager to effectively manage the bank;
 - g. determining the ongoing monitoring and assessment needed to ensure banks can implement OBR in practice; and
 - h. understanding the options to resolve (exit) a failed bank after it has been brought into OBR.

4. **Note** that officials intend to report back to Cabinet by the end of September 2012 to seek approval for the legislative changes necessary to support the effective implementation of OBR.
5. **Note** that the Reserve Bank will publish the attached Regulatory Impact Assessment in the coming weeks and its report comparing OBR to the Financial Stability Board's principles for effective resolution regimes by the end of July 2012.



Hon Bill English

Minister of Finance

10 / 5 / 2012