

## **THE OPEN BANK RESOLUTION (OBR) POLICY**

### **PROPOSAL**

1. This paper is to inform Cabinet that:
  - the Reserve Bank of New Zealand (the Reserve Bank) intends to conduct a technical consultation with banks beginning January 2011 to understand what systems modifications would be required to implement an OBR in practice;
  - a public communications strategy will be developed in advance of this consultation;
  - Treasury and Reserve Bank officials will be undertaking further work on other aspects of the OBR policy, including its macroeconomic implications, the legal framework for its implementation and the design and implementation of government guarantees to support the continued trading of the bank if an OBR was implemented; and
  - I will report back to Cabinet about the outcomes of this work and next steps in the second half of 2011.
2. This paper can be read in conjunction with the companion paper on "Deposit Insurance".

### **EXECUTIVE SUMMARY**

3. A key lesson to emerge from the recent financial crisis is the potentially enormous fiscal costs associated with supporting troubled banks, particularly those that are deemed systemically important. Moreover, government-funded bailouts of banks give rise to moral hazard issues as creditors and, to a lesser extent, shareholders, come to expect full protection from losses due to failure. As a result, finding alternative solutions for dealing with failed or failing banks has become a key priority for governments and regulators.
4. The Reserve Bank has been working on policy options for dealing with failing banks since the 1990s. This has resulted in the development of the Open Bank Resolution (OBR) policy. OBR is a bank resolution tool that could help manage the fiscal costs of bank failures and minimise moral hazard while providing continuity of core banking services. In an OBR a failing bank would be placed under statutory management and its liabilities would be legally frozen. The authorities will then determine the proportion of creditors' claims that should remain frozen to absorb losses. The remainder is then unfrozen and released to creditors at the start of the next banking day.
5. Significant work has been undertaken in recent years to ensure that the structures of financial institutions in New Zealand and the payments system are consistent with the implementation of the OBR as a live policy option. The next stage of this process is for banks to pre-position their internal systems to enable an OBR to be effectively implemented. The Reserve Bank intends to conduct a technical consultation with banks on the appropriate approach for pre-positioning an OBR. A public communications strategy will be developed in advance of this consultation commencing.

6. Having a fully operational OBR policy would ensure that in the event of the failure of a registered bank, the government would have the option to implement an OBR, rather than being restricted to choosing between a full bailout and a closed resolution via receivership or statutory management. The aim is not to set OBR as the default failure management approach, rather as an important option to be considered at the time. The Reserve Bank will be responsible for implementing the policy with the banks. In the event of a bank failure, any decisions to activate the policy for a specific institution will be taken by Ministers on advice from officials.

## BACKGROUND

7. The Reserve Bank began working on alternative options for dealing with failed banks following the Asian crisis of the late 1990s. This resulted in the development of the OBR policy (formerly called Bank Creditor Recapitalisation). The policy is intended to provide depositors and creditors with access to liquidity in the short-term whilst losses are analysed and allocated. It has been consulted on previously with banks and presented publicly.<sup>1</sup>
8. The global financial crisis has increased attention on how the fiscal costs associated with bank bailouts can be minimised or eliminated whilst maintaining banking services and access to funds by borrowers and depositors. This has led a number of jurisdictions to implement or develop processes with similar qualities to the OBR policy.
9. The Reserve Bank has undertaken a significant body of work in recent years to remove many of the practical barriers to implementing an OBR. In light of these developments, it is now an appropriate time to undertake the necessary steps to operationalise OBR. The next stage of this process is to undertake a technical consultation to establish an appropriate programme for implementing the necessary pre-positioning of each bank's systems. Further work will also need to be undertaken on other aspects of the OBR policy, including an assessment of macroeconomic implications, the legal framework for its implementation, and the implementation of government guarantees to support the continued trading of the bank if the option of an OBR was pursued.

## COMMENT

### International developments

10. One of the key lessons to emerge from the recent financial crisis is the potentially enormous fiscal costs associated with supporting troubled banks, particularly those that are deemed systemically important. Moreover, government-funded bailouts of banks give rise to "moral hazard" issues as creditors and, to a lesser extent, shareholders, come to expect protection from losses due to failure. As a result, finding alternative solutions for dealing with failed or failing banks has become a key priority for governments and regulators internationally.
11. Reforms being pursued internationally are currently geared towards putting in place mechanisms enabling creditors to share the costs of resolving bank failures, in addition to shareholders assuming the burden of first loss. A number of jurisdictions are currently in the process of developing policies and mechanisms to respond to these challenges, including the US and the UK.

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<sup>1</sup> Harrison, I, S Anderson and J Twaddle (2007), "Pre-positioning for effective resolution of bank failures".

12. The Financial Stability Board (FSB) is particularly concerned with reducing the moral hazard posed by systemically important financial institutions. An important policy position the FSB has taken is that all jurisdictions should have effective resolution tools to enable authorities to resolve financial firms without systemic disruptions and without taxpayer losses. It notes that the attributes of an effective resolution regime include providing authorities with tools *“to act safely and quickly to resolve a firm in a manner that ensures the continued performance of essential financial functions..., without causing a panic or destabilising the financial system, and without exposing the taxpayer to the risk of loss”*.<sup>2</sup>

### Overview of OBR

13. Bank failures can be resolved in a number of ways, including through private sector takeovers, regulatory forbearance<sup>3</sup>, liquidation, or government bail-out. In the event of a large bank failure it is likely to be difficult for a rival institution to successfully execute a takeover due to market conditions, timing constraints or competitive concerns. The OBR process is designed to provide an additional option for government which may overcome some of the main downsides associated with the other resolution options. As such, the key objectives of OBR are to:

- enable the core of the bank to be kept as intact as possible to manage disruption to the payments and wider banking system;
- provide creditors with access to a portion of their funds to minimise any flow-on effects from the failure to the wider economy;
- provide a mechanism that ensures that the urgent matter of managing the liquidity impact on the economy does not dictate how the important matter of loss allocation is determined;
- provide government with a tool to manage fiscal risks;
- allow the real possibility that creditors could suffer loss in a failure – consistent with obligations they enter into; and
- preserve exit options.

14. The key feature of the OBR is that depositors are able to access a portion of their funds at the time the bank is placed in statutory management. [withheld under s9(2)(f)(iv)]

This assessment would be carried out overnight, with the bank re-opening the following day with the unfrozen portion of funds guaranteed by government to avert a further depositor run. Additional funds can be unfrozen at a later date, but only if sufficient funds are available once the final losses have been determined.<sup>4</sup> The key elements of the process can be broken down into the following phases:

- imposition of statutory management and temporary closure of the bank;
- imposition of a haircut on transaction and savings accounts and term deposits to freeze a portion of funds while placing a government guarantee on the remainder;
- re-opening the bank for core transaction business;

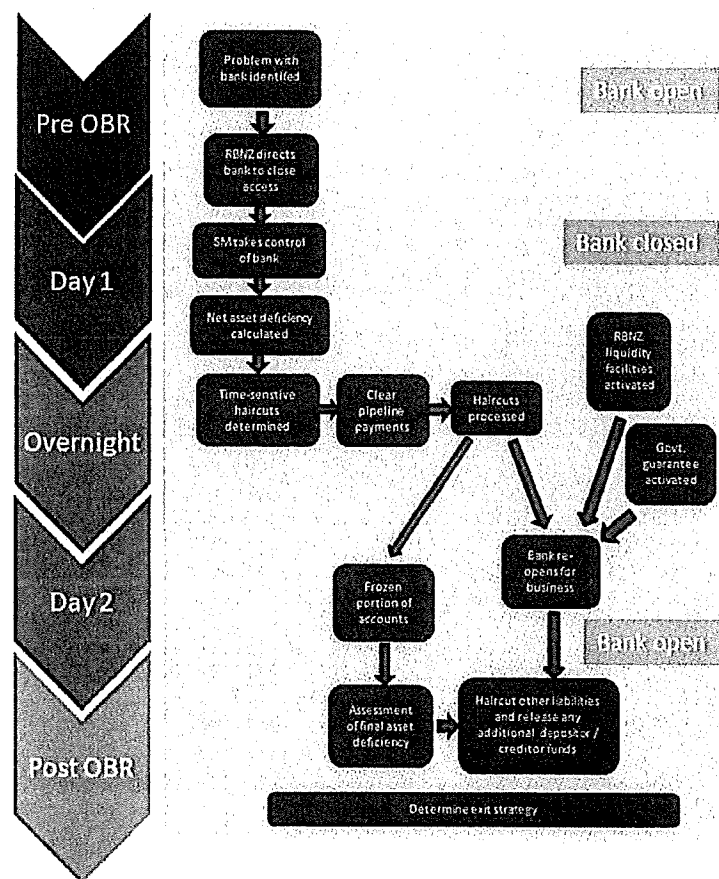
<sup>2</sup> FSB (2010), “Reducing the moral hazard posed by systemically important financial institutions”.

<sup>3</sup> Forbearance is the granting of temporary relief from regulatory requirements by a supervisor.

<sup>4</sup> Alternatively, frozen funds may be converted to equity stakes in the institution as part of a resolution strategy.

- imposition of haircuts on other liabilities; and
  - decisions on future operations and restructuring.
15. Non-deposit liabilities would remain frozen for a period after the re-opening of the bank for transaction business, whilst their haircuts were calculated and applied. A priority order would have to be established for these liabilities that would take into account their seniority and the importance of releasing them for the future of the bank.
16. The 'haircut' process would preserve, as much as possible, the ranking of creditors that would apply in a conventional liquidation. Secured creditors should be able to be paid in full (assuming their security is adequate) while subordinated creditors would not receive any payment unless the senior creditors had been paid in full.
17. Figure 1 presents the various steps of the OBR scheme in a stylised form. It should be noted that the responsibility for placing the bank under statutory management rests with the Minister of Finance on advice from the Reserve Bank. At this time, the OBR will be one of the options open to the Minister, rather than the default solution. The Reserve Bank will also advise on the use of OBR and the size of haircut required.

**Figure 1: Stylised example of the OBR scheme**



18. As identified in figure 1, the final step of the process would be to determine the appropriate exit strategy. It should be noted that the OBR itself does not resolve the future of the bank or allocate final losses. Rather it is a mechanism that ensures on-going liquidity for depositors whilst the government determines the appropriate strategy.

[withheld under s9(2)(d)]

. By making practical short-term arrangements,


the OBR does, however, mitigate the risk that urgent liquidity concerns dictate how losses are allocated between shareholders, creditors and (perhaps) the government. In essence, it provides government with real options for managing the failure of a large bank, and would be consistent with a range of possible exit options, including:

- liquidation;
- government recapitalisation prior to restructuring and on-sale;
- restructuring to become a stand-alone bank with creditor shareholders;
- sale to new owners prior to recapitalisation; and
- re-purchase by the parent bank.

19. The OBR keeps these options on the table while maintaining and enhancing market discipline, and helping to manage moral hazard.

### **Trans-Tasman dimensions**

[withheld under s6(b)(i)]



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

25. The impact of OBR on other banks in the New Zealand financial system would be mitigated through a combination of factors. First, and most importantly, any decision on applying OBR to specific entities will be assessed on a case-by-case basis taking account of wider market issues. In the event that OBR was considered to be the appropriate approach, any impacts on other institutions should be manageable through a combination of central bank support facilities and/or guarantees.

26. [withheld under s6(b)(i)]

27.

## **Implementation of OBR**

### *Operational pre-positioning and consultation with banks*

28. To make the OBR operational, the bank will need to re-open within the necessary timeframes. To meet the objectives of minimising disruption to the financial system, this would require the bank to be ready to re-enter the payment system on the next business day.
29. For this to be possible, each bank covered by the policy will need to be pre-positioned to facilitate the process. This is primarily a systems issue, relating to the bank's capacity to:
- determine creditor positions at the time of statutory management;
  - freeze part of each transaction account balance;
  - provide access to the unfrozen balance through the payments system on the next business day; and
  - periodically release frozen funds to transaction accounts.

30. The Reserve Bank has previously undertaken a pilot exercise with one of the large banks aimed at determining the feasibility of pre-positioning for OBR. The study showed that the OBR was operationally feasible and at modest cost. While there is no reason to expect the situation would be different for the other banks, the initial consultation to be undertaken by the Reserve Bank will enable a better estimate of expected costs, which will inform the overall analysis of costs and benefits prior to full implementation.
31. The purpose of this consultation will be to inform the assessment of the appropriate approach to the implementation phase. The consultation will:
- describe in detail the process and objectives of the policy;
  - outline the outcomes that will need to be met by the pre-positioning exercise (as summarised in paragraph 29;
  - seek views on the practicality, and costs, of meeting those outcomes given the banks' current operating systems;
  - seek views on the most efficient timing for the implementation for each bank given their own systems upgrade plans; and
  - seek views on the appropriate treatment of different liabilities and instruments.
32. Given their concerns, the Australian banks might be expected to push back on the implementation and overestimate the practical difficulties with the scheme. However, a number of domestic banks have indicated strong support for the policy in discussions with the Reserve Bank, and indicated that it will be very straightforward to implement the necessary system upgrades.

#### *Government guarantees*

33. For the application of an OBR to be successful in the long-run, the Reserve Bank and government will need to provide support facilities and guarantees directly to the re-opened bank to ensure that counterparties are willing to transact with it on an on-going basis. [withheld under s9(2)(d)]

34. Treasury officials will be reviewing the process to ensure that the government is in a position to put in place such a guarantee if it is needed as part of an OBR [withheld under s9(2)(d)]

#### *Legislative framework*

35. For the authorities to carry out an OBR appropriate legal powers are needed in order to close the bank, freeze a portion of creditors' claims and extinguish existing shareholders' interests. New Zealand's legal arrangements give considerable power to the authorities to resolve a failed bank, however, as these powers are untested in this regard, officials will be conducting a further review to ensure that the policy will be robust under the existing legislative framework.

36. [withheld under s9(2)(h)]

### *Timeline*

37. Table 1 below summarises the various elements of the work programme and provides an indication of the likely timetable. The Cabinet paper on final policy will outline the implementation strategy to be followed. On completion of that process, the OBR will be available as a resolution option. The use of the tool in practice will remain a decision for Ministers.

**Table 1: Key stages**

<b>Stage</b>	<b>Indicative timing</b>
Communications strategy	December 2010
Technical consultation	January 2011
Assessment of macroeconomic implications	Q1 2011
Review of legislative framework	Q1 2011
Assessment of the design and implementation of the government guarantee	Q2 2011
Cabinet paper on final policy	Second half of 2011
Phase II implementation	To be determined

### **CONSULTATION**

38. The Ministry of Economic Development has been consulted in the preparation of this paper and the Department of Prime Minister and Cabinet have been informed.

39. Registered banks will be consulted as part of the Reserve Bank's public consultation early in 2011. The responses to this consultation will inform the final decision on proceeding to full implementation of the policy.

### **FINANCIAL IMPLICATIONS**

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

### **HUMAN RIGHTS**

41. 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**

42. This proposal does not have legislative implications.

### **REGULATORY IMPACT ANALYSIS**

43. The Cabinet's Regulation Impact Analysis (RIA) requirements do not apply to this paper. A Regulatory Impact Analysis will be carried out next year to support the final decision on whether or not to proceed with the implementation.



## **PUBLICITY**

44. In light of the potential market reaction and the trans-Tasman sensitivities, a communications strategy will be developed prior to consulting with banks. The strategy will include consideration of, amongst other things, the timing of statements; who will make each statement; the nature of the communication; and the treatment of OBR in the wider policy landscape (including interactions with deposit insurance).

## **RECOMMENDATIONS**

45. It is recommended that Cabinet:

1. **note** the objectives of the Open Bank Resolution policy are to:
  - enable the core of the bank to be kept as intact as possible to manage disruption to the payments and wider banking system;
  - provide creditors with access to a portion of their funds to minimise any flow-on effects from a failure to the wider economy;
  - provide a mechanism that ensures that the urgent matter of managing the liquidity impact on the economy does not dictate how the important matter of loss allocation is determined;
  - provide government with a tool to manage fiscal risks;
  - allow the real possibility that creditors could suffer loss in a failure – consistent with obligations they enter into; and
  - preserve exit options.
2. **note** that since the global financial crisis there has been renewed focus around the world on operationalising resolution mechanisms with the above features;
3. **note** that officials will be undertaking the following work to gain a complete picture of the requirements to fully implement an Open Bank Resolution:
  - development of a public communications strategy;
  - assessment of the macro-economic implications of implementing an Open Bank Resolution;
  - review of the legal framework for implementing an Open Bank Resolution;
  - technical consultation with the banks about the system modifications required to implement an Open Bank Resolution; and
  - assessment of the design and implementation of a government guarantee for use in an Open Bank Resolution.

4. note that I will report back to Cabinet in the second half of 2011 about the outcomes of this work and the next steps.



Hon Bill English

Minister of Finance

18, 11, 10