RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

THE TREASURY
Kaitohutohu Kaupapa Rawa

Release of the Treasury and Reserve Bank's Advice on the Open Bank Resolution and Deposit Insurance

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Given the recent interest in options to manage a bank failure, the Treasury and Reserve Bank have each released advice on policies in this area. Treasury has released its advice to Government on bank failure policies from the beginning of 2009. The Reserve Bank has released additional advice on deposit insurance and alternate resolution options to the Open Bank Resolution dating back to 2000.

The documents released by Treasury are available here and those released by the Reserve Bank here.

Overview

Following the Asian financial crisis, the Reserve Bank began reassessing the different options available to address bank failures, resulting in the development of a policy known as Bank Creditor Recapitalisation, later known as Open Bank Resolution.

After the Global Financial Crisis, Treasury and the Reserve Bank revisited bank failure resolution tools, with a particular view to investigating the different options to address the implicit guarantee of support for systemically important banks. The advice recommended further work to strengthen banks' capital buffers and to take credible actions to signal that shareholders and creditors could be exposed to at least part of the cost of bank failures. The new Basel III capital requirements address the first of these, while the Open Bank Resolution was the focus of the second.

Officials also considered the case for a permanent deposit insurance scheme, given the need to provide the market with certainty around arrangements after the Retail Deposit Guarantee Scheme expired on 31 December 2011. Advice on the RDGS has previously been released on the Treasury's Retail Deposit Guarantee Scheme information release page.

The Open Bank Resolution

The Open Bank Resolution (OBR) policy has been under development by the Reserve Bank for some time. It aims to provide the Government with an alternative to a taxpayer bailout or liquidation, by maintaining access to a bank's core transactional functions while enabling losses to be borne by creditors, once shareholders' funds have been extinguished.

In 2010 the RBNZ advised the Government of its intention to consult with registered banks about the necessary changes to IT systems to provide the functionality required for OBR. This intention to consult, the broad outline of the OBR process, and additional work proposed by officials to support its operation was noted by Cabinet in November 2010.

In May 2012 Cabinet noted the Reserve Bank's intention to require all registered banks with retail deposits greater than $1bn to pre-position for OBR. The main benefits of making OBR a live option in the Government's toolkit included:

- Placing stronger incentives on creditors to monitor banks' risk, which can reduce the probability of failure;

- The reduced expectation of Crown support could have a positive impact on perceptions of Crown risk; and

- Increasing the probability that shareholders would support the failing bank.

Supporting the Reserve Bank's intention to require prepositioning, the Assessment of Regulatory Impacts indicated that pre-positioning would provide net present value benefits of more than $1 billion to the New Zealand economy. This Assessment of Regulatory Impacts along with further information on OBR can be found on the Reserve Bank's Open Bank Resolution information webpage.

To date advice to Government has focused on the high level design features of OBR, noting that pre-positioning will result in the key OBR functionality being in place. Advice on more detailed design aspects will be provided to Government in due course.

A permanent retail deposit insurance scheme

In May 2010 the Reserve Bank and Treasury advised the Minister of Finance that, following the closure of the Retail Deposit Guarantee Scheme on 31 December 2011, there was not a case to introduce a deposit insurance scheme on its own.

The Treasury and Reserve Bank considered the case for a permanent Deposit Insurance scheme in New Zealand in light of the international literature, lessons from the crisis and policy and regulatory changes in New Zealand. The advice considered a wide range of matters, including the impact of deposit insurance on: preventing retail bank runs; protecting retail depositors from financial loss; market discipline; pricing the implicit government guarantee; the cost of capital; managing financial crises; promoting competition; the cost of regulation; and managing exit from the Retail Deposit Guarantee Scheme. It also considered the implications for New Zealand as one of the few developed countries without Deposit Insurance.

Taking the broad range of considerations into account, officials' view was that Deposit Insurance would have at best modest benefits that would be outweighed by the costs.

In November 2010 Cabinet agreed that no permanent Deposit Insurance Scheme would be introduced.