

An Overview of Prudential Regulation Under the RBNZ Act

February 2018



Purpose of This Presentation

This presentation provides an overview of the current prudential framework under the Reserve Bank of New Zealand Act 1989. It covers:

- 1. The statutory purposes of prudential regulation**
- 2. Who is subject to prudential regulation (application of the framework)**
- 3. The way prudential requirements are applied to registered banks**
- 4. The crisis management framework**
- 5. The role of the Minister under the prudential framework**
- 6. A contrast with the other prudential regimes operated by the RBNZ.**

The presentation aims to provide an understanding of the status quo to allow for informed consideration of areas that are appropriate for further review.



The RBNZ as Prudential Regulator

The Reserve Bank is the prudential regulator of:

- **Banks**
 - Part 5 of the Reserve Bank of New Zealand Act 1989
- **Insurers**
 - Insurance (Prudential Supervision) Act 2010
- **Non-bank Depositors**
 - Non-bank Deposit Takers Act 2013

The Reserve Bank also regulates settlement systems and is an AML supervisor under the AMLCFT Act 2009.

This presentation will focus on the RBNZ's role as prudential regulator of banks under the Reserve Bank of New Zealand Act.



Statutory Purposes

The purpose of the Act is to make the RBNZ responsible for (among other things):

- Promoting the maintenance of a sound and efficient financial system.

Part 5 of the Act which provides for prudential regulation requires the RBNZ and the Minister to use their powers under the Act for:

- Promoting the maintenance of a sound and efficient financial system.

OR

- Avoiding significant damage to the financial system caused by the failure of a registered bank.

Broad purposes with a systemic focus allows the RBNZ to pursue different prudential strategies and objectives provided they are directed to one of the purposes above.



Application of the Act

- **The Act applies to registered banks.**
- **Any person in the business of borrowing and lending may apply to be a registered bank.**
- **Once registered as a bank, a bank becomes subject to prudential regulation by the RBNZ and subject to a range of potential regulatory powers.**



Registration as a Bank

- **Financial institutions may apply to be registered as a bank.**
- **The Act directs the RBNZ to have regard to statutory criteria including ownership, capital, risk management, and the “standing” of the applicant.**
- **These criteria are elaborated in published policies of the RBNZ.**
- **Registration is a merit test; banks are at the higher end of the financial sector.**



Advantages of Registration

Being registered as a bank confers considerable benefits:

- Enhanced access to central bank liquidity and settlement funds.
- Increased standing in the financial markets.
- Permission to use the word “bank” in name or title.

However registration is not compulsory for those carrying on banking activities:

- Some financial institutions prefer to be regulated as non-bank deposit takers (more so prior to the NBDT Act).
- Some financial institutions may operate without using the word “bank”.
- Some financial institutions provide services from off-shore and are beyond New Zealand and RBNZ’s reach.



Statutory Framework for Regulating Banks

The Act requires the RBNZ to prudentially supervise registered banks.

Banks are supervised against the following:

- Standards of prudent conduct (“carrying on business in a prudent manner”).
- Financial strength measured against RBNZ policies.
- Legal compliance with obligations imposed by the Act.

The primary tool for imposing prudential requirements on banks is conditions of registration. The framework has allowed for adjustments in regulatory strategy (e.g. increased regulatory discipline) and significant new policies (e.g. liquidity, Basel II and III capital).

The framework has also provided for the introduction of macroprudential policies.



Conditions of Registration

- **The Act provides the regulation of banks via conditions of registration.**
- **Conditions of registration are conditions placed on the registration of the bank.**
- **Breach of condition leads to a range of consequences (e.g. must be publicly disclosed, can be prosecuted as an offence, can trigger serious consequences).**



Conditions of Registration in Operation

Conditions must relate to statutory matters referred to in the Act. The matters are often broad, for example:

- Risk management systems and policies of the bank
- Capital
- Risk exposures
- Internal controls
- Suitability of senior officers and directors.

There are mandatory consultation requirements on the RBNZ before imposing conditions and the RBNZ must follow normal standards of due process.



Conditions of Registration in Operation

Cont.

- **The RBNZ formulates detailed policies relating to the statutory matters conditions may refer to.**
- **There are policies on capital, liquidity, outsourcing, governance and other matters, which can be found on the RBNZ website.**
- **These policies are incorporated into conditions of registration.**
- **While these policies are similar in effect to formal regulations, they are not “legislative instruments” subject to Parliamentary disallowance and other procedures under the Legislation Act 2012.**
- **Conditions can be tailored in the case of individual banks, e.g. by varying a requirement for that bank based on its risk profile. While this occurs, mostly conditions are standardised and banks are treated the same.**



Other Regulatory Requirements

- **The other main tool for prudential regulation is Disclosure Statements:**
 - Registered banks must disclose prescribed financial information to the public.
 - Disclosure Statements are set via Orders in Council.
 - Penalties apply under the Act against directors for false and misleading Disclosure Statements.
- **Changes in ownership in registered banks must be approved by the RBNZ.**
- **Registered banks are required to obtain and maintain a credit rating.**



Supervision

The Act provides powers for the prudential supervision of registered banks that RBNZ is required to carry out:

1. Information gathering powers
2. Powers to require third party reports
3. Investigatory powers (including search and seizure powers)

While 1 and 2 are routine, 3 requires an escalation threshold to be met before being invoked.

There are no powers for “routine” compulsory on-site inspections of registered banks by the RBNZ.



Crisis Management

Banks are inherently vulnerable and the Act provides powers to the RBNZ and the Minister of Finance to be used when a bank gets into serious difficulties:

- Directions
- Statutory management

There are thresholds for the use of these powers (“crisis thresholds”). In summary the registered bank must be:

- Insolvent or near insolvent
- Not carrying on business in a prudent manner or
- Posing a threat to the soundness of the financial system

Directions may also be issued if the bank or a director is in breach of a condition of registration or of any other requirement under the Act

Crisis management powers also apply to “associated persons” of registered banks (broadly, holding companies and subsidiaries).*

*The remaining slides refer to registered banks only, but the content is applicable to associated persons.



Directions

When a crisis threshold (or one of the additional thresholds for directions) is crossed, the RBNZ may (with the consent of the Minister) issue a direction.

In broad terms directions may require the registered bank:

- To consult with RBNZ about its circumstances and actions it is intending to take to deal with those circumstances.
- To carry on or cease carrying on its business according to the direction.
- Take other action directed by the RBNZ to deal with its financial difficulties.

Directions can also remove directors from the registered banks and appoint new directors.



Statutory Management

- **If a registered bank has crossed one of the crisis thresholds or if it has failed to comply with a direction it may be placed into statutory management.**
- **Statutory management is effected by Order in Council made by the Governor General on advice of the Minister of Finance in accordance with a recommendation of the RBNZ.**
- **Statutory management means the business of the registered bank is taken over by an appointed statutory manager. That person assumes the power of the board and shareholders in respect of the failed bank.**
- **The statutory manager is not an agent of the RBNZ or the minister: it is an agent of the failed bank.**



Statutory Management cont.

- **Statutory management gives the statutory manager broad powers that can be applied flexibly to deal with the range of matters that may arise in a bank failure in as timely manner as possible, including by altering the ordinary legal position in a range of areas.**
- **This is justified by the extreme economic risks caused by bank crises.**
- **The flexibility of the legislation has allowed the RBNZ to design its OBR policy.**



Objectives of Statutory Management

The primary purpose of the RBNZ and Minister in exercising powers in the context of statutory management is to avoid significant damage to the financial system caused by the failure of the registered bank.

The statutory manager must have regard to statutory considerations:

- The need to maintain public confidence in the operation and soundness of the financial system.
- The need to avoid significant damage to the financial system.

Lower ranked considerations for the statutory manager are:

- The need to resolve as quickly as possible the difficulties of the failed bank.
- Preserving the position of creditors and maintaining the ranking of creditors.

Key Features of Statutory Management

- **Control of the failed bank by a statutory manager and displacement of existing management.**
- **A moratorium on access to any debts of the bank existing when it entered into statutory management; the statutory manager can later release money at its discretion and in a way that is not consistent with prior creditor position or ranking.**
- **Powers to sell assets of the failed bank and transfer its business undertaking to a new company, and sell shares in that new company.**





Supervision of the Statutory Manager

The RBNZ supervises the statutory manager and may both advise and direct it, and is required to approve many of its actions.

Certain powers of the statutory manager require the Minister's involvement:

- Incorporating the New Zealand business of a foreign bank (must be by Order in Council).
- Selling the assets of a registered bank or shares in a “bridge bank”.

The Minister may terminate the appointment of the statutory management on various grounds following a recommendation of the RBNZ.

The Minister or RBNZ can supplement the Act through contractual arrangements that can determine reporting and performance expectations of the statutory manager (subject to such arrangements not conflicting with their roles under the Act).



Role of the Minister Under the Act

The Minister is responsible for the Act and any regulations made under it and sponsors any amendment to the legislative framework.

The day-to-day operation of the prudential framework is carried out by the RBNZ at arms length from the Minister.

The Minister has the following formal means of influence:

- The Minister may direct the RBNZ to have regard to a government policy that relates to the Bank's prudential regulatory functions.
- The Minister has the opportunity when the Bank drafts its statement of intent to comment on the RBNZ's financial sector regulatory outcomes it seeks to achieve. The RBNZ must demonstrate how it has considered those comments.
- The Minister may seek a regulatory impact assessment from the RBNZ on prudential policies adopted by the Bank.
- Engagement with the RBNZ board of directors, who monitor the Bank on the Minister's behalf.



Role of the Minister in Crisis Management

The Minister has a formal role in crisis management, which puts him or her in a position to manage any fiscal risk arising from a decision he or she has made such as providing a guarantee or other public support.

In addition to his or her role in placing the Bank into statutory management the Minister must consent to certain actions of the statutory manager, such as selling the failed bank's assets and transferring its business to a new entity.

The Minister can terminate the appointment of and replace a statutory manager. The Minister advises the Governor General to terminate the statutory management by Order in Council.

Powers of the Minister are exercised on the recommendation of the RBNZ, but the Minister is free to accept or reject a recommendation and make his or her own inquiries.



Prudential regulation: Contrast with IPSA

Broadly same legislative framework: licensing, conditions of licence, supervision, credit ratings, crisis management.

Differences are:

- Statutory “have regard to principles” in addition to purpose statement.
- Insurers must be licensed to do insurance business in New Zealand.
- More detailed fit and proper regime.
- Solvency rules are via Solvency Standard, which is a disallowable instrument, rather than policies incorporated into conditions.
- Broad scope for conditions of licence, but not as extensively used.
- Detailed credit rating requirements.
- Statutory fund requirements for life insurers.
- Limited disclosure requirements.



Prudential Regulation: Contrast with NBDT Act

NBDTs are financial institutions as are banks.

NBDT Act has same statutory purposes as RBNZ Act (systemic focus).

Differences are:

- NBDTs must be licensed if taking retail deposits.
- Detailed fit and proper regime.
- Role for debt security trustees, who have obligations to the RBNZ to report NBDT compliance.
- RBNZ crisis management powers limited to directions.
- Disclosure dealt with by FMC Act rather than bespoke requirements.
- Requirements imposed by regulations, rather than conditions of licence or RBNZ policy. Some scope for conditions of licence.