To: The Treasury

rbnzactreview@treasury.govt.nz.

**Submission on the Scope of Phase 2 of the Review of the Reserve Bank of New Zealand Act 1989**

**Submitter**

**Hugh Smith**

9(2)(k)

This submission is made in my personal capacity. It is made on the basis of my learnings and observations of dealing with the Reserve Bank of New Zealand (RBNZ) since it began consultation on its Outsourcing Policy in 2004.

I am a "senior" lawyer, currently working for one of the large Australian owned banks in the Regulatory Affairs area. My title is "Special Counsel". My area of speciality is Outsourcing Policy and Open Bank Resolution (OBR). I am also involved with the Payments area and have been involved with making submissions to RBNZ on matters such as DTI, FMIs, the treatment of margins for cleared and uncleared derivatives and capital strengthening.

Prior to joining the bank, I was a director of Mercer and before that a partner in Buddle Findlay.

This submission contains my personal views. These views are not those of my employer and have not been sanctioned by it. Geof Mortlock, an expert consultant on prudential supervision whom I have worked closely with on a number of matters, has shared his submission with me. It is an excellent analysis. He has had the courage to include things that I don't. It is a way better submission than mine because he has had the advantage of being "on the inside" with his roles at RBNZ and APRA. I commend his submission to you. Mine comes from a different angle. We share the same conclusion – that the current prudential supervision regime is fundamentally not fit for purpose. In fact, there are aspects of the current regime, such as OBR and abrupt separation under Outsourcing Policy that threaten to undermine the soundness of the financial system.

I do not claim confidentiality in respect of this submission or any part of it.

**Looking after other peoples' money**

When I started my career, as a much younger lawyer in private practice, solicitors' nominee companies played a very significant role in financing home purchases because only limited credit was available through banks and other financial institutions. As a profession we took collective responsibility for training and approving lawyers to operate their nominee companies and on ongoing monitoring of the management of the nominee companies. If there was a defalcation due to the professional misconduct of a practitioner, the profession would take collective responsibility for making good that loss through the solicitors' fidelity guarantee fund, on the basis that this was necessary for the credibility of the profession and that, through the law society, the profession was best placed to manage the risk.

This was my grounding in the principles that need to apply to looking after "other people's money". In an ethical sense, I see them as being equally applicable to the bank/depositor relationship. Without adherence to these principles customers will not have the essential "trust and confidence" to make deposits. And without deposits we cannot get the benefits of fractional reserve banking (and are forced back to the solicitor nominee company model, where people had to rely on long terms savings of others to buy their homes).

Of course, there is a significant legal difference between a lawyer acting under a fiduciary duty to their clients and the borrower/creditor relationship between a bank a depositor. However, in substance retail depositors don't generally perceive their transactional or short-term, interest bearing, accounts as lending to the bank. They very much perceive it be their money (i.e. stored value), which the bank holds as a custodian, pending the customer transferring it through the payment system, which is mostly also facilitated by the bank. It is a very symbiotic and reasonably efficient relationship. Depositors make an assumption that their money is safe with the bank without paying any attention as to why they believe this is so. It is widely acknowledged that New Zealanders lack financial literacy (apart from the system allows for tax free gains to be made on property investment and are beginning to appreciate the value of KiwiSaver as a long term saving vehicle). Although, efforts are being made to improve financial literacy, getting a wide spread understanding of risk, at a retail level, is a long way off.

**For starters**

I apologise for the long-winded introduction but I want to disclose my position at the outset. I have drawn on what I personally want as a customer with money on deposit with my bank, not just my experience as a lawyer and my dealings with RBNZ:

- Emphasis need to needs to be placed on preserving and promoting the strength of New Zealand banks, not just on preventing them from failing or what happens on failure. By the it is too late, the damage has been done.[1][2]
- I am a strong advocate for depositor protection, including deposit insurance up to a reasonable cap (e.g.  4 X NZ average after tax income or some formula like that);
- I am totally opposed to OBR. The concept is a denial of the sense of social responsibility, we should have as a community. I believe that it is at odds with the moral compass New Zealand has as a nation. The Crown is the combination of the people, not something distinct from them. The primary purpose of the State is to protect its citizens from harm and promote their welfare. This includes in a financial/banking crisis as much as in a natural disaster. It appears to me that RBNZ and The Treasury have become overly obsessed with adopting policies that have eliminating any moral hazard on the part of the Crown as their focus, rather actually mitigating the risk concerned. Eliminating the moral hazard to the Crown in respect of a bank failure does not feature in the purposes for which RBNZ can exercise it powers under the RBNZ Act. With the modest amount of debt the Crown has, it can well incur a lot more to protect depositors before there is any impact of the soundness of the financial system. OBR is also counter to the fundamental principles of resolution of a failed bank – no creditor should be worse off than on liquidation; all creditors of the same class must be treated equally and according to their preferential ranking on a winding up; resolution should be for the benefit of creditors and managed so it returns as much of their

[1] In This Time is Different (2010), which I understand to be the definitive analysis of banking and sovereign debt crises, the authors, Reinhart and Rogoff, found that on average it took a country 6-7 year to restore its GDP to its pre-crisis level

[2] Ominously, another of their findings was that the most common factor in banking crises was the failure to control the use of offshore funding to inflate domestic asset values. At some stage profligate borrowers and their willing facilitators, i.e. lenders chasing market higher returns on assets which become riskier and riskier, are likely to be caught out badly, when an unexpected externality causes a drop-in market confidence. It is this activity that needs to be intensively supervised, not the provision of critical shared services.

money as it can as quickly as possible. OBR is currently not authorised by the RBNZ Act without amendment. Yet in anticipation of the amendments being made, RBNZ has forced the banking industry to spend probably more than $100M in "pre-positioning" for OBR. The rating agencies totally discount OBR from their assessments on the grounds that the Minister of Finance would never allow OBR to be invoked because of the devastating electoral consequences. The IMF shares this view.[3] Of course, the same political considerations apply to the passing of the amendments to the RBNZ Act in order to make OBR lawful. As a consequence of these political considerations, 6 years after the OBR policy was issued by RBNZ, the amending legislation has not been consulted on let alone passed.[4]

- Facilitating full quick account portability combined with giving the statutory power to transfer accounts to another bank so long as it is viable, would avoid the need (and expense) of banks having to pre-position "robust back-up capability" on the very remote prospect that they may be required to separate. Account portability would also encourage greater competition between banks. I am confident that account portability could be developed at considerable less cost than implementing solutions based on abrupt separation.
- I am against bail-in as a resolution remedy. However, bail-in should be allowed if it is in accordance with instruments specifically issued for that purpose and acquired voluntarily on an informed basis – often referred to as Total Loss Absorbing Capital or TLAC. Because of the risks of misselling, or allegations of misselling, I am opposed to such instruments being offered to retail investors. If a statutory manager is to be granted bail-in powers, there should be a clear definition of which debts bail-in and in which order. Any bail-in by a statutory manager (as opposed to a contractual bail-in) should be subject to Court supervision to ensure creditor' rights are protected and only applied to amounts which exceed the insurance cap. It needs to be stressed, that OBR is not a bail-in and doesn't resolve the failed bank. In terms of the law the frozen remains on the balance sheet and debt ranks equally with unfrozen debt.
- I am completely in favour of deposit insurance, particularly the ex post Financial Claims Scheme (FCS) type the Australians have. [5]
- Regulation needs to be risk based. This requires clear identification of risks and the appropriate mitigants according to the degree of remoteness and potential size of the harm. Risks come on both side of the balance sheet (i.e. there are risks with both assets and liabilities), they may be internal or external, financial or technology based. Risks associated with externalities, such as offshore funding, are likely to be the greatest because of their size and the only certain control is to limit exposure (which would have a negative impact on growth and the soundness of the economy).
- Regulations (or standards) need to set independently from the agency that is responsible for supervising whether banks are complying with them. Primary legislation should set the objectives, the key risks that are to be managed and how it wants the risks to be managed – this could include promoting upside as well as guarding against downside. Regulation should be used for the next level of detail of risk management that may need to change more frequently, and Orders in Council for even greater detail. The concept being, that the supervisor is just that, a supervisor who is responsible for interpreting and applying the regulations/standards, without any discretion to change them. This is necessary to address

[3] Para 44 IMF FSAP Technical Note – Contingency Planning and Crisis Management Framework
[4] I have not addressed what remedies that banks might have if the amendments are never passed.
[5] It is the best-looking thing that I have seen come out of Australia since I stood next to Miranda Kerr in the queue at the Maranui surf club. She was really very pleasant to talk to.

the risk of the agency over-time, disregarding its own Act as well as the Rule of Law, not complying with administrative law principles when it comes to consultation or exercise of powers and making its own rules up ad hoc as it goes along. Regard should be had to the work of the Productivity Commission in this area.[6]

- The supervisor needs to be a separate agency. Governed by a board, with a majority of external representatives. The CEO/Director needs to have experience at CRO/CFO level at a large bank. The agency needs sufficient high calibre resource to fulfil its responsibilities. The agency could be part funded by industry levies.
- Whatever regulatory framework is adopted, it has to have robust transparency, and independent checks and balances, to ensure the development of policy is to the highest standard in terms of objectives and clarity and that the exercise of powers is not arbitrary and is open to review without fear of reprisal. Regulations/standards need to be reviewed regularly and maintained up to date.
- Close alignment and cooperation with Australian authorities is essential. It needs to be spelled out to an even greater degree in the governing legislation. It should be made explicitly clear that Australian legislation can be relied on at face value and that regard must be had for the close relationship between Australia and New Zealand.
- In terms of Outsourcing, there should be specific recognition that critical shared services can be provided through a special purpose vehicle (SPV) that is 100% owned by the Australian parent, so long as it is ring-fenced in terms of financial risk (i.e. it can continue to be independently financially viable in the event of failure of other members of the group), services are supplied on an arm's length basis and without preference between group members. The SPV should have independent management and the board should include a majority of independents as well as representatives from the recipients of the services.
- As a first priority, work on abrupt separation requirements under the revised BS11 (Outsourcing Policy) must be called to an immediate halt and an independent investigation conducted into all aspects of the policy, including how it fits into New Zealand's relationship with Australia and Australia's support of New Zealand's economy. The Policy is by far and away the worst thing I have come across in 42 years' of working as a lawyer. It is poorly conceived, poorly drafted (as in impossible to understand in places – although this may be attributable in part to RBNZ's assertions that some provisions mean the exact opposite of how they have been written), hideously expensive to implement (my guess would be well in excess of $1 billion across the 4 large Australian owned banks) and is likely to increase annual operating expenses across the 4 banks by circa $200 p.a.. This does not include the lost opportunity costs suffered because resources that would otherwise be devoted to innovation and ongoing improvements to bank's systems to make sure they are "always up" and more resilient to risks, such as cyber-attacks, will be diverted on to compliance work in respect of the Policy - which is designed to shrink the bank so that it just provides only basic banking services to its existing customers, in the event that its parent bank fails and there is a threat of a denial of critical shared services if New Zealand does not contribute to a single point of entry of the parent.[7]
- Crisis management needs a complete rethink based on the Financial Stability Board's Key Attributes for Effective Resolution of Financial Institutions. The RBNZ Act requires a bank in

[6] New Zealand Productivity Commission – Regulatory institutions and practices - https://www.productivity.govt.nz/sites/default/files/regulatory-institutions-and-practices-final-report.pdf

[7] I heard this explanation personally from a senior RBNZ official and I believe it was also provided to the directors of the bank for whom I wok.

statutory management to be resolved as quickly as possible – by sale or liquidation. RBNZ's revised BS11 and its Guidance to the preparation of a separation plan for the purposes BS11, indicates that during statutory management, the failed bank is going to turn into a phoenix from the ashes and return to its former AA- glory. The analysis in Appendix 1 shows that this is never going to happen, so why build solutions for it. Therefore, having policies like positioning for abrupt separation under Outsourcing Policy are a waste of the very considerable time and money that is going into them, especially when the remoteness of the risk and the forgone opportunities because of diversion of resource are factored in.[8]

- There need to be an uplift in financial literacy. Particularly, in respect of risk and the significance of ratings and the risk/reward relationship. This should be the responsibility of a centre of excellences, such as the FMA of the Commerce Commission, which have a much greater consumer focus.

**Scope of Submission**

I have limited the scope of my submission to prudential supervision and crisis management of registered banks.

**Executive Summary**

The Reserve Bank of New Zealand Act 1989 (RBNZ Act) is materially out of date and is no longer fit for purpose. It is contributing to very poor regulatory practices and policies/conditions of registration that are suboptimal. Having the central bank, whose primary responsibility is monetary policy, does not help. The required leadership, culture and skill set are completely different. The Minister is right, it is time to have a fundamental review of the RBNZ Act.

There needs to be clear separation of prudential supervision from monetary policy and other functions of the RBNZ. A new culture that has a better understanding and better relationships with banks is required.

Much more emphasis needs to be placed on keeping banks strong than what happens if they fail, which has been the principal area of focus of RBNZ over the last 15 years.

The most important thing is there must be better alignment with Australia. In particular, in the areas of understanding ratings and crisis management. Since 1989, there has been a lot of development in this area under the auspices of the IMF, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision in the approaches that should be taken to prudential supervision, particularly since the GFC, which the review should take into account by the review.

There is merit in orthodoxy – e.g. deposit insurance combined with intensive supervision. The New Zealand regime should only depart from the international norms if greater protection is required because of New Zealand's risk profile, not because the regulator is under skilled and under resourced. Unorthodoxy is a distinct disadvantage, when raising funds offshore. For example, light touch supervision and OBR are a hurdle. Offshore lenders don't understand or relate to this approach, so they create barriers for the New Zealand banks. It is acknowledged that greater resources will be required. However, given what is at stake, it would be imprudent to cut corners on the grounds of saving costs.

**History**

[8] See Appendix 1.

I have set out my observations on the history of the RBNZ's Outsourcing Policy, as they have shaped my proposals for the scope of phase 2 of the review.

Although no doubt well intentioned, the poor drafting of the RBNZ Act and the unorthodox interpretation by officials of their responsibilities, has led to a regime that is badly out of alignment with modern prudential supervision approaches. RBNZ's "three pillars" approach, professed to be "world leading" in the late 80s, has in fact never had any followers to my knowledge. In fact, history records that it wasn't even supported by the RBNZ's own supervisors at the time (who advocated for an intrusive supervision approach). However, the supervisors lost out the RBNZ economists, who had the support of the then Governor. The economists argued that if you had director attestation and disclosure to depositors all that was required was light touch supervision. This was in line with prevailing economic thought in some parts of the Western world at the time.

RBNZ's long standing "three pillars" approach to supervision is: (1) Self-discipline based on director attestation; (2) disclosure based on very lengthy technical disclosure that very few customers know is there; and (3) light touch, non-intensive supervision.

Having a prudential supervision regime that is significantly different from other jurisdictions is a distinct disadvantage when it comes to assessing ratings and raising funding offshore, particularly when you are a small bank from a small country with a narrow base to its economy.

During the 90s and early 2000s, the 4 large Australian banks acquired significant dominance of the New Zealand banking scene until they accumulated holdings of circa 85 % of New Zealand banking assets. This makes them (and probably no other single institution) systemically important. They started to integrate their New Zealand operations with their Australian ones to gain the benefits of scale and the synergies of consolidation of back office operations. Infrastructure was transferred (or proposed to be transferred) to Australia and there were direct reporting lines from New Zealand into senior management in Australia. RBNZ viewed this as a "hollowing out" of the systemically important New Zealand banks and had concerns that it would compromise a statutory manager's ability to resolve a failed New Zealand bank in a crisis.

This led to consideration between Australia and New Zealand as to who should take responsibility for supervision of New Zealand banks. The New Zealand Minister of Finance at the time favoured APRA becoming the sole prudential supervisor, with an on the ground presence in New Zealand. This was rejected as being too hard in a joint paper prepared by officials from both counties in 2004. If urban myth is to be believed, there were some very "acrimonious" discussions between the two camps about the future of supervision and outsourcing.

RBNZ formed a view that the "legal and practical" control test under the original BS11 (which came into force at the start of 2006) could not be satisfied in respect of core functions that were outsourced to an Australian parent. In the middle of 2006 legislation was passed by the Houses of Parliament on both sides of the Tasman that was intended to facilitate outsourcing to an Australian parent. However, the RBNZ couldn't get comfortable that this legislation provided an absolute assurance that the Australian authorities would not take action to disrupt the provision of critical shared services to a New Zealand subsidiary if it became necessary to do so in order to discharge their statutory duty to protect Australian depositors. A specific example was never provided, except that in the event of the failure of a parent, the Australian authorities might want to implement a single point of entry bail-out and ask the New Zealand government for a contribution on the basis that their contribution could be used to support the New Zealand subsidiary. RBNZ claimed that there was a risk that APRA might use its powers to threaten to direct the parent bank to disrupt the provision of shared services to the New Zealand subsidiary in order to put pressure on the New Zealand Government to contribute.

The probability of this scenario playing out is remote. According to the rating agencies the probability of one of the AA- rated parent banks failing would be something in the order of 1 in over 250 years[9]. It would be contrary to the Australian government view that*: At a government-to-government level, Australia's relationship with New Zealand is the closest and most comprehensive of all its bilateral relationships.*[10]It would also be incredibly destructive to the value of the very significant investment by Australia in New Zealand, including in New Zealand's 4 largest banks.[11]

**Divergent paths**

I believe that the history outlined above and the differences in the respective Acts covering prudential supervision have lead Australia and New Zealand down significantly divergent paths in respect of prudential supervision and crisis management.

Australia's regime focuses on instilling the essential "trust and confidence" into the Australian financial system. As a result of the Financial System Inquiry (2014), the Australian government gave a mandate to APRA to ensure that Australian banks are "unquestionably strong" – meaning they have to be in the top quartile of banks globally. This is on top of the protection of depositors, depositor preference and depositor insurance under Australia's Banking Act 1959:

- Under s12(1) APRA has a duty to exercise its powers and functions for the protection of depositors;
- Under s13A(3)(c) depositors have a preference to other creditors (except APRA); and
- Under Division 2AA depositors have the benefit of a government provided (funded ex post claims) deposit insurance scheme, the Financial Claims Scheme (FCS), which protects account balances up to $250,000. The design of the FCS is very efficient.
- Deposit insurance needs to be backed by intensive supervision. In order to reduce the likelihood of claims being made under the insurance scheme, the insurer ensures that the supervisor is well funded and resourced to implement intensive supervision. Funding the supervision is done under a mixed model, where it is part funded by government and part funded by levies on industry.
- APRA has recently had its crisis management powers strengthened.

By way of contrast the New Zealand regime does not recognise depositor protection as a purpose of RBNZ. Instead the purposes for which RBNZ can exercise its supervisory powers are stated in very nebulous terms in s68 of the RBNZ Act - i.e.:

- promoting the maintenance of a sound and efficient financial system; or
- avoiding significant damage to the financial system that could result from the failure of a registered bank.

This formulation of purpose has led to RBNZ placing an undue emphasis on what to do in the event of failure of a New Zealand bank or its Australian parent. This is reflected in their policies BS11

[9] Note – RBNZ used a probability statutory management being 1 in 133 years for the purposes of the Cost Benefit Analysis performed as part of the Regulatory Impact Statement relating to the revised BS11. They did not mention the ratings of the banks as published on the RBNZ website or say why it preferred its own probability to the assessment by the rating agencies.

[10] http://dfat.gov.au/geo/new-zealand/Pages/new-zealand-country-brief.aspx

[11]See Appendix 2

(Outsourcing Policy) and BS17 (Open Bank Resolution or "OBR"), which are incorporated into the conditions of registration of the large Australian owned banks. These policies significantly undermine the trust and confidence depositors and wholesale lenders should be able to have in New Zealand banks. These policies are poorly conceived (particularly in the case of OBR) and poorly drafted (in the case of Outsourcing Policy).[12]

**Ratings Ratings Ratings**

New Zealand must be one of the luckiest countries in the world when it comes to its banks. AA rated banks are like hen's teeth. New Zealand has 4 of them. The same as Australia. In fact, they are the same 4. The AA- ratings are crucial to both economies, as they enable funding to be sourced from offshore. The New Zealand AA- rated banks source 20%-30% of their funding from offshore. Remove this, and there would be significant shrink in the size of the economy and the standard of living.

The rating agencies are able to rate the Australian owned banks AA- because they assign a 3-notch uplift because they assume that there would be implicit support from their strong Australian parents and the New Zealand government (i.e. they are making assumptions that OBR will never become law or be invoked because of the electoral consequences). To put it another way, the New Zealand banks, on a standalone basis, would be rated only BBB+ - or one notch above Coop and Heartland and one below TSB. Looking at how the agencies assess, Kiwibank, it would appear that the only way a standalone New Zealand bank can be rated AA is to be directly owned or guaranteed by the New Zealand Government.

Where I land on this, is that supervision must not just aim at preventing a bank from failure or resurrecting a bank after it has failed, it needs to focus on ensuring that the AA- ratings is maintained by the 4 systemically important Australian owned banks because ifs lost its never coming back.[13] To do this requires very close cooperation and alignment with APRA as the home supervisor of the Australian owned banks and adherence to internationally accepted orthodoxy. This includes abandoning RBNZ's position that New Zealand is unique because of the concentration of the 4 Australian banks and its view that it can pick and choose what standards we comply with because, unlike Australia, we are not a G20 country. These are specious arguments. New Zealand and Australia are in the same position. They are both small countries who depend heavily on access to offshore funding. The size of the New Zealand banks relative to their parents is such that the failure of a New Zealand bank would cause serious stress to its Australian parent. Given the tremendous benefits that New Zealand derives from the presence of the Australian banks, it behoves New Zealand to have a prudential supervisory regime that is fully aligned with Australia (and certainly doesn't undermine it).

Having the ratings of the Australian parents at risk because of a light supervisory regime applying to their New Zealand subsidiaries is not something that an Australian supervisor can tolerate. And rightly so,

Any differences should be justified on the basis that they are necessary to strengthen a New Zealand bank because they are inherently weaker than their parent (on a standalone basis). In no circumstances should policies be adopted that undermine the assumptions made by the rating agencies – as OBR and Outsourcing Policy currently do.

[12] I am very happy to provide reasons for this statement.

[13] In Appendix 1, I have tracked trough what happens if an AA- rated bank is allowed to fail under the current regime

**Aussie! Aussie! Aussie! – O! Oi! Oi!**

New Zealand benefits way out of proportion to its size because of the dominance of the Australian banks and the commitment by the Australian government that their banks must be unquestionably strong.

The IMF are undertaking an FSAP review of Australia this year. The difference in regulatory regimes between New Zealand and Australia must be seen as detracting from the strength of the Australian regime. Australia is a member of the G20 and so doesn't have the luxury of claiming to be able to pick and choose which Key Attributes it will adopt. The perception that NZ's regulatory environment is not aligned with the FSB's Key Attributes, and therefore may be putting the Australia parents at risk of being stressed by a failure of a NZ bank, that might have been avoided by a more orthodox regulatory approach, must be very disturbing for APRA and World monetary authorities such as the IMF.

If they are to be consistent, and don't see a commitment being made by NZ to make progress on their recommendations, the logical recommendation for the IMF to make to the Australian authorities would be - for the recommendations made in respect of New Zealand to be achieved by imposing the requirements through the parents or for Australia to reduce its exposure to NZ. This might not provide New Zealand depositor protection but it would result in more intrusive supervision by APRA and strengthened capital requirements being imposed through the parent. If intrusive supervision is inevitable, it is likely to be more efficient and result in better outcomes if it is performed by a single local supervisor.

RBNZ is inclined to cherry pick what international body requirements it complies with on the basis that it is not bound to do so because NZ is not a member of the G20. This is pure sophistry on the part of RBNZ. If the Australian banks own 85% of NZ's banking assets and the failure of any of the large Australian owned NZ banks would cause stress for its Australian parent, then it is a G20 problem and one that IMF and Australia need to be deeply concerned about.

**IMF FSAP (May 2017)**

**IMF's Staff Report for the 2017 Article IV Consultation IMF's FSAP Technical Note**

Paragraph 26 of the Staff Report states:

***26. Bank balance sheet resilience should be strengthened further through increases in bank capital requirements under the ongoing RBNZ capital review.***
***The large banks feature a strong similarity in business models*** *with a high risk concentration in mortgage lending and the dairy sector and significant reliance on foreign funding, which all imply significant negative externalities in a stress situation.*
*…..*
***In staff's view, the review should recommend higher capital ratios for the larger banks, given the systemic risk dimension.*** *A reasonable benchmark could be capital adequacy ratios for New Zealand's large banks that are somewhat higher than the Australian Prudential Regulation Authority's (APRA's) "unquestionably strong" capital targets for the large Australian banks, as systemic risks relative to peers seem somewhat more pronounced. Higher capital requirements could be instituted by a surcharge for domestic systemically important institutions or, given likely moral hazard concerns of the authorities, by generally higher minimum capital requirements.*

I agree with the above assessment. I support having a capital strength target of unquestionably strong in the Act and then define it in Regulations as being in the "top quartile" with the specific CET-1 requirement being in an Order in Council as being x basis points higher than APRA's requirements for the Australian parents.

IMF have identified significant reliance on foreign funding as being a significant negative externality. New Zealand now has an entrenched dependency on being able to access offshore funding in order to support its domestic growth, particularly with the pressure coming from rapid population growth. The common factor in financial crises is the use of offshore funding to inflate domestic asset values rather than increase production. Given magnitude of this risk, it should be called out at the highest level. This aligns with what is said in paragraph 27 of the Staff Report.

Paragraph of the Staff Report states:

***28. Upgrades to oversight and crisis resolution regimes would add to financial system resilience****. The FSAP has identified several areas in which structural upgrades would help, including to: (i) increase the weight of regulatory discipline relative to self and market discipline in New Zealand's three-pillar approach to bank regulation; (ii) foster even stronger home-host supervisory cooperation with APRA; (iii) adopt current reform plans to align the regulatory and supervisory framework for financial market infrastructures with international standards; (iv) broaden the regulatory perimeter for the asset management industry; and (v) enhance the credibility of the Open Bank Resolution (OBR) framework, including by higher de minimis exemptions from freezing and haircutting deposits under the OBR in lieu of the first-best solution of a deposit insurance.*

Again, I agree with the Report, except when it comes to OBR. To my mind OBR is unconscionable. It places the risk on to the party who is least able to manage it: (1) the overwhelming majority of customers are not aware of the policy; (2) the "disclosure pillar" that forms part of RBNZ's three pillar of discipline is a complete fiction – the overwhelming majority of customers are not aware that the bank publishes disclosure statements and its credit rating; if they were aware of it and could find it on a bank's website, they would find the 90 pages too long to read; if they read it they would find it too technical to understand; if they understood it and it disclosed a problem they would seek to switch banks, only all the large banks are homogenous so they would be most unlikely to avoid a risk posed by an externality; if they were able to switch and they told others who did likewise, it would become a run. Suffering a run is how banks fail. It is a fallacy to hold out disclosure as being a discipline that can be exercised by depositors.

I am not saying that banks should not be required to publish prescribed information. I think information is very useful. It is just shouldn't be treated as a discipline because it is not an effective risk mitigant. There is certainly a case for the FMA or the Commerce Commission, as centres of excellence, to pick up responsibility for producing guides to understanding ratings and how to identify risks and strategies for managing them.

**IMF's FSAP Technical Note – Contingency Planning and Crisis Management Framework (May 2017)**

The following recommendations (in italics) were made in IMF's Technical Note – Contingency Planning and Crisis Management:

*Reconsider the merits of deposit insurance, or in the continued absence of policy support, introduce a limited depositor preference to provide legal certainty for the de minimis exemption contemplated in OBR.*

I totally support the recommendation that deposit insurance be adopted. New Zealand is very much an outlier in not having deposit insurance. At the end of 2013 it was the only western country amongst the 47 countries who had not adopted deposit insurance. It is acknowledged by almost all commentators that pre-positioned deposit insurance is effective in stemming a run on a bank. RBNZ argue that deposit insurance encourages management to take greater risks. Coming from the regulator of insurers this is a somewhat contradictory assertion and one that would not be accepted by insurers. For instance, I have never heard it suggested that ACC promotes risk taking behaviour. Insurers take on risk on the basis that they can impose mitigating behaviours on the insured, that if not met will negate the cover, and they put a lot of effort into helping insureds mitigate risk. This is why intrusive supervision has to be a concomitant of deposit insurance.

*Revise the RBNZ Act to provide greater clarity and certainty in resolution:*
Agreed

*Insert objectives in resolution including protection of depositors and the public interest.*
Agreed

*Require accountability reporting against the resolution objectives in both the RBNZ Act and IPSA, and NBDT Act when revised as recommended above.*
Agreed

*Clarify that the RBNZ is the sole resolution authority.*
My preference is for there to be a separate resolution authority. I don't believe the RBNZ or any separate prudential supervisor would have the necessary wherewithal to manage the failure of a large bank. They would be totally out of their depth and experienced clear heads, familiar with banking operations, operational risks and representing the provider of any support funding are required.

*Insert an express requirement for Ministerial consent for resolutions with fiscal or systemic implications only.*
The Minister should also have a role in setting the regulatory framework.

*Clarify Treasury's role as a provider of advice to the Minister on the RBNZ recommendations regarding resolution.*
Treasury should be responsible for the Act, Regulations and other regulatory instruments.

*Provide express bail-in powers to the statutory manager*.
Not without court supervision. There needs to be a clear waterfall of claims. I propose: (1) costs of resolution; (3) depositors up to the insurance cap; (4) balance of depositor money, lenders and general creditors (it is their money and they should get as much of it back as soon as possible and it should not be used to resolved systemic issues – unless expressly sanction by Act of Parliament); (5) subordinated debt; (6) preference shares; (7) instruments that bail-in; (8) shareholders);

**Deposit Insurance**

An overwhelming majority of countries have deposit insurance for retail deposits. For example, Australia's Financial Claims Scheme (FCS) scheme provides for immediate access to account balances up to the cap of $250,000 per accountholder. The insurance cover is not pre-funded under FCS. Claims are met by the government from a pre-approved appropriation, which is shown as a contingent liability in the Commonwealth's financial statements. Access to insured deposits is available immediately. This provides certainty and transparency. Investors and depositors can deal with the bank with certainty as to their position. Any claims on the government are reimbursed by a super-priority on the winding up of the failed bank, supplemented by a right to levy all banks if there is a shortfall. This meets the Key Attributes requirements[14].

If NZ adopted the FCS model RBNZ's performance as prudential supervisor would be closely scrutinised by Treasury to minimise the risks of claims on the government purse. To avoid becoming accountable, RBNZ would have to adopt more intensive supervisory practices. This compares with RBNZ not being accountable to anyone at present.

Under an FCS type deposit insurance scheme, where the government is the insurer, one would expect the government's costs of borrowing to increase and the banks' to possibly reduce. Because the New Zealand banks borrow substantially more than the NZ government there could be a substantial efficiency gain for NZ Inc, if this is correct and banks flow any lower funding costs through to their customers.

**OBR**

There are many reasons why I don't like OBR. Here are the main ones. Because there are so many I have set some of them out in Appendix 3:

- OBR undermines confidence in banks and will lead to a run, possibly on all banks, in a crisis.
- No other country has pursued an OBR policy because deposit insurance schemes provide a more viable alternative. Deposit insurance is known to stem a run on a bank.
- It is not unfair to describe OBR as bullying[15] by RBNZ and Treasury. It passes the risk of losses on to the smaller retail depositors, who are in the weakest position to protect themselves. More sophisticated investors and large customers will get wind of trouble and will have pulled as much of their money out as they can before there is regulatory intervention. There are many examples of this. In fact, it can be this activity that finally tips a failing bank over the edge.

Conclusion – OBR is a sub-optimal solution (leaving to one-side that it cannot currently be invoked without amendments to the RBNZ Act and that it has negative implications for ratings purposes).

**Outsourcing Policy**

There are things about the revised BS11 Outsourcing Policy that are totally at odds with RBNZ's claim to be a light-touch regulator who is too under resourced to be an intensive supervisor and wants to remain that way. There cannot be a more intrusive/intensive outsourcing policy in the whole world than the revised BS11:

- The level of intrusion into supply arrangements that have nothing to do with the soundness or efficiency of the financial system, is hugely inefficient and should not be countenanced. I have calculated that it may be costing the bank $30,000 - $60,000 to process a single application for a non-objection to an outsourcing arrangement to or through a parent bank or to have something added to the White List of exempt arrangements. Across industry

[14] Although the IMF prefers an ex-ante funded scheme to ex post insurance schemes due to concerns about the insurer's ability to recoup following a crisis. I would argue that there is no certainty that a funded scheme will be sufficient and the government will have to top it up. A funded scheme comes with much higher overheads and investment risk. In the case of NZ, the fund would have to be invested in foreign sovereign debt, for example US Treasuries. This strikes me as being not a very efficient use of NZ funds

[15] Defined as - taking advantage of an imbalance of power to force one's will onto someone in a less powerful position.

there will be 100s with parent banks and 100s more eligible for the White List of exempt services and functions. Absolutely, no value is added by the processes mandated by RBNZ and delays caused to the bank finalising arrangements can be significant.

- Pre-positioning for abrupt separation to deliver a limited range of basic banking services to a diminishing pool of existing customers of deteriorating quality (as good customers will migrate to viable banks which can provide credit and other services) is a very expensive and very high-risk option. My estimate, is that the costs of establishing abrupt separation capability across the large Australian owned banks is likely to exceed $1 billion over 5 -years plus an increase in operational costs of $200M per year. This is without taking lost opportunity costs into account. There is minimal benefit in pre-positioning for an event so remote[16] as to require abrupt separation.
- The failed bank will not be in a position to supply meaningful amounts of credit. Any remaining viable bank would aggressively pursue "good" customers of the failed bank. Under current Payments NZ (NZ) protocols, banks are resourced so that accounts must be switched within 5 working days of a customer's request. Open Banking and the advancement in the use of APIs for payments should make full account portability in even shorter time frames a possibility. Account portability could be introduced up-front to stimulate competition between banks. Chances are with developments in Open Banking, account portability is likely to be mandated at some stage in the reasonably near future.

Conclusion – Outsourcing Policy does not pass the "sniff test" of being genuinely required for the soundness and efficiency of the NZ financial system. It creates a completely unnecessary and disruptive wedge between Australia and NZ. It has been made for a purpose not authorised under the RBNZ Act and RBNZ has taken irrelevant considerations into account. This makes it vulnerable to judicial review. Abrupt separation is never going to be used. The abrupt separation requirements under bS11 should be immediately discontinued.

**Other recommendations for the review**

Other areas that should be addressed are:

*Separation*: Prudential supervision has suffered very badly in all respects by being lumped in with monetary policy. It is clearly the poor cousin. It has been under resourced for a long time. The quality of RBNZ's work has suffered accordingly.

*Governance*: Prudential supervision should be governed by a board, with a majority of external representatives, to provide better alignment with the banking sector;

*Banking experience*: All senior management need to have had experience in Risk or Finance roles at a large bank, with the CEO/Director having experience at CRO or CFO level.

*Conditions of Registration*: The concept of banking standards, which are incorporated into conditions of registration, is fundamentally flawed. Under the RBNZ Act a failure to comply with a condition of registration is an offence for which a fine of up to $1,000,000[17] can be imposed. It is unacceptable

---

[16] Based on the ratings of the parents the failure of a parent is greater than 1 in 250 years and the likelihood of separation being required just because a parent failure is greater again. Also, if the purpose of abrupt separation is to protect the ability to invoke OBR and OBR is never going to be invoked, the benefit of abrupt separation must have a negative benefit of well over $1 billion. It should be discontinued with immediate effect.

[17] S156AB RBNZ Act

for the RBNZ to make conditions of registration with only limited consultation (7 days[18]) and against principles that it has a discretion to change without consultation[19]. This regime does not comply with the *Rule of Law*[20].

*Banking Standards*: Greater checks and balances need to be built into the making of banking standards. They should be made through regulations or other legislative instrument for which another agency is responsible (e.g. The Treasury). This would facilitate, greater transparency, better consultation, clearer drafting and regular review. Regulatory Impact Assessments must he issued with the initial draft of the standards (and not after the event).

*Culture and understanding of Administrative Law principles*: There is significant room for improvement in RBNZ's understanding of its own Act, what it does and does not permit RBNZ to do and the Administrative law principles that apply to consultation and exercise of powers. It is not acceptable for banks to believe that they cannot seek judicial review because of fear of inevitable reprisals from the regulator. This just leads to poor regulatory outcomes.

*OBR*: OBR needs to be rejected. It undermines confidence in New Zealand banks; is set to the wrong moral compass – it pushes the risk from those who are best equipped to manage it (in terms of information and resource) on to those who are least able (i.e. they are likely to be completely unaware that under OBR their money is actually safer under their mattress than in a bank). In any event the RBNZ Act needs to be amended to make the operation of many aspects of OBR lawful. OBR clearly provides an incentive to depositors to run before the appointment of a statutory manager.

*Crisis Management*: The design of the crisis management regime in the RBNZ Act is badly out of date. It needs a thorough review in light if the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions and other international developments. It is essential that this work be closely aligned with forth coming developments in APRA's approach to crisis management. Crisis management regimes need to be developed in detail and kept up to date, well in advance of any crisis. At the moment, we have a Memorandum of Cooperation (2010) between the New Zealand and Australian authorities, which has bones but no flesh. I favour a dedicated Resolution Authority on which all key stakeholders are represented. I don't believe any single agency would have the necessary wherewithal to cope.

*Bail-in instruments*: Bail-in debt instruments (which expressly convert to shares or where the debt is written off – even if forgiveness of debt has potential tax implications) are accepted globally as having a place in capital structures and provide certainty to investors who are made aware of, and accept, the risk at the outset. These instruments have the potential to diversify the sources of capital. There is no reason why they should not be recognised as having a place in the resolution waterfall.

*Recovery Planning*: Emphasis has been put on resolution planning but having comprehensive recovery plans would be more useful.

---

[18] S74(3)(a) RBNZ Act

[19] S75 RBNZ Act

[20] The rule of law is the principle that law should govern a nation, as opposed to being governed by decisions of individual government officials. It primarily refers to the influence and authority of law within society, particularly as a constraint upon behaviour, including behaviour of government officials. It includes concepts that the law is known (i.e. it must be clear, certain and capable of being known) and must be observed by all (government and citizens).

**Appendix 1**

**Analysis of a failure of an AA- bank**

Set out below is my analysis of how the failure of a AA- rated bank would play out. It has been reviewed by more than one "second pair of eyes".

*Analysis* **–** *Failure*

The starting point is the bank's Contingent Funding Plan (CFP) which is approved annually by RBNZ. The CFP assumes that as times get tighter and tighter the bank's sources of funding shrinks until it is dependent just on its Registered Mortgage Backed Securities (RMBS) facility, provided by RBNZ, under which the bank assigns to the RMBS trustee good mortgage backed loans, in order for RBNZ to provide the bank with liquidity.

As long as the bank's doors are open it is obliged to meet all withdrawal instructions. Withdrawal instructions must take priority over providing credit. The bank's ability to provide credit slows, eventually to a standstill. It then becomes necessary to stop the outflow because it is not sustainable. This is done by appointing a statutory manager.

Once a bank is unable to provide credit, customers will start to switch to banks that can. Under PNZ protocols they are able to do this within 5 working days. This will become shorter under Open Banking[21] and with increased us of payment APIs etc. Withdrawals must be met in priority to providing credit. The bank has no power to refuse to meet withdrawal instructions if it has funds available. Customers are paid out in the order instructions are received. Smart money moves first and in large amounts. Customers are still able to switch banks in statutory management – they are just not able to transfer any frozen balances.

At some stage (probably very quickly) the withdrawals (commonly known as a run) cannot be met. At this stage, if it hasn't happened already, a statutory manager must be appointed to stop the run. No one else can do this, including RBNZ.

Once appointed a statutory manager has power to stop withdrawals. Only a statutory manager has this power under the RBNZ Act.

Once in statutory management, a bank is rated "D" for untouchable. Only RBNZ or the Crown will be prepared to fund it. But remember the Crown has already refused to bail the bank out, so funding from the Crown post-the appointment of a statutory management is not going to happen, except for acute liquidity needs. A statutory manager is able to discriminate amongst customers for this purpose.

The statutory manager will use his/her powers to steady the ship. However, customers will be rapidly switching banks (see above) so they can have access to payment systems and obtain credit. There will only be limited deposits received from customers (and these will rapidly diminish). The bank is not a trust, so any resulting assets (from the deposits) go into the "pot" for all creditors (frozen and unfrozen, equally.

Statutory management does not stop the accumulation of losses – i.e. the longer statutory management runs for, the greater the losses are likely to be. Therefore, the RBNZ Act requires the statutory manager to resolve the bank as quickly as possible.  Large creditors will be using all their

[21] Not to be confused with Open Bank Resolution.

legal rights and influence (e.g. turning off the funding tap to other banks and the NZ government) to ensure this is done.

Under the RBNZ Act the statutory manager does not have power to restructure the failed legal entity (e.g. it has no rights to bail-in existing debt, cancel shares or issue new ones). If the statutory manager wants, he/she can incorporate a new company and transfer assets and liabilities from the failed bank to the new entity. Only good assets would be transferred. The liabilities transferred will be positive account balances. Funding would not be transferred because those facilities will be in default. This is known as good bank/bad bank solution.

It is not clear who would be the shareholder in any new entity or how it would be funded. There is no commercial imperative for any of the other banks to acquire it, as they can cherry pick the bankable customers through switching, without capital outlay just by leveraging off their existing infrastructure and using the PNZ protocols. Kiwibank is not a potential purchaser because it would result in an increased contingent liability on the Crown under its implicit support, which is exactly what the government is seeking to avoid.

The customers at the top end of town are often multi-banked and their needs would probably be met by the branches of the other Australian banks and the niche international banks like HSBC and Citi. Most retail customers are multi-banked, in that they have credit cards with more than one bank. Many also have existing accounts with more than one bank.

What the Australian owned banks bring to the table is their ability to access offshore funding in sufficient amounts and on favourable terms by virtue of their AA- ratings, so that NZers can enjoy a lifestyle above the level of domestic savings. They can do this because they get a 3-notch uplift in their ratings from the rating agencies (because the agencies assume implicit support from the strong Australian parent and the New Zealand government). Unless the new entity has a shareholder, who is rated AA- or greater (such as the New Zealand government), it will not be able to raise funds offshore in the way the Australian owned banks can do today. The other large banks have no reason to acquire the new entity (because they already have the infrastructure in place) and the government has effectively ruled itself out. It is unlikely that an offshore bank with an AA rating would be interested in entering an overcrowded New Zealand retail banking market, when it would be at a distinct disadvantage to the incumbents.

The new entity would only be able to fund itself from its (inferior) customer base. After reviewing the way in which the agencies assess the rating of the Australian owned banks and Kiwibank, I calculate the new entity would be rated BBB- or BB+ before factoring in the inferior quality of the new entity's asset base and the deterioration in economic circumstances generally that would be associated with the crisis. This would be lower than the ratings of any retail bank currently operating in New Zealand. This would be reflected in its funding costs and lending rates – i.e. it would not contribute to competition in the market.

On the basis of the above, I cannot see any statutory manage going through resolution just to achieve this outcome. There would be no economic benefit in doing so.

If contrary to my very strong submission that the abrupt separation requirement under BS11 be discontinued, I recommend that any solutions that are positioned for implementation on or post-separation be assessed as "fit for purpose" against this scenario.

*Analysis – Ability to provide credit*

The large NZ banks play a critical role in the provision of credit. For example, employers may rely on credit to meet payroll and pay their suppliers, and individuals rely on credit to buy houses, cars or in some cases, just to meet their costs of daily living.

For the reasons given in the section on *Ratings and Funding* below, a bank in OBR/separation will not be able to fund the ongoing provision of credit to its existing customers in a sustainable way.

Good bankable customers will be enticed away by viable banks with credit to offer. This could apply to both the liabilities side in respect on unfrozen money and the asset side if a customer wanted to refinance, top -up or obtain a new loan. Customer migration is likely to be encouraged as it downsizes the size of the problem that statutory manager has to deal with and the government's exposure under the Crown guarantee.

Once in statutory management the failed bank will be rated D, and no one (except RBNZ and the Crown) will be prepared to lend to it. The CFP assumes that the government would have to borrow in order to on-lend to bank, as it would be very difficult to find borrowers prepared to lend to BNZ directly even with a Crown guarantee.[22] Without a Crown guarantee, depositors would stop making deposits. Without deposits and wholesale funding BNZ would not be able to provide credit to its customers and any liquidity would be applied towards meeting withdrawal instructions in a priority to be determined by the statutory manager, subject to the rider that on the finalisation of resolution, the preference and priority of creditors must not be altered.

In order to obtain credit, customers would switch banks to one that can provide it. Under protocols agreed to by the banks under the auspices of PNZ, switching requests must be met within 5 working days. This timeframe is likely to become shorter with the introduction of payment APIs and Open Banking (not to be confused with OBR).

Once under statutory management, a bank would:

- have a shrinking asset book, which would be deteriorating in quality due to good loans being assigned to RMBS (leaving the remaining portfolio containing a greater proportion of poor quality loans) and the high probability that its failure would be part of a major deterioration in general economic conditions;
- have a rapidly shrinking customer base as existing customers switch to banks that can provide credit. These are likely to be the most "bankable" customers and it can be anticipated that remaining viable banks will be marketing very aggressively to them. This leads to further deterioration in the size and quality of the bank's customer base.

This shrinkage and deterioration takes place within days and without any actions by the statutory manger and will have major impact the options the statutory manager is able to pursue.

Any surviving banks would face a significant increase in demand for credit, which they may not be able to fulfil because following a failure of a large NZ bank it would be much more difficult to obtain offshore funding as the offshore institutions are likely to set lower limits for their exposures to individual NZ banks and a lower overall country limit for NZ.

In this situation, credit may become rationed, interest rates could be bid up because demand exceeds supply and economic activity would reduce, resulting in increased unemployment, lower tax

[22] Question, why would the government support a bank post-failure when the cost of the support the government refused to give pre-failure would have been much less?

take and lower government expenditure (unless the government could replace the lower tax take with offshore borrowing, which might be difficult because of the lower tax take and lenders' reducing their country limits on NZ).

*Analysis - resolution*

Under the RBNZ Act (as it currently stands) there are no provisions which enable the bank, to be restructured as the same legal entity, to be restructured by the statutory manager into a solvent legal entity. The Act anticipates that resolution will take place by selling off assets and transferring liabilities, probably to a new legal entity established by the statutory manager or by liquidation. It is not clear who would own this new entity or fund it.

A1.2(b) of BS11 requires that an outsourcing arrangement *must not compromise the bank's ability to – facilitate the carrying on of basic banking services by any new owner of all or part of the bank*. It is likely that RBNZ had in mind a "new owner" established by a statutory manager. And, although A1.2(b) only refers to objectives referred to in as being in relation to "outsourcing arrangements", RBNZ probably intended that the objectives apply to separation plans as well.

A reasonable scenario on which a bank's separation plan can be based, is that it contemplates the statutory manager selling assets and transferring liabilities to a new entity established by the statutory manager. It can be assumed that this entity will not be owned by the Crown or have the benefit of any express or implicit government guarantee[23]. The new entity will have a much smaller customer base (for the reasons outlined above), which will comprise assets of lesser quality (as competitors will have cherry picked the best customers and good loans will have been assigned to the RMBS).

Therefore, the credit rating of the new entity is likely to be based on:

- the 3-notch uplift, to the AA-rating the agencies give to the Australian owned banks based on assumptions of implicit support by a strong parent and the government, being withdrawn by the rating agencies; and
- the 1-notch downgrade from A+ to A the agencies applied to Kiwibank when the express guarantee by NZ Post was cancelled on the partial sell down of Kiwibank to ACC and the New Zealand Superannuation Scheme, after factoring in a 3-notch uplift attributable to assumptions by the agencies of strong implicit support from the NZ government because of the identity of the ownership of Kiwibank (i.e.NZ Post, ACC and the New Zealand Superannuation Scheme).

An AA – rating is an essential pre-requisite to a New Zealand bank being able to obtain offshore funding in sufficient amounts and on reasonable terms. To have an AA- rating, the new entity would need to be owned by an entity which is rated at least AA, such as another Australian bank with a AA-rating (if any remained), or direct ownership or a full unconditional guarantee by the NZ government (which is highly unlikely) which has an AA rating. It is probable (on the assumptions above) that the new entity would be rated BBB- or BB+, before factoring in the deterioration in the size and quality of its customers and any general deterioration in the NZ economy.

With a rating of BBB- or lower the new entity would not be able to access overseas funding and, therefore would not be able to grow its customer base. BBB- would be lower than the current ratings for TSB, Coop and SBS. The new entity would have limited ability to source funding for

[23] On the basis that if the government is prepared to provide support, it would have done so before the point of failure rather than afterwards, as the cost of support post-failure will be considerably greater.

providing credit accordingly. It could not bank the "top end of town". In theory, its borrowing costs and therefore its lending costs should be the highest in the market. It is unlikely that an additional bank with such a low rating would serve any useful purpose at the overbanked retail end of the market. As such it would not provide any competition or other economic value to the market. Therefore, it is improbable that any serious effort would be into resolving a failed bank by having it morph into a new entity.

*Analysis – Ratings and Funding*

The NZ economy (i.e. the lifestyles of NZers) is supported by offshore borrowing in order to fill the gap for the demand for credit and domestic savings. The offshore borrowing to support this lifestyle can only be accessed in the required amounts by the Large NZ banks with AA- ratings.

The 4 Large Australian owned banks get a 3-notch upgrade from BBB to AA- from the rating agencies because the agencies assume implicit strong parent and New Zealand government support. Once it becomes clear to the agencies that they can't rely on these assumptions, the agencies will have to downgrade the NZ banks to BBB. Although, I am not sure the same tipping point applies to both; (1) the ability to make an assumption in respect of implicit government support; and (2) the ability to make an assumption in respect of implicit parent support. In other words, the assumption in respect of implicit government support may have a different threshold for becoming unreliable than the assumption as to implicit parent support does.

Once a bank is downgraded to BBB, it cannot readily access overseas funds.

It is possible that a downgrade could happen when the agencies become aware of the work RBNZ is requiring the banks to do pre-position for separation or the government introduces the legislation that is necessary to make OBR lawful. Logically, the higher the credibility of the policies being activated becomes, the less able the agencies are able to rely on their assumptions.
Legal advice from a major law firm is that a rating downgrade is an event of default under a bank's wholesale funding instruments.

The advice also confirms that a downgrade would also be an event of default under LCH rules leading to close out of a bank's cleared derivatives and loss of membership of LCH. Close out is also likely to happen well within 20 days under ISDAs and other derivatives. This would result in it the bank's FX funding becoming unhedged and exposing it to the risk of heavy FX losses in a market where the NZD would be collapsing, if it couldn't re-hedge bilaterally with RBNZ or the Crown.

The 4 large NZ Australian owned banks are almost mirror images of each other – i.e. they are largely homogenous, with the same dependency for access to overseas markets for funding, based on assumptions of implicit strong parental and New Zealand government support and have similar asset portfolios. This concentration risk creates a systemic issue. A rating downgrade applied to one bank is highly likely to result in a downgrade being applied to all the Australian owned banks simultaneously. Resulting in NZ Inc having minimal access to offshore funding. In other words, is RBNZ unknowingly creating a credit crisis for NZ just by virtue of taking actions that can be seen as firming up the possibility that its OBR and separation policies?

Conclusion (1)– OBR and abrupt separation policies under BS11 may create a risk of New Zealand being excluded from offshore funding markets by their mere existence if they are given any credibility by RBNZ or the Government. A crisis would certainly eventuate if the policies were ever invoked in anger.

Conclusion (2) – the NZ banks are large enough in proportion to their respective parents' balance sheets to pose a threat to their parent's viability if the NZ bank fails. Perversely, a downgrade of a New Zealand bank may result in a rating downgrade of the parent.

Conclusion (3) – Just by firming up these policies to give them credibility RBNZ may be undermining the ratings of all the large Australian banks.

Conclusion (4) – allowing a large AA- rated NZ bank to fail on the speculation that under resolution it will rise like a phoenix from its ashes to its former glory is a forlorn hope. The best it can hope for is a BBB- rating. Even if it comes under government ownership it will only be rated A (the same as Kiwibank). As such it will not be able to source offshore funding as it previously could as AA- bank. As a result, there will be a shortage of credit and the cost of credit will rise.

Conclusion (5) - we may have a 'house of cards" affecting both New Zealand and Australia that RBNZ are about to topple over.

Determining the economic impact on the availability of credit in New Zealand if an AA- bank is no longer able to provide it or the contagion effect, is beyond my skills. The rating agencies would need to adjust the ratings of any surviving Australian owned banks if the uplift assumptions enabling the AA- rating can no longer be relied on. This adjustment would, in turn, impact the parents' ratings. I would imagine the ratings of both countries would be impacted, with resulting reduction in Country limits and increase in interest rates.

*Analysis - Liquidity*

if the above scenario plays out and offshore funding dries up, the amount of liquidity the large banks could provide would be substantially reduced. This would result in a significant reduction in economic activity.

RBNZ is a lender of last resort for the large NZ banks. This is accessed through the banks' respective RMBS facilities. Would RBNZ have the wherewithal to provide liquidity to all 4 large banks concurrently in order to keep the economy ticking over for a sustained period of time or would credit have to be rationed (see below) with a resulting downturn in economic activity?

It would appear that under OBR, a Crown wholesale guarantee would be required to restore access to offshore markets.

The above situation would play out in anger if the appointment of a statutory manager/separation took place.

Conclusion – just having a requirement for abrupt separation as a policy (and justifying on the basis that it is necessary to protect the running of OBR) and giving credibility to OBR by seeking to enact the required amendments to the RBNZ Act, could result in a shortfall of liquidity and credit in the system, possibly to the significant detriment of the NZ economy.

*Analysis – Access to Payments systems*

A large proportion of deposits are of short duration (under 12 months) and most accounts have small balances. It is likely that these accounts represent stored value which is waiting to be used in the Payments systems.

Accountholders need prompt access to their on demand or short term account balances, otherwise their lives and economic activity will be severely disrupted.

RBNZ and Treasury are promoting OBR as a means of providing access to at least part of customers' account balances. This can be equally achieved through deposit insurance.

*Analysis – Impact on people*

It is the impact of a banking or financial crisis on individual people that is the most important thing:

- The proposed level of de minimis ($10,000) under OBR is extremely low by comparison with deposit insurance caps in the rest of the world and would provide very little comfort.[24] It would not protect people's Kiwisaver, pay-rolls, savings for first homes etc.
- Without access to their frozen funds and credit, living standards would drop.
- Unemployment would increase, with resulting increase in social welfare spend.
- People would suffer from stress. Their health and relationships would be affected.
- Mental health would become a major concern. There would be an increase in suicides and attempted suicides, particularly in rural areas which already suffer from a disproportionately high successful suicide rates.
- Safety and security become a major concern. Banks know that a proportion of their customers cannot handle financial stress and resort to violence or threats of violence.[25] There is potential for uncontrolled mob behaviour in widespread locations across NZ. A very large number of NZers have access to weapons.[26] I would have grave concerns for the safety of bank personnel and the security of bank premises, also that of any Ministers and RBNZ officials involved.

- [24] . I found very little comfort in RBNZ's claim as to the proportion of accounts it would cover. If correct it shows that NZers are poor, have spread their risk across multiple banks or have already gone to storing cash under the mattress (which might explain the ramp up in the number of $50 and $100 notes that have been issued since the GFC despite a very significant rise in electronic transactions).

[25] For instance, a former BNZ CEO was forced to go into hiding in a secure guarded location for 6 months because of threats of violence from a disaffected farming customer.

[26] Last year I heard that according to official records there were over 1.3 million weapons (including 13,000 fully automatic military style weapons) in NZ. This compares to approximately 4,400 regular soldiers, 2000 territorials and 9000 police, of whom 25% can be expected to be directly impacted if OBR is invoked in respect of any one of the Large Banks.

**Appendix 2**

**Economic Relationship between Australia and New Zealand according to the Australian Department of Foreign Affairs and Trade**

**Bilateral economic and trade relationship**

The economic and trade relationship between Australia and New Zealand is shaped by the Australia New Zealand Closer Economic Relations Trade Agreement (CER or ANZCERTA), which came into effect on 1 January 1983. ANZCERTA is one of the world's most open and successful free trade agreements. Two-way trans-Tasman merchandise trade has increased at an average annual rate of around eight per cent following its adoption. New Zealand is Australia's sixth largest goods trading partner, ninth largest source of foreign investment and third most important destination for Australian investment abroad. For detailed information on ANZCERTA see About ANZCERTA. For information on Rules of Origin under ANZCERTA, see CER Article 3 – Rule of Origin.

In 2016, trans-Tasman goods and services trade was valued at around $24.8 billion. Australian merchandise exports to New Zealand totaled $8.7billion, while merchandise imports from New Zealand totaled $7.6 billion. Two-way trade in services amounted to $8.5 billion in 2016.

In the year up to March 2017 Australia was New Zealand's number one overall trade partner, its largest destination for total exports as well as most important services trading partner.  China was New Zealand's largest goods trading partner both as a destination for exports and source of imports.  The EU was New Zealand's number one overall import source.

In 2016 Australia's total investment in New Zealand was $106.9 billion; while New Zealand's total investment in Australia was $46.2 billion. Australia is the largest foreign investor in New Zealand, with over half of the stock of Australia's total investment in FDI ($66.6billion in 2016), reflecting the high level of economic integration. Australian investment in New Zealand includes the banking, insurance, building, infrastructure, telecoms, energy and retail sectors.

## Appendix 3

## Some additional reasons I don't like OBR

OBR doesn't resolve the failed bank. Frozen balances/obligations remain senior unsecured debt which remains extant on the bank's balance sheet, ranking equally on a winding with the unfrozen guaranteed balances. There is no mechanism for writing these frozen obligations off under the RBNZ Act short of transferring them to a new bank established by the statutory manager or on liquidation of the failed bank. I am not sure of the accounting treatment. Is it necessary to create an entry in the P & L for the estimated loss or does it sit in the notes as a contingent provision?

Even if OBR was authorised by legislation so that the estimated loss was bailed-in instead of freezing it, this would not restore the bank's 3-notch uplift to the AA-rating. which is necessary to access offshore funding. Without the implicit support of a strong parent it would be rated only BBB at best (i.e. it would have no credible prospect of being anything more than a big TSB) or A if it had implicit government support through ownership.

There is an old saying about "Markets abhor uncertainty". RBNZ's approach of having OBR and separation as tools in its tool kit sounds all very well and good but it actually creates uncertainty, as there is no pre-determination of the circumstances in which they might be used. This makes it hard for offshore lenders to get their heads around the risks of lending to NZ banks. This is likely to reflect in the extra effort being required by NZ banks to attract offshore investors and add to the country's risk premium.

In theory OBR should have reduced the government's borrowing costs and increased the costs to the banks. This did not happen because the ratings agencies have discounted the risk of OBR being invoked on the assumption that the electoral consequences of invoking OBR are so great, it can be assumed that no Minister of Finance would ever allow it to be invoked. This assumption should apply equally to the willingness of a government to pass the legislation necessary to make OBR workable.

As OBR is just a RBNZ policy and was not envisaged by the drafters of the Act. The RBNZ Act does not cover who can invoke it or stop it being invoked. On my reading of the RBNZ Act, it is the statutory manager who can invoke OBR, probably at the direction of the RBNZ. However, the statutory manager would probably need to seek directions from the Court to ascertain whether invoking OBR is within the powers of a statutory manager under the RBNZ Act. For the record, I don't believe it is. Uncertainty is a very bad thing in a crisis regime, as it creates opportunity for delay and leads to decisions being challenged in Court.

OBR is just a RBNZ policy that depends on ignoring requirements that are in the RBNZ Act and doing things that are not catered for in the Act or relying on very tenuous interpretations of certain provisions of the Act. RBNZ is just a bank regulator. It cannot alter the rights of bank creditors. Under the surviving parts of Magna Carta (1225) which are part of New Zealand's constitutional law, only Parliament and the Courts can alter creditor rights or dispossess people of their personal property (which is what OBR effectively does when it effectively extends the time to resolve the failed banks so there is a longer time for losses to accumulate and the statutory manager focusses on resolving the bank within the estimated losses so the government is not called on under the Crown guarantee, rather than for maximum value for the benefit of creditors).

Under the law, creditors of the same class rank equally. All bank senior unsecured creditors form a single class and need to be treated equally. However, OBR purports to treat some of those creditors differently from others. This is unlawful. This is one of the reasons why amending legislation is required to make OBR workable.

Not having certainty in the RBNZ Act is asking for trouble in an actual crisis. Large bank failures are usually very litigious affairs, as deep pocket creditors will litigate on any possible argument to get their money back as soon as they can. They generally prefer the certainty of being paid out than being locked into an arrangement that defers payment on the speculation of a greater return. Litigation invariably frustrates timely resolution and funds that would otherwise be available to pay creditors are dissipated in the statutory manger's fee and legal costs.

The assumption used by the rating agencies that no Minister of Finance would approve the invoking of OBR because of the inevitable electoral consequences applies equally to the passing of any amending legislation to authorise a haircut being applied to customer accounts. No government is going to commit electoral suicide by attempting to pass such legislation. Amending legislation was drafted in 2012. Every Statement of Intent by RBNZ since has referred to its intention to amend the RBNZ Act to enable OBR. It did not happen under the National government. RBNZ's briefing to the incoming Minister of Finance (October 2017) states that Treasury and RBNZ will seek a final decision on legislation required to introduce OBR, which they euphemistically refer to as "depositor protection and crisis management". It contains the view that 80% of account holders have balances that would be protected by a de minimis of $10,000 per accountholder. However, RBNZ say in the Briefing - "*it is expected that public reaction [to OBR] would be driven by wealthier depositors who tend to hold large bank deposits, and would prefer the introduction of full scale deposit insurance as it has the potential to deliver much higher coverage limits*. By "wealthier depositors" it is assumed that RBNZ is referring to customers with larger balances, such as those saving for their first home, retired people who have their retirement savings with the bank because it is "safe" and, indirectly, peoples' Kiwisaver which is invested "conservatively" in bank deposits, as well as farmers and businesses who may have suffered the misfortune of making some money and lacked the wisdom to spend it quickly on things like stock or payroll.

The Labour party has a record of preferring deposit insurance over OBR, which goes back to 2013. The Greens wanted deposit insurance to be part of their2017 coalition deal (they had Treasury do costings). NZ First has a track record of supporting deposit insurance, which also goes back to 2013. Therefore, it is reasonably certain that OBR will not see the light of day under the current government.

Conclusion (1) – it is reasonably certain that OBR is dead.

Conclusion (2) - if OBR is dead, and the benefit of abrupt separation under Outsourcing Policy, claimed by RBNZ, is to protect the benefit of being able to run OBR, it follows that there is benefit to be had by retaining the requirement under BS 11 for a large bank to be able to separate abruptly in order to run OBR.