The Treasury

Reserve Bank Act Review Phase 2 Second Consultation Information Release

July 2019

This document has been proactively released by the Review of the Reserve Bank Act Team on the Treasury website at:

https://treasury.govt.nz/publications/information-release/reserve-bank-act-review-phase-2-proactive-release

Information Withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act).

Where this is the case, the relevant sections of the Act that would apply have been identified.

Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[2] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

Copyright and Licensing

Accessibility

The Treasury can provide an alternate HTML version of this material if requested. Please cite this document's title or PDF file name when you email a request to information@treasury.govt.nz.

Reference: T2019/436 File No: MC-1-7-3-1-16

Date: 21 February 2019

To: Minister of Finance
(Hon Grant Robertson)

Deadline: None

Aide Memoire: Deposit insurance and the Reserve Bank's capital proposals

This aide memoire provides you with a primer on the relationship between deposit insurance, regulatory capital requirements, and the wider tools of the banking regime. The primer has been prepared in response to your meeting with the Reserve Bank Act Review Team on Monday 18 February, which discussed the Team's advice on in-principle Phase 2 decisions (T2019/80 refers).

At that meeting, you asked the Team to advance the connections between deposit insurance and the Reserve Bank's proposals to strengthen capital requirements for New Zealand banks. The primer situates and explains, at a high-level, the role for deposit insurance within the wider banking system architecture. It has a particular focus on the interaction between deposit insurance and bank capital. If you wish, the Review Team would be happy to discuss with you in more detail the information presented in the primer.

You may choose to share this primer with your Associate Ministers of Finance ahead of their upcoming meeting with the Review Team on Monday 25 February.

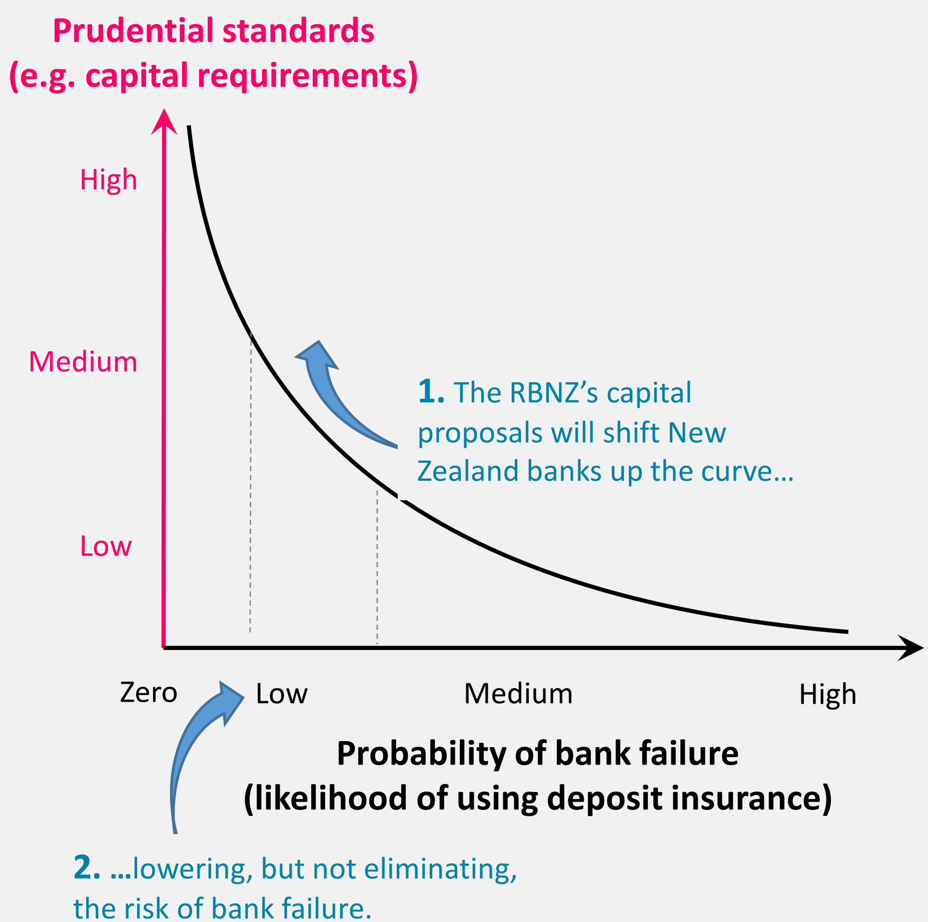
Bronwyn Kenna, Senior Analyst, Reserve Bank Act Review, [1]
Bernard Hodgetts, Director, Reserve Bank Act Review, [1]

Tighter prudential regulation reduces, but doesn't eliminate, the risk of bank failure

As capital and liquidity standards tighten and supervisory intensity increases….

…the probability of a bank failure goes down (but is not eliminated) …

…and the probability that depositors will face losses is reduced (but not eliminated).



Stricter prudential standards (like capital requirements) can reduce the *chance* of a bank failure, which also reduces the likelihood that deposit insurance will have to be used. But even if the risk of bank failure is low, it is never zero: banks must be able to fail in an efficient and dynamic financial system. Government will always face a hard choice when a bank fails: whether to allow depositors to face losses, or whether to intervene to protect them.

A deposit insurance scheme makes that decision easier, by setting out, upfront, a transparent framework for how depositors will be compensated (and where that compensation should come from – for example, an insurance fund built on industry levies), rather than relying on ad hoc decisions and taxpayer-funded interventions with each failure.

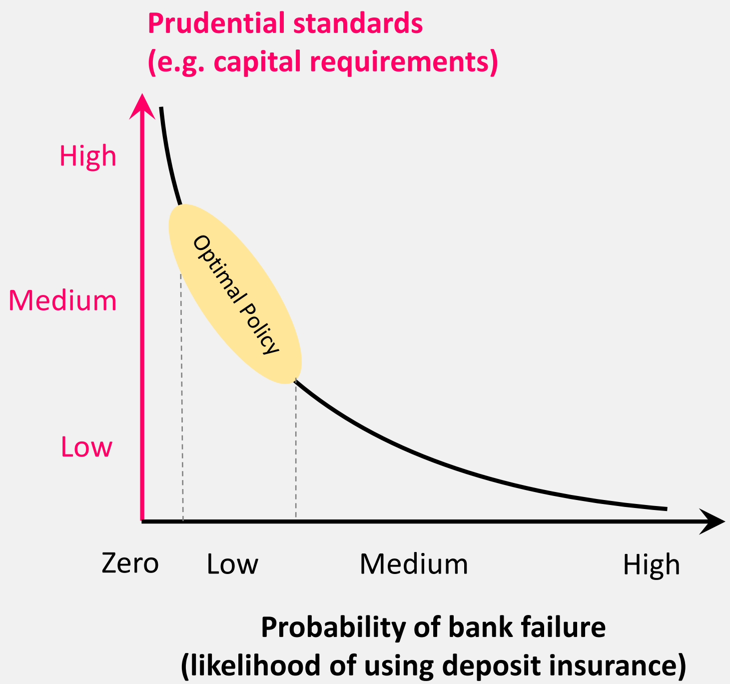
Tighter prudential regulation reduces the cost of deposit insurance

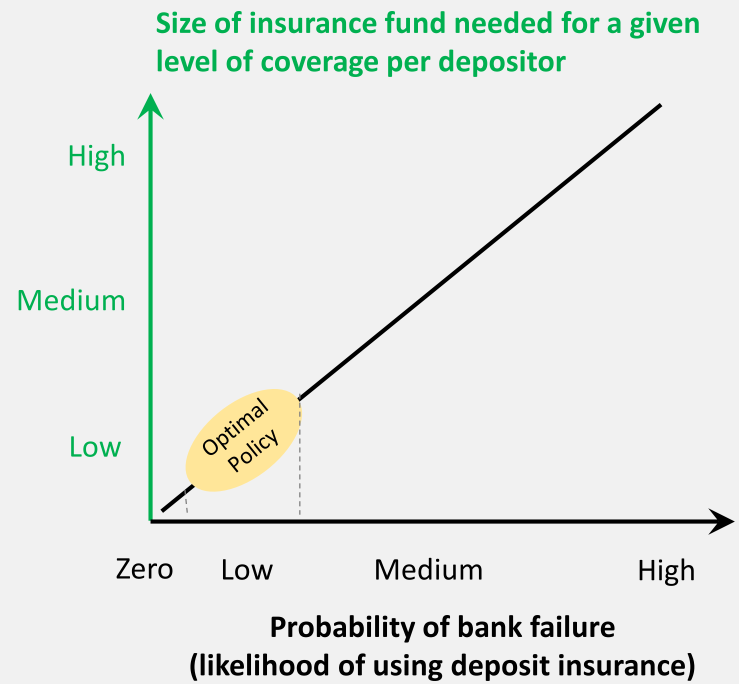
As capital and liquidity standards tighten and supervisory intensity increases….

…the probability of a bank failure goes down…

… which reduces the chance that deposit insurance will have to be used…

…which, other things equal, reduces the size of the deposit insurance fund needed to provide a given level of insurance per depositor





Stricter prudential standards (like capital requirements) can reduce the costs of providing deposit insurance. This is because tighter prudential standards lower the chance of bank failure, and reduce potential losses facing depositors. These effects work together to lower the expected costs of running an insurance scheme – because the scheme won't have to pay out as often, and when it does it will be more likely to recover its costs from the failed bank. This means if prudential standards are stricter, you need a smaller insurance fund for a given level of insurance cover. Other things equal, the higher prudential standards are, the cheaper it becomes to build and maintain a deposit insurance scheme.

Where does depositor protection sit in the financial safety net?

Banks, like all firms, can fail. The financial safety net exists to reduce the economic and social costs of bank failures. Without deposit insurance in the net, it is harder for Ministers to deal with a failure without putting public funds at risk.

"Each part of the safety net is designed to achieve different objectives. If a country has well-developed mechanisms in only some but not all parts of the safety net, it is still likely to face difficulties in finding effective solutions for preventing or resolving problems in its banking system." **- Basel's Financial Stability Board**

	Crisis prevention tools			Crisis management tools	
TOOL	**Prudential regulations**	**Supervision & monitoring**	**Liquidity provision**	**Deposit insurance**	**Recovery & resolution**
PURPOSE	Lays the foundations for a resilient financial sector that can weather shocks	Incentivises compliance with prudential regulations and helps identify and manage risks proactively	Safeguards the payments system and provides liquidity to the financial system	Enhances depositors' personal resilience to financial shocks and supports public confidence in financial services	When financial shocks can't be absorbed by a bank's own capital, supports orderly wind-down and limits wider fallout
Role in reducing the chance of bank failure	Strong risk management, culture & conduct, capital, liquidity, and disclosure requirements increases the banks' resilience.			Pre-planned insurance can use good design features to encourage risk-monitoring	Credible resolution tools can support investors' incentives to monitor their banks
Role in restoring a distressed bank to stability	Close and continuous monitoring can detect and resolve emerging problems at banks early, before it leads to failure.		Can relieve tensions in core funding markets and stabilise market confidence.	Can help to reduce depositors' incentives to run	Recovery actions can restore a distressed bank to viability
Role in reducing the adverse effects from a bank failure	Strong prudential regulation and effective supervision makes other banks more resilient to contagion from a failing bank.		Liquidity provision can help to protect other banks from contagion	Can protect banks customers, markets, and the general public from the risk of disorderly failure. Insurance can make the closure of small banks easier, support the resolution of large banks, and lend confidence to depositors at surviving banks.	