The Treasury

Reserve Bank Act Review Phase 2 Submission Information Release

October 2019

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TE TAI ŌHANGA
THE TREASURY

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

SAFEGUARDING THE FUTURE OF OUR FINANCIAL SYSTEM

Submission form for consultation document 2A

The role of the Reserve Bank and how it should be governed

To have your say on these important issues, please answer the questions below and send this form by email to rbnzactreview@treasury.govt.nz by 5pm on 16 August.

To get more information on these topics and the wider Reserve Bank Act Review, see the full consultation document at treasury.govt.nz/rbnz-act-review.

Chapter 1

Should prudential regulation remain with the Reserve Bank?

No follow-up questions for Chapter one.
Please use "any other comments" section to provide feedback in this section.

Chapter 2

What financial policy objectives should the Reserve Bank have?

2.A What other objectives should the Reserve Bank have?

- Which of the objectives discussed in Chapter 2 should feature in the Reserve Bank Act, and why?
- Are there any other objectives not covered in Chapter 2 that should be considered?

2.B Should the Reserve Bank be given a more explicit climate change objective? If so, what would be your preferred mechanism for achieving this?

2.C Where in the legislative hierarchy should any additional objectives sit – as 'secondary objectives', or as 'considerations' that the Reserve Bank must look at?

2.D How should the Reserve Bank's objectives be specified? Do you see a role for a 'financial policy remit'? If so, what should it include?

2.E What is your view on creating a new 'Deposit Takers Act' that combines material from the NBDT Act with the Reserve Bank Act's banking regulation material?

2.F Looking at the example of the Reserve Bank's objective set, which elements do you support and which would you change, and why?

Click or tap here to enter your answer. Text box expands as you type

Chapter 3

How should the Reserve Bank be governed?

3.A What factors are most important for achieving the establishment of an effective governance board with responsibility for all the Reserve Bank's decisions outside of monetary policy?

3.B What is the appropriate degree of delegation from the board to the Governor? Are there any decisions that should be reserved for the board?

3.C What approach should the Treasury adopt in monitoring the Reserve Bank? What should the Treasury's monitoring responsibilities be? Should the Treasury's monitoring responsibilities be different for the MPC?

3.D Do you think there is merit in reclassifying the Reserve Bank as an independent Crown entity?

3.E For the new governance board:

- what should the split of executive and non-executive members be?
- what skills and expertise should non-executive members have? Is there merit in having representation from the FMA and/or the Treasury?
- how should members be appointed and removed? Should the board be able to appoint the Governor as CEO?

3.F Are there any aspects of the board's operation would benefit from legislative clarity or guidance?

Click or tap here to enter your answer. Text box expands as you type

Chapter 4

How should the regulatory perimeter be set?

4.A What is the appropriate definition of 'deposit taker'? Do you agree that the definition should be framed around entities that take retail 'deposits' and lend? If not, what approach do you consider would be preferable?"

4.B Should the Reserve Bank's ability to monitor non-licensed entities be enhanced, for example through increased data reporting requirements? What do you consider would be the costs and benefits of such an approach?

4.C Should the Reserve Bank be given discretion to extend the perimeter within clearly specified parameters to avoid regulatory arbitrage (such as designating in entities with business models economically similar to deposit takers)? Do you agree that changes that are more significant may be more suited to legislative change, supported by pre-positioning?

4.D Should tools that are not linked to licensing have a different perimeter? For example, it is common internationally for non-bank lending institutions to be subject to macro-prudential lending tools, even though they do not take deposits.

Click or tap here to enter your answer. Text box expands as you type

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Chapter 5

Should there be depositor protection in New Zealand?

5.A Are the interactions between depositor protection and the other parts of the financial safety net set out in Part I of Section 2 described appropriately?

5.B What objectives should the depositor protection regime in New Zealand have? Should its objectives be:

- to protect depositors from loss?
- to contribute to public confidence and financial stability?
- both of these?
- something else?

5.C The Minister has made an in-principle decision that the depositor protection regime should have a limit in the range of $30,000-$50,000. Given your answer to 5.B, what coverage level would be best within this range?

5.D How would your preferred limit affect depositor wellbeing, public confidence, and depositors' responsibilities for their financial choices?

5.E Do you think the New Zealand depositor protection regime should be supported by a preference for insured depositors? How would this affect the costs and benefits of a depositor protection regime in New Zealand?

5.A
We are of the view that the interactions between depositor protection and the other parts of the financial safety net, as set out in Part I of Section 2, are described appropriately. In particular we find the following statement to be particularly insightful and prescient:

"By protecting New Zealand depositors from the consequences of risks beyond their control and improving their personal resilience to financial shocks, depositor protection can contribute to public confidence in financial services and help to prevent contagion. Working with the rest of New Zealand's prudential framework, a depositor protection scheme should contribute to the stability of New Zealand's financial system and support greater wellbeing for New Zealanders."[1]

5.B
The primary purpose of deposit insurance should be to promote financial stability. It will do so by contributing to public confidence in the event of a bank failure, by providing a legal commitment that ordinary savers will not face losses. Depositor confidence is paramount in a crisis because the "sequential service constraint" provides incentives to run. Moreover, lack of information as to which banks will be affected leads to flights to safety, defunding the financial system. Insurance is an excellent method to provide confidence in a crisis, ex post.

Our proposal, however, goes one step further: it concerns the well-known problem that insurance may increase the likelihood of crises ex ante, by encouraging moral hazard when insurance is mispriced. In

[1] The Treasury, *Safeguarding the future of our financial system. In-principle decisions and follow-up questions on: The role of the Reserve Bank and how it should be governed.* Consultation Document 2A Phase 2 of the Reserve Bank Act Review, June 2019, p 83.

theory, this can be abated by choosing insurance premia that reflect the risk of bank failure, and hence likelihood of insurer pay-out. Improperly priced deposit insurance may effectively subsidise bank risk-taking, by driving a wedge between the fair market price of deposit insurance, and the realised price. It is therefore important to determine the fair market price for deposit insurance.

"This implicit [deposit insurance] guarantee incentivised some large international banks to take excessive risks, which amplified the extent of the GFC."[2]

Importantly, the fair market price for deposit insurance will differ from bank to bank, depending on their respective risk profiles. Consequently, the application of an homogeneous risk-insensitive price for deposit insurance is not recommended. Under such a system, all institutions are assessed at the same rate, but this is inequitable, as more prudently managed, low-risk institutions, effectively subsidise higher-risk institutions, generating perverse incentives.

An alternative is a risk-adjusted (differentiated) premium system, whereby the risk posed to the deposit insurer by a member institution is incorporated into the premium structure. This attenuates the moral hazard issue created by a flat-rate (and therefore risk-insensitive premium), by providing member institutions with an incentive to take a more prudent approach to risk management. Differential premiums are more equitable, as cross-subsidisation among institutions is reduced. An important advantage of risk-adjusted systems is that it can lead to pressure on bank management to address risk-related issues, when premiums are raised. By encouraging more prudent behaviour ex ante, a risk-sensitive premium would actually make bank failure less likely.

Determining the bank-specific, fair market price of deposit insurance, in the absence of a competitive market for deposit insurance, is likely to be challenging and resource intensive, if it is possible at all. Government bodies may be unable to determine the fair market price for several reasons, including the lack of the requisite capacity, experience, and expertise, as well as the impact of lobbying by major banks.

We therefore recommend the establishment of a competitive market for deposit insurance to act alongside the government provision. Depository institutions should be required to insure a proportion of their deposits ($0<a<1$) with private sector counterparties. Premiums levied by private insurers will provide a valuable signal to the government deposit insurer, when deciding appropriate bank-specific insurance premia, for the remainder of bank deposits insured by the government.

One important issue associated with the private provision of deposit insurance is that the insurers may be unable to meet their obligations in the event of a major banking crisis. To mitigate this risk, we recommend that the proportion of privately insured liabilities be as small as possible, while also providing a means to elicit the fair market price of deposit insurance, on a bank-by-bank basis. We have conducted research into the optimal percentage of private vs government insurance in this proposed differentiated, co-provision premium system model, and would be pleased to provide the outcomes of that research to this Inquiry.

For this type of co-provision model to work, legislation must be put in place to ensure proper separation between banks and insurers, and to avoid excess concentration in the deposit insurance industry (taking the current level of concentration in the banking sector as given).

In particular, it would be necessary to limit the scope for collusion between banks and insurers. Mechanisms to prevent collusion could include:

[2] ibid., p 24.

i) a bank shall not have any shareholding (much less controlling shareholding) in any insurers in this portion of the market, either directly, or through a parent company or subsidiary;
ii) banks, their parent or subsidiary companies, should not be allowed to have any seats on the Boards of any insurers in this market;
iii) insurers in this market should not be allowed to own any shares directly, or through their parent or subsidiary companies, in any banks;
iv) insurers in this market should have to comport with all the usual prudential requirements that are imposed on insurers generally by the Prudential Authority, i.e. demonstrate adequate provisioning, and all the other actuarial requirements that are well-established in the insurance industry, and to which Chief Actuaries must attest etc, so as to ensure that insurers act prudently, and within the scope of their capacity, when providing insurance in this market (so as to ensure that insurers are not 'betting the firm' in an attempt to gain market share).

We acknowledge that in the event of a banking crisis, the speed of resolution is critical. Our model does not necessarily rely on the private insurer paying out immediately. The government can pay out immediately, and then recoup from the private insurer later. This would still provide the benefit of a market-based premium / market discipline, during normal times.

Insurers will be required to have the usual level of re-insurance. That re-insurance serves two purposes:

i) it acts as a 'sober second thought' or 'double redundancy'. The reinsurer will charge a risk-sensitive premium to the (direct) insurer, by conducting its own risk assessment of the liabilities and obligations of the direct insurer;
ii) in the event of a claim against the direct insurer, part of that liability will be spread to the reinsurer.

5.C.
Deposit insurance will be most effective if the majority of the deposits of the majority of retail depositors are protected. Setting the limit too low will be counter-productive. Therefore, we feel that the upper range of the Minister's proposed limit should be adopted: NZD 50,000. In principle, we believe that an even higher limit may be desirable.

One caveat is that many countries impose a limit, which is per bank account, rather than per person, such that the practical limit is a multiple of that set by the insurance scheme (by virtue of individuals splitting their deposits into multiple accounts). A decision should be made on whether this limit should be strictly per individual.

5.D
We believe that the provision of deposit insurance up to NZD 50,000 will enhance public confidence in the banking sector, and will improve the wellbeing of depositors by reducing the risks that they face. In theory, the provision of deposit insurance may reduce the degree to which retail depositors exercise discipline over banks. However, we believe that this effect will be minimal in practice.

Large and sophisticated wholesale investors are well-placed to evaluate the risks posed by the business models of different banks, and therefore exercise depositor discipline. The investment decisions made by these large investors may provide some effective market discipline in the banking sector.

The same is not true of retail depositors, most of whom lack the requisite knowledge and resources to effectively discriminate between the business models of competing banks. Consequently, we do not believe that the banking decisions of retail depositors generally reflect changes in the risk profile of banks, even in the absence of deposit insurance, and so the actions of retail depositors do not provide much in the way of market discipline with respect to bank risk-taking.

"For most people, though, and even for many businesses, closely monitoring their bank, and therefore exercising “depositor discipline” over it, is about as practical as suggesting that people train to perform surgery upon themselves."[3]

5.E

The question of whether the deposit insurer has preferred creditor status in the event of a bank collapse will affect insurance premia, and is thus relevant to our proposal. Setting aside our co-provision suggestion for a moment, preferred creditor status for the insurer will lead to the bank’s junior bondholders suffering heavy losses, and indeed likely being wiped-out completely. Given this set-up, interbank lending – which is usually in the form of junior debt – will be far more risky in the lead-up to a crisis, because such debt only has a residual claim on bank assets, after the insurer’s claims have been met. If the government is interested in crisis resolution – that is, preventing bank failure by assisting in the take-over of a troubled bank – then such a preference for insured deposits may make such an action that much more difficult. Indeed, in the USA, the FDIC does not have a preferred status, and the insurer has equal claimant status to the banks’ other creditors.

The advantage of preferred claimant status for the insurer is reduced losses in the event of failure. This will reduce the actuarially fair insurance premia. Thus, while losses are reduced in the event of failure, the insurer will also receive less in premiums and (in theory) the effect will net out. Thus, the disadvantage in making bank funding more difficult (by allowing insurers preferred creditor status) outweighs any funding advantage from granting preferred status to the deposit insurer.

With respect to our co-provision model, for private insurance premia to be accurately priced, it is vital that private insurers not be protected from their expected losses, in the event of bank failure. Preferred status for the private insurer would similarly reduce the private insurance premium charged. If preferred status were granted to the government insurer, we recommend that it not be granted to the private insurer, such that private insurance corresponds to the risk for junior bond-holders, which should bear strong similarity to the CDS price (if one existed for the NZ bank in question).

[3] T. Petri & B. Ely, "Better Banking For America: The 100 Percent Cross-Guarantee Solution", *Common Sense: a Republican Journal of Fact and Opinion* (Fall, 1995), p 4.

Any other comments?

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