

# The Treasury

## Reserve Bank Act Review Phase 2 Submission Information Release

October 2019

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30 August 2019

Phase 2 of the Reserve Bank Act Review  
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## Phase 2 of the Reserve Bank Act Review: Consultation 2A and 2B

ASB Bank Limited (**ASB**) welcomes the opportunity to provide feedback to the Treasury on the Reserve Bank Act Phase 2 review (the **Review**), including consultations 2A and 2B. Our submissions on the Review generally are set out in Section 1, and in Section 2 we set out our submission on each of the chapter focus areas.

We have also contributed to the New Zealand Bankers' Association submission on the Review (the **NZBA submission**) and endorse the points made therein, except where expressly indicated otherwise in this submission.

We acknowledge that ASB's submission may be published on the New Zealand Treasury and/or Reserve Bank of New Zealand (the **Reserve Bank**) websites, and may be released in response to a request under the Official Information Act. ASB does not seek confidentiality for any aspect of this submission, other than my direct contact details below.

If you require any further information in relation to this submission, please do not hesitate to contact me.

Yours sincerely,

[1]

**Sam Kelly**

Head of Regulatory Affairs (Acting)  
**ASB Bank Limited**

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## SECTION 1: THEMATIC COMMENTS

1. ASB is proudly committed to its purpose of accelerating the financial progress of all New Zealanders. Fundamental to this purpose is the stability and efficiency of the underlying financial system. Accordingly, ASB fully supports the objectives of the Review and we consider that a number of the proposed reforms will have a meaningful impact on the stability of New Zealand's financial institutions and the resiliency of the financial system, and in turn contribute to the economic and social outcomes of ASB's customers and the public at large.
2. It is clear that the Reserve Bank of New Zealand Act 1989 (the **RB Act**) and the New Zealand prudential regime are outdated and out of step in a number of areas with what is considered best prudential practice internationally (as has been highlighted by the International Monetary Fund (**IMF**) in its 2017 Financial System Assessment Programme (**FSAP**)<sup>1</sup>). It is appropriate that the regime is being reviewed comprehensively. However, given the economic significance of prudential regulation, care must be taken that this opportunity for reform is taken thoughtfully, approached holistically and ultimately produces settings that are consistent with the Reserve Bank's statutory objectives to "*promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy*". In particular:
  - a. Careful consideration must be given to ensure that an appropriate balance is struck regarding the ultimate settings of the many interconnected elements of the financial safety net (refer to Appendix A) under reform to avoid the prudential framework being set too conservatively, resulting in adverse flow-on economic and efficiency impacts. These include the proposals that are subject to this Phase 2 Review, the Reserve Bank's proposed higher capital adequacy settings, and other prudential reforms that are currently under consideration (including a review of bank liquidity settings and a change to mortgage bond requirements).
  - b. The efficiency objective should continue to sit at the same financial policy objective hierarchy level as financial stability. The efficiency objective is an important moderator of the financial stability objective, ensuring that the Reserve Bank's regulatory interventions are targeted and a net benefit to society.
  - c. While ASB supports the Reserve Bank having greater resources, tools and powers to effectively discharge its functions, there must be robust governance and accountability arrangements to ensure that the resources are efficiently applied and the powers are exercised appropriately.
  - d. ASB supports the introduction of a formalised depositor protection scheme, but the design of the scheme is critical to ensure it meets the objectives of the scheme and limits unintended consequences. Further, the ultimate settings of the scheme must be considered in the context of other prudential settings.
  - e. Opportunities for regulatory arbitrage must be minimised to avoid market distortions.
  - f. Reforms to the Reserve Bank's prudential framework must take into account the reality of New Zealand's internationally-connected financial institutions and, accordingly, home-host coordination is critical.

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<sup>1</sup> See the IMF FSAP New Zealand: <https://www.imf.org/en/Publications/CR/Issues/2017/05/08/New-Zealand-Financial-Sector-Assessment-Program-Financial-System-Stability-Assessment-44886>.

3. ASB looks forward to ongoing engagement with the Review team and industry as the Review progresses. In particular, if the Review team wishes to discuss any aspects of our submission, we would be happy to meet with you to do so.

## SECTION 2: SUBMISSIONS ON CONSULTATION PAPERS 2A AND 2B

### Consultation 2A

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#### Chapter 1: Should prudential regulation remain with the Reserve Bank?

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1. ASB supports the in-principle decision to keep the responsibility for prudential regulation with the Reserve Bank. We have no further submission on this chapter beyond the comments made in our submission to the first consultation of the Review (**Consultation 1**).

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#### Chapter 2: What high-level financial policy objectives should the Reserve Bank have?

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2. ASB submits that the efficiency objective should continue to sit at the same hierarchal level as financial stability, as stated in our response to Consultation 1. The efficiency objective is an important moderator of the financial stability objective, ensuring that the Reserve Bank's regulatory interventions are targeted and a net benefit to society (and therefore consistent with the recently-amended overarching purpose of the Act "*to promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy*").
3. Subject to our position in paragraph 2, we support the NZBA submission.

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#### Chapter 3: How should the Reserve Bank be governed?

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4. ASB supports the NZBA submission. Key points include that:
  - The Crown entity structure is the best-suited for the Reserve Bank given the nature of its activities.
  - The governance model used by the Financial Markets Authority would be a useful base from which to develop the Reserve Bank's new governance structure.
  - The Treasury should assume the role of administering the RBNZ Act

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#### Chapter 4: How should the regulatory perimeter be set?

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5. ASB supports the NZBA submission. Key points include that:
  - It is important that the regulatory perimeter for licensed entities should be aligned with the scope of any depositor protection scheme (**DPS**) to prevent regulatory arbitrage and market distortion.
  - Additionally, at a minimum, New Zealand should put in place a regime along the lines of the registered financial corporation regime in Australia providing for periodic financial reporting by non-licensed entities. This will enhance transparency about the financial system and enable emerging financial stability or other risks outside the regulatory perimeter to at least be assessed.
  - it is important to ensure that application of macro-prudential tools (such as high LVR restrictions) is competition-neutral.
6. In addition, ASB is concerned to see comparability of treatment between non-deposit-taking lenders and deposit takers, including banks, on key issues (cf. the Australian Credit License Regime).

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## Chapter 5: Should there be depositor protection in New Zealand?

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7. ASB supports the introduction of a formalised DPS, as stated in our response to Consultation 1 (see Appendix B for ASB's submission).
8. We consider that a DPS is an important feature of a well-constituted prudential safety net and critical to preserving public confidence in times of distress. Indeed, the New Zealand Government's decision to hastily introduce the emergency Crown Retail Deposit Guarantee Scheme during the 2008 Global Financial Crisis (the **GFC**) to "*stem the threat of depositors running from New Zealand banks and triggering widespread market disruption and economic stability*"<sup>2</sup> exposed the risks of not having formalised depositor protection.
9. The absence of a DPS is a clear gap in New Zealand's prudential framework and we note that New Zealand is an outlier internationally against all other comparable jurisdictions in not having a DPS, as recognised, for example, by the 2017 IMF FSAP. The IMF FSAP states<sup>3</sup> that the "introduction of deposit insurance would be the best option" to enhance the credibility and strength of the financial safety net.

### **Depositor protection must be considered in the context of the wider prudential safety net**

10. The New Zealand prudential framework is currently undergoing significant reform as part of this Review, the Reserve Bank's proposed higher capital adequacy settings and other prudential reforms (including a review of bank liquidity settings and a change to mortgage bond requirements). ASB welcomes these important areas of reform which will materially enhance the stability of New Zealand's financial system.
11. However, it is critical that as part of this review, the settings for depositor protection are considered in context with the other elements of the financial safety net which detect, and protect the financial system against, risks and contain the consequences of financial stress (refer to Appendix A). Accordingly, the choices for depositor protection will be particularly affected by, and affect, policy choices in relation to the (a) Open Banking Resolution, (b) crisis resolution framework, (c) Reserve Bank liquidity settings, and (d) capital settings.
12. Accordingly, given the degree of interconnectedness above, careful consideration should be given to the overall settings to avoid the prudential framework being set too conservatively and resulting in adverse flow-on economic and efficiency impacts.

### **A depositor protection regime must have dual objectives of both protecting depositors from loss AND contributing to public confidence and financial stability**

13. The objectives of a DPS must be consistent with the objectives of the elements that make up the financial safety net generally, which are to promote a stable and resilient financial system. On that basis, an objective of a DPS must be to contribute to public confidence and financial stability. At the same time, "covering the vast majority of individual depositors strengthens the role of deposit insurance systems in the safety net"<sup>4</sup>. We would go further, as explained below, and say

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<sup>2</sup> Controller and Auditor-General, 2011, p. 5

<sup>3</sup> IMF FSAP New Zealand: <https://www.imf.org/en/Publications/CR/Issues/2017/05/08/New-Zealand-Financial-Sector-Assessment-Program-Financial-System-Stability-Assessment-44886>, page 7

<sup>4</sup> International Association of Deposit Insurers, 2013, p.15

that the total level of deposit funds protected is important, not merely the proportion of depositors.

14. Depositor protections scheme around the world tend to have dual objectives of protecting depositors and contributing to public confidence and financial stability. We also note that New Zealand's Crown Retail Deposit Guarantee Scheme had dual objectives of "*maintaining public confidence in the domestic financial system*" and "*maintaining the confidence of general public depositors in New Zealand's financial institutions*"<sup>5</sup>.

#### **Design of the DPS is critical**

15. Assuming the in-principle decision to introduce a DPS is adopted, the design of the scheme will be critical to ensure that it meets its public policy objectives and to prevent market distortions. In this regard, three key design features need careful consideration, namely (a) the quantum of protected deposits, (b) whether the scheme is pre- or post-funded, and (c) whether levies charged to fund the scheme reflect the underlying risk of each financial institution.
16. Further, the answers on these issues will, as set out in Appendix A, impact the appropriate settings for other prudential instruments. For example, the Reserve Bank's capital adequacy proposals announced in December 2018 were made prior to Cabinet's in-principle decisions about a DPS. We submit that the creation of a DPS will enable the Reserve Bank to work with capital settings more closely aligned with comparable jurisdictions internationally.

#### Quantum of protected deposits

17. The quantum (i.e. proportion by value) of protected deposits must be set at a level that has the ability to achieve the public policy objectives of the scheme (i.e. sufficiently high to effectively contribute to public confidence and the stability of the financial system as a whole). Therefore, consideration must be given to the total level of deposit funds exposed to loss, not just the number of individual deposit accounts. The latter measure can be distorted by large numbers of very low-value deposits. In this regard, we note the literature (referenced on page 99 of the Consultation Paper) documenting the lessons learned from the GFC that "*a too low coverage level leads to the complete ineffectiveness of deposit insurance*".
18. On that basis, an insured limit range of \$30,000 to \$50,000 that, while covering 90% of individual depositors by number, leaves 60% of deposit funds (by value) exposed risks failing to achieve either policy objective. Further, we note that the proposed range is low when compared to both the mean and the mode of other comparable jurisdictions and is low in the context of the materially-higher limits set in New Zealand under the Crown Retail Deposit Guarantee Scheme (originally \$1 million per financial institution when introduced in 2008, re-set in 2010 to \$250,000 for non-bank deposit takers and \$500,000 for banks).
19. However, as noted in paragraphs 10-12 above, the ultimate setting of the insured limit must consider the settings of the other elements of the financial safety net. Further, the economic context is important in setting the size of the insured limits. Funding the scheme will come at a cost, and while banks will absorb some of the impact, some will invariably be passed on to bank customers. Where it is not desirable to pass this on to depositors in the form of lower returns (particularly acute in the current low interest rate environment), it may be partly passed on to

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<sup>5</sup> Retail Deposit Guarantee Scheme – Amended Policy Guidelines: <https://treasury.govt.nz/sites/default/files/2008-12/t2008-2024.pdf>, page 4

borrowers who will be particularly impacted by the Reserve Bank's capital adequacy proposals (which are likely to result in higher borrowing costs).

#### Pre-funding versus post-funding

20. We note the in-principle decision to establish and operate the DPS by way of pre-funded bank levies. We support this in-principle decision (over a post-funded model) as we consider that a (well-understood) pre-funded scheme that can be called on in times of crisis will more effectively promote confidence and stability. However, our support for pre-funding is conditional on:
  - the adoption of risk-based levies to reduce cross-subsidisation by conservative institutions of their more risk-taking competitors; and
  - decisions on the other matters referred to in paragraph 11, which mean that the overall cost does not become disproportionate. In particular, the costs of the DPS should be taken into account in setting the levels of capital banks are required to hold and therefore the associated costs.
21. In the event of a bank failure(s), a pre-funded model will dampen the impact on bank customers and the public generally at a time when the economy is likely to be in crisis. By contrast, a post-funded model is likely to add further stress to the financial system as bank levies are introduced.
22. We note that a post-funded model offers no opportunity to incentivise financial institutions and depositors to manage risk and curb behaviour that inherently makes a default event more likely and more expensive. A post-funded scheme is likely to experience a greater degree of 'moral hazard' relative to a well-designed pre-funded scheme (covered in paragraph 15), with the latter better able to reduce or eliminate perverse behavioural changes that would otherwise increase financial system risk. Further, where an institution fails, it will be the prudent institutions that will be required to subsidise the failed, poorly-managed institutions.

#### Risk-based levies

23. If a pre-funded deposit insurance model is adopted, levies charged must reflect (a) the size of an institution's insured deposits (as opposed to profits/balance sheet size) and (b) the inherent risk profile of the institution (for example as reflected by the institution's credit ratings, non-performing loans as a percentage of gross loans and advances), thereby mitigating the 'moral hazard' created by the existence of the scheme. Without adjusting for risk, market distortions will naturally result. Depositors are otherwise incentivised to seek the highest deposit rate while having no regard to the risk profile of the deposit-taking institution, which can channel funds into higher-risk institutions.
24. Higher-risk financial institutions may take advantage of the guarantee to raise large amounts by attracting deposits merely through offering better deposit rates than less-risky institutions, in turn using those deposits to fund riskier loans. This behaviour was observed when the Crown Retail Deposit Guarantee Scheme was initially introduced. Prior to the setting of risk-based levies, deposit money flooded back to soon-to-be-guaranteed finance companies to take advantage of the high interest rates on offer. The introduction of the deposit scheme clearly encouraged a shift in deposits to (higher-risk) finance companies (refer to Appendix C). Risk-based levies reduce these distortions that an insurance scheme introduces.
25. We note that the risk-based approach is favoured for the proposed European Deposit Insurance Scheme.

#### **Other DPS features for consideration**



26. In addition to the above key design features, we note the following factors must be carefully considered in subsequent rounds of consultation.

Transition period

27. Sufficient time to build up the insured fund must be given to minimise the impact on customers, who will inevitably bear some of the cost. This will be particularly important in the current low interest rate environment and while banks are building up capital reserves as a result of the Reserve Bank capital adequacy reforms. Further, once the target fund size is reached, levies should cease to be charged to avoid the levies becoming a perpetual tax on institutions.

Operation and governance of the deposit insurer

28. Careful consideration will need to be given to how the ultimate deposit insurer is managed and governed.

Definition of depositor and deposit

29. What constitutes a depositor requires careful consideration. For example, are beneficiaries of deposits under trust arrangements protected? What is the position on joint account holders? Equally, what products are subject to deposit insurance for example, would this include KiwiSaver fund investments in bank deposits?

What institutions are subject to the DPS?

30. It is essential to align the DPS with the deposit-taking regulatory perimeter that is adopted as part of this Consultation (refer to Chapter 4 of Consultation Paper 2A) so as to reduce the potential for regulatory arbitrage.

**NZBA submission**

31. Subject to our position on a DPS above, we support the NZBA submission.

## Consultation 2B

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### Chapter 1: What prudential regulatory tools and powers should the Reserve Bank have?

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1. ASB supports the NZBA submission. Key points include that:
  - We consider that the detailed prudential rules that are currently contained in the Banking Supervision Handbook should be subject to Parliamentary or other scrutiny conventionally applying to instruments of their significance.
  - We support the introduction of an executive accountability regime in New Zealand, but appropriate consideration should be given to the design of the regime, taking into account New Zealand's regulatory context and the best-practice that has emerged internationally. In addition, there are currently several proposals/regimes in the regulatory policy arena proposing an executive/senior manager accountability regime (namely the Ministry of Business, Innovation and Employment (MBIE) options paper, amendments to the Credit Contracts and Consumer Finance Act 2003, existing provisions in the Financial Markets Conduct Act 2013 and what is proposed in this consultation). Whatever solution New Zealand adopts needs to be consistent to avoid creating regulatory and competitive distortions. In addition, multiple regimes will create disproportionate administrative burdens on single entities. (Refer also to NZBA's submission to MBIE on its "Conduct of Financial Institutions" options paper).

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### Chapter 2: What role should the Reserve Bank have in macro-prudential policy?

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2. ASB supports the NZBA submission. Key points include:
  - The Reserve Bank should have the primary role in relation to macro-prudential policy and be given the necessary powers to help prevent the build-up of systemic financial risks, subject to robust independent oversight.

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### Chapter 3: How should the Reserve Bank supervise and enforce prudential regulation?

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3. ASB supports the NZBA submission. Key points include that:
  - An improved regime should provide for more intense supervision, an expanded range of enforcement tools, and more rigorous oversight and accountability arrangements. Reform should target those areas found to have weaknesses in the IMF FSAP report.
  - The Reserve Bank should have additional resources as necessary to effectively discharge its responsibilities now and as contemplated in future.
  - The governance and accountability arrangements of the Reserve Bank must be robust to ensure that prudential policy delivers efficient financial stability outcomes.
  - The prudential framework also needs to be coordinated in a way that reflects the interconnected and evolving nature of the financial system, including a more coordinated approach to:
    - home-host arrangements, as recommended in the IMF FSAP – it is important that there is specific consultation on this topic to ensure outcomes which take account of the reality of New Zealand's internationally-connected financial institutions; and
    - regulation and other arrangements between New Zealand's domestic agencies.

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**Chapter 4: How should the Reserve Bank’s balance sheet function be formulated?**

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4. ASB has no comments.

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**Chapter 5: What features should New Zealand’s bank crisis management regime have?**

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5. ASB supports the NZBA submission. Key points include:

- We support the modernisation of New Zealand’s crisis management regime given the fundamental role it plays in underpinning financial stability and the significant influence it has on a range of prudential policies and potential capital and funding instruments.
- Due regard should be given to international best-practice. Bank resolution and recovery regimes have been fundamentally overhauled internationally, most notably through the Bank Recovery and Resolution Directive in the European Union and the Federal Deposit Insurance Corporation receivership process and Orderly Liquidation Authority in the United States.
- The crisis management regime, and prudential policies more generally, also need to be reviewed in light of the in-principle decision to adopt a deposit protection regime. The design of that regime needs to be considered alongside and as part of the broader review of recovery and resolution arrangements, and should also be informed by international best-practice guidance, including from the Financial Stability Board and the International Association of Deposit Insurers. There is a need for a strong framework with the flexibility to evolve to meet new challenges and emerging best practice, including by providing for periodic review.
- The importance of coordination and cooperation between the Reserve Bank and foreign resolution authorities.

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**Chapter 6: How should the Reserve Bank coordinate with other government agencies?**

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6. ASB supports the NZBA submission. Key points include:

- The prudential framework needs to be coordinated in a way that reflects the inter-connected and evolving nature of the financial system.
- A higher degree of coordination is needed between members of the Council of Financial Regulators.
- Consideration must be given to the rationalisation of the number of regulators to come closer to a true “Twin Peaks” prudential and conduct model.
- The need for more coordination also extends to the international home-host arrangements, as recommended in the IMF FSAP – it is important that there is specific consultation on this topic to ensure outcomes which take account of the reality of New Zealand’s internationally-connected financial institutions.

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**Chapter 7: How should the Reserve Bank be funded and resourced?**

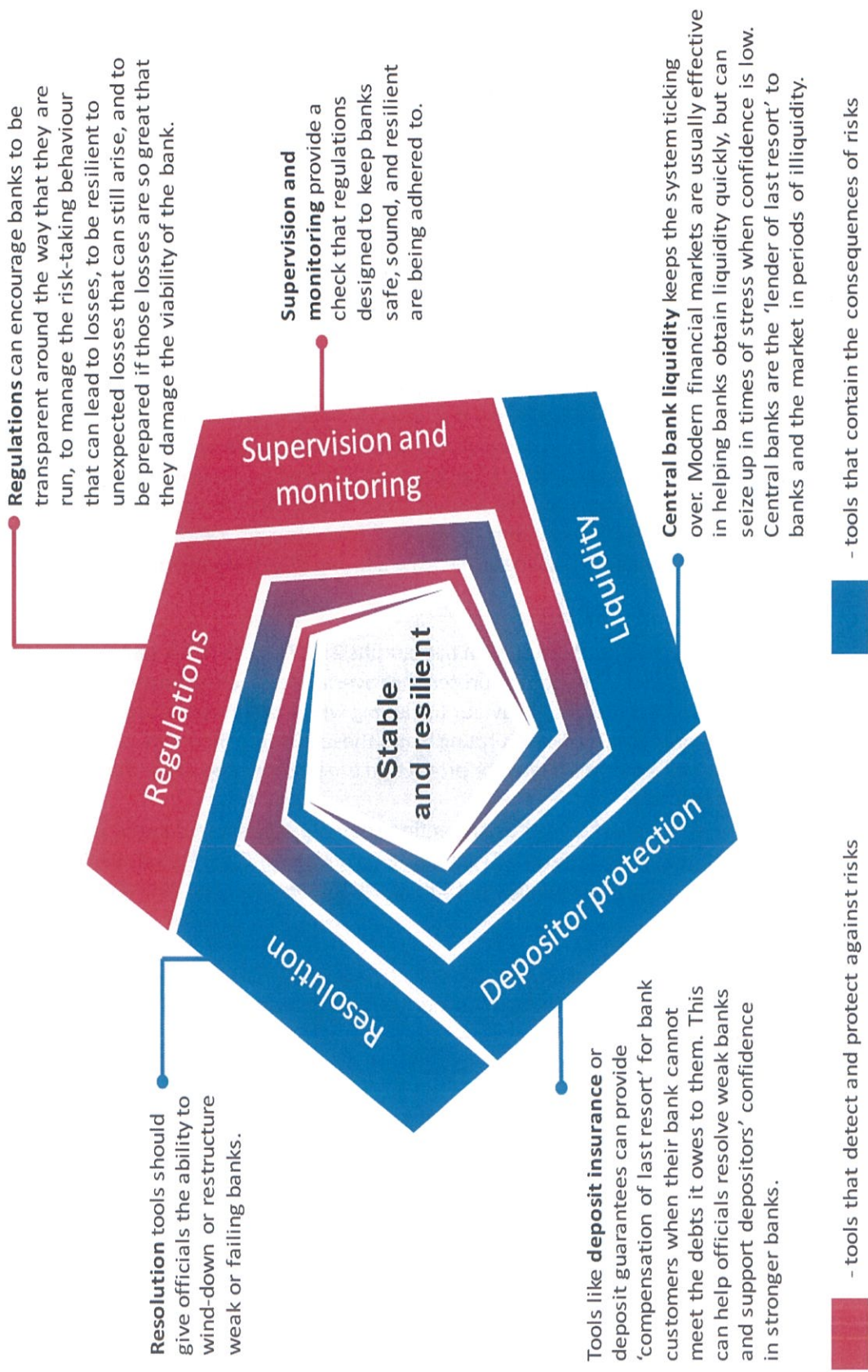
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7. ASB supports the NZBA submission. Key points include:

- The introduction of an industry levy if this will result in the Reserve Bank being better resourced and able to operate more effectively.
- However, this will need to be accompanied by appropriate governance arrangements to ensure that the additional resources are effectively and appropriately applied.

## Appendix A

### The Financial Safety Net (as represented in Consultation Paper 2A)



## Appendix B

### ASB's submission on the proposal to introduce a depositor protection scheme under the Consultation 1, Phase 2 review

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#### Chapter 4: Should there be depositor protection in New Zealand?

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ASB supports the view expressed in paragraph 22 of the NZBA submission that the current prudential regulatory requirements and supervision framework of NZ banks/deposit takers, including the Open Banking Resolution (**OBR**) regime, and in conjunction with bank risk appetites and governance settings, make the likelihood of bank failure and the consequent threat to depositors remote.

Notwithstanding the above, ASB considers that a formalised depositor protection scheme would be beneficial to ASB's customers, to ASB itself and to the broader environment within which banks operate. The current OBR regime is untested in a crisis environment, and in the case of a severe downturn there is likely to be increased public scrutiny of the OBR regime and the protections it provides (in that it effectively "bails-in" depositors). Without an explicit form of depositor protection in place that is well understood by the New Zealand public, our view is that this is likely to necessitate the re-introduction of hastily-considered "in-crisis" back-stop insurance in a form similar to that taken during the Global Financial Crisis where the New Zealand government introduced a guarantee scheme.

ASB supports the comments expressed in paragraphs 23-27 of the NZBA submission, that:

- the introduction of depositor protection, over and above the protections already in place, is likely to impact market behaviour (including wholesale investor behaviour, pricing of retail banking products, and credit ratings) and these impacts should be closely considered when determining whether depositor protection is necessary and, if so, the design of that protection; and
- the introduction of depositor protection should be considered in the broader context of current prudential regulatory requirements and other bank failure resolution and bank resilience policies (including the OBR) in order to ensure that they remain relevant and effective.

We understand that if there is support for the introduction of depositor protection, the form and details of the scheme will be subject to further consultation and we look forward to engaging with you further on this topic.

### Appendix C

Growth in retail deposits with finance companies before and after the New Zealand Crown Retail Deposit Guarantee Scheme was introduced

