

The Treasury

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Westpac New Zealand Limited

Submission to The Treasury of New Zealand on Phase 2
of the Reserve Bank Act Review: Safeguarding the future
of our financial system

30 August 2019

Mark Weenink
General Manager, Regulatory Affairs,
Corporate Legal Services and General Counsel New Zealand
Westpac New Zealand Limited

1. Background

- 1.1 This submission to the Treasury is made on behalf of Westpac New Zealand Limited (**Westpac**) in respect of the second consultation papers relating to Phase 2 of the *Reserve Bank Act Review: Safeguarding the future of our financial system*. Westpac's contact for this submission is:

Mark Weenink
General Manager
Regulatory Affairs, Corporate Legal Services & General Counsel
Westpac New Zealand Limited
PO Box 934
Auckland 1010

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2. Introduction

- 2.1 We welcome the opportunity to provide feedback to the Treasury on the consultation documents, "*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**) and *The Reserve Bank's role in financial policy: tools, powers, and approach* (**Consultation Document 2B**) (**Consultation Documents**).
- 2.2 We view this review as an opportunity to make New Zealand's prudential regulation regime more effective, efficient and flexible, for the benefit of all participants in the financial sector. We hope to see a regime that creates a framework for financial strength and stability, but also encourages innovation and competition. It is also essential that this regulatory framework is capable of effectively responding to new developments in this constantly evolving sector.
- 2.3 Westpac refers to its earlier *Submission to Treasury of New Zealand on Phase 2 of the Reserve Bank Act Review: Safeguarding the future of our financial system* made on 4 February 2019 (**First Submission**). Westpac continues to support submissions made in its First Submission.
- 2.4 Westpac has contributed to and supports the New Zealand Bankers Association's submissions (**NZBA submission**).

3. Executive Summary

- 3.1 Our key priorities in responding to this review are:

- (a) the long-term maintenance of financial stability in New Zealand through efficient prudential regulation supported by an effective financial safety net;
- (b) a comprehensive financial safety net that considers the broader context of New Zealand's unique bank failure and resolution policy framework, including the establishment of an effective depositor protection scheme; and

- (c) the development of a new crisis management scheme that draws on the significant frameworks and work streams underpinning the current crisis management regime (including BS11 and the Open Banking Regime (**OBR**)).

3.2 Specifically, our submissions are:

- (a) *Objectives of the Prudential Regulator:* Westpac supports the RBNZ's overarching objective of promoting financial stability. The retention of an efficiency concept is important, given proposed additions to the RBNZ Act, as a foundation for new accountability provisions, future financial policy remits, and in preparing for the RBNZ's proposed new interventionist tools. It is also important to ensure that regulatory objectives are implemented in a way that puts the least burden on the economy. If a regulatory objective is framed as the avoidance or mitigation of risk without consideration of the costs to the economy of that risk avoidance or mitigation (efficiency), then regulatory actions will tend toward the absolute. Westpac proposes that financial stability should be the primary objective, with efficiency retained as the sole secondary objective, used to moderate the financial stability objective.
- (b) *Depositor Protection:* Westpac supports the introduction of a deposit insurance scheme, subject to, further consultation in respect of the scheme design, the insured limit, the allocation of the economic costs of the scheme, the outcome of a holistic review of crisis management and bank resilience policies. The design of the scheme will be critical to its effectiveness. Customer confidence that they are covered 100% up to a certain amount, and rapid repayment, have been shown internationally to promote financial stability and reduce the risk of retail bank runs.
- (c) *Supervision:* Westpac supports more intensive supervision by the RBNZ to assist a deeper understanding of banks' business and complexities, and protection of the financial stability objective. However, supervisory intensity should not be considered in isolation of the RBNZ's other policies and initiatives. For example, if supervisory intensity increases, the need for banks to hold proposed increased levels of capital or for the RBNZ to de-recognise additional tier 1 Capital (AT1) hybrid capital, both as proposed by the RBNZ, is mitigated to the extent that the proposals are premised on current levels of supervision..
- (d) *Enforcement:* Westpac proposes a clearer pathway to enforcement and escalation, including a broader range of lower level enforcement outcomes, more published guidance and updating "Banking Supervision Handbook" to assist interpreting the RBNZ's requirements. We support an Executive Accountability regime provided it is subject to further consultation on the scope of the regime the development of a singular scheme, rather than multiple across different regulatory regimes in New Zealand; and resolution of conflicts of laws issues between any such RBNZ regime and APRA's BEAR regime in the case of subsidiaries of Australian financial institutions.
- (e) *Resourcing and capability:* Westpac supports more resourcing and capability within the RBNZ to enable a stronger approach to supervision and enforcement. The supervisory approach should incorporate a more

coordinated approach to policy development and engagement with both domestic and international home-host arrangements.

- (f) *New crisis management regime:* Westpac supports a holistic review of crisis management and bank resilience policies. The proposed change requires further consultation and should be considered in the broader context of New Zealand's unique bank failure resolution and resilience policies and systems (including OBR, statutory management and the proposed depositor protection scheme). It is important that these existing elements of the financial safety net and any new regime are designed to work together efficiently.

4. Objectives of the Prudential Regulator

- 4.1 Westpac supports the in-principle decision to replace the RBNZ's existing "soundness" and "efficiency" objectives with a single high-level objective to "*protect and enhance the stability of New Zealand's financial system*" (the **financial stability objective**). However, financial stability should not be absolute. The proposal to remove efficiency as a criterion is significant, particularly in the absence of a definition of the replacement concept, "financial stability".
- 4.2 We acknowledge the number of proposals put forward in Consultation Document 2A, and the preferred options within the NZBA submission that Westpac contributed to and supports. Westpac proposes that financial stability should be the primary objective, with efficiency retained as the sole second tier mandatory objective, used to moderate the financial stability objective.

Financial stability and efficiency

- 4.3 A key issue in implementation of the in-principle decision is the meaning of "financial stability". While financial stability is described in the Consultation Documents as encapsulating "*the most relevant aspects of soundness and efficiency*",¹ there is no settled definition.
- 4.4 The inclusion of an efficiency concept is critically important given proposed changes to the RBNZ Act, which include setting the basis for further accountability provisions, future financial policy remits which could be made, and in preparing for the use of the RBNZ's proposed new interventionist tools.
- 4.5 Efficiency is a measure of how well the financial system performs functions essential for economic development and prosperity.
- 4.6 It is important that regulatory objectives are underpinned by regulatory efficiency, for implementation that puts the least burden on the economy. If a regulatory objective is framed as the avoidance or mitigation of risk without consideration of the costs to the economy of that risk avoidance or mitigation (efficiency), then regulatory actions will tend toward the absolute.
- 4.7 International practice underlines overall financial system performance and efficiency as being integral to the concept of "financial stability".² A clear definition of financial

¹ Consultation Document 2A page 3

² Refer footnote 1 page 16

stability is essential to implement the in-principle decision to adopt the financial stability objective.

- 4.8 Westpac continues to support the position on efficiency in the First Submission – that financial stability should be the primary objective but that efficiency should be retained as a mandatory objective to moderate the financial stability objective.
- 4.9 While the efficiency objective should be secondary to the financial stability objective, it should be a mandatory consideration. This is important to ensure that financial stability is not pursued as an absolute objective. The RBNZ must therefore consider the actions it takes in pursuance of financial stability against the efficiency costs of these actions.
- 4.10 Consultation Document 2A suggests a number of potential secondary objectives that suggest a broad range of potential considerations. Given importance of efficiency, we support efficiency as a single mandatory second tier objective. Multiple second tier objectives place less importance on efficiency and risk dilution of the in-principle decision to focus on key objective of financial stability.
- 4.11 In regards to the scope and meaning of the efficiency objective, we reiterate our First Submission comments in relation to regulatory and dynamic efficiency. The scope and meaning of the RBNZ's efficiency objective is currently in doubt and as such it should be clarified to focus on "regulatory" and "dynamic" efficiency. The legislated efficiency objective should be explicitly limited to these concepts. A focus on dynamic efficiency is more important now than ever before, with financial technology (**Fintech**) changing the way market participants conduct their financial affairs. Fintech promises reduced costs and/or increased functionality for users, and the RBNZ should ensure that such innovations are not unfairly inhibited by regulation.

Climate change

- 4.12 Westpac supports the RBNZ actively considering climate change as playing a significant role to protect and enhance the stability of the financial system. However, we support the RBNZ's climate change obligations to not be conferred as a mandatory objective.
- 4.13 Climate change initiatives and science are developing and evolving quickly. To be effective, climate change initiatives need to be dynamic and capable of being updated in step with the developments. By embedding a climate change objective as a mandatory second tier objective in primary legislation, there is a risk that the definition becomes obsolete and limits development. We support climate change initiatives as a mandatory "consideration", not objective.
- 4.14 Further, we support the FSC submission that climate change initiatives should be informed by the existing entities that advise Government in this area, for continuity, efficiency and optimal coordination.
- 4.15 We support the RBNZ's role in climate change initiatives to be focused on the effects and risks of climate change on the financial system, and supportive of broader Government objectives, rather than leading or duplicative of those objectives.

5. Depositor Protection

- 5.1 We support the in-principle decision to introduce a deposit insurance scheme in New Zealand, subject to further consultation in respect of the scheme design, the insured limit, the allocation of the economic costs of the scheme, and the outcome of a holistic review of existing bank failure management and bank resilience policies (discussed at paragraph 7 below).
- 5.2 As observed in Consultation Document 2B, a deposit protection scheme is commonly regarded as one of several key elements of an effective financial safety net, evidenced by its universal deployment in other OECD jurisdictions.
- 5.3 If properly designed, it can support crisis management in several areas, including by reducing the risk to public money and by making resolution more predictable and flexible. Depositor protection is useful for maintaining financial stability and public confidence in the system, and may need to be introduced in a crisis to reduce the risk of a bank run. A well-designed scheme, where customers have confidence that they are covered 100% up to a predefined limit, with a mechanism for speedy payment of funds, could decrease the likelihood of bank runs, reduce moral hazard and enhance financial stability.³

Deposit insurance scheme design

- 5.4 A key consideration for a deposit insurance scheme is the insured limit. Deposits must be protected to a high enough level to have a meaningful effect on public confidence and therefore reduce the risk of a bank run, while not encouraging irresponsible conduct by institutions. However, a higher level of protection necessarily leads to higher costs involved in funding the scheme. Higher levels of protection may also even undermine longer-term financial stability by placing emphasis on the safety net of deposit insurance rather than prudential regulation and supervision and/or market discipline (Pillars Two and Three) as the primary mechanism for depositor protection.⁴
- 5.5 New Zealand's proposed protection limit within the \$30-50,000 limit is low compared to other jurisdictions.⁵ Implementing a limit of \$50,000 would protect the deposits of approximately 90% of Westpac's customers. The balance of approximately 10% of customers would include a proportion of potentially vulnerable customers. This could include, for example, customers over the age of 65 years and customers saving for a first home who may hold deposits of over \$50,000.
- 5.6 However, the disadvantages of a comparatively low limit of \$50,000 are mitigated by the resulting likely change in customer behaviour towards spreading multiple deposits across different financial institutions to keep each deposit within the limit and attract depositor protection insurance on each deposit. Such spreading of risk would have the effect of extending depositor protection to a wider group of customers than the 90% cited in paragraph 5.5. Although this may make a complete financial picture of the depositors financial position more difficult for a creditor to assess, this

³ House of Commons Treasury Committee “*The run on the Rock*” Report, together with formal minutes volume 1 (ordered by the House of Commons to be printed 24 January 2008) page 95

⁴ Refer footnote 3 pages 91-92

⁵ Australia depositor protection limit of \$250,000 (APRA Financial Claims Scheme <https://www.fcs.gov.au/about-apra>). European Union countries limit of €100,000. (European Commission Directive 2014/49/EU on deposit guarantee schemes).

- impact should be limited, especially in the context of likely future data sharing and Open Banking.
- 5.7 Confusion about the level of protection and the operation of a scheme can also counteract its effectiveness. This was shown in the UK Northern Rock experience during the Global Financial Crisis (**GFC**), where a run occurred because the deposit guarantee in the UK was complex and poorly understood.⁶ Therefore it will be important to ensure that a depositor protection scheme, which is an entirely new concept in New Zealand, is simple and clearly understood by its beneficiaries.
- 5.8 It will of course be possible to adjust the insured deposit limit in future should evolved circumstances or depositor understanding and behaviour warrant it (acknowledging that it may be more easily increased than decreased). Introduction of a simple scheme with a comparatively low threshold of protection is therefore supported as a first step.
- 5.9 As noted above, our support for depositor insurance is subject to the design details of the scheme. We look forward to engaging in further consultation on this.
- Moral hazard**
- 5.10 Westpac reiterates comments on moral hazard in respect of depositor insurance in the First Submission noting that:
- (a) we accept that moral hazard is a valid cause for concern, but submit that concern regarding it is misplaced as it tends to overlook the extent to which moral hazard already exists in the system, and that it does not outweigh the benefits to financial stability of a depositor protection regime;
 - (b) a properly defined depositor protection scheme should reduce rather than increase, the moral hazard already present in the system. The moral hazard exists based on investor perceptions that some institutions are “too big to be [allowed to] fail”, and realpolitik considerations that allowing a large bank to fail with consequential widespread depositor losses would be politically unacceptable to any government (for example, as seen in the UK in the GFC and in the case of South Canterbury Finance in NZ);
 - (c) A depositor protection scheme would replace this perceived implicit government support of large banks with an explicit guarantee, limited as to amount, thus limiting the damaging effect of moral hazard.
- 5.11 For these reasons we consider that there would be a decrease in moral hazard if a depositor protection scheme was introduced. We refer to the RBNZ Act Phase 2 Review team’s survey of 1,000 New Zealanders on the issue of depositor protection, which showed that a majority of respondents were not aware that their deposits are at risk in case of a bank failure.⁷ By making explicit the fact that amounts up the limit are guaranteed, the scheme would also be making explicit the fact that deposits above the guaranteed amount are not guaranteed.

⁶ Refer footnote 3 pages 95

⁷ Refer footnote 1 pages 84- 85

Interaction with bank resilience and failure resolution

- 5.12 Depositor protection must be considered in the broader context of New Zealand's bank failure resolution and bank resilience policies and systems, including the OBR regime, statutory management, and minimum capital requirements. These policies and systems have been designed for an environment without depositor protection, and it is essential that the extent to which they remain relevant and effective if depositor protection is introduced is examined. It is also important that these existing systems and any depositor protection regime are designed to work together efficiently.
- 5.13 For this reason we submit that the introduction of depositor protection should occur at the same time as a broad review of the Reserve Bank's bank failure resolution and bank resilience policies. Our support for the introduction of depositor protection is dependent on the outcome of such a review. We look forward to engaging in further consultation on this, as well as on the specific design of the depositor protection scheme. See comments on crisis management more broadly below at paragraph 7.

Depositor preference

- 5.14 We reiterate comments from the First Submission that we do not support the introduction of depositor preference. Depositor protection should be focussed on maintaining financial stability. This is a key element of deposit insurance, which reduces the risk of bank runs by promising immediate payment to depositors regardless of the status of the bank. This is not true of depositor preference, which applies only after a bank is in liquidation. Depositor preference is also likely to cause a material increase in the price of wholesale bank funding by subordinating that funding in priority to deposits.

6. Supervision and enforcement

Supervision

- 6.1 Westpac is supportive of more intensive supervision to assist in a deeper understanding of banks' business and complexities, and protection of the financial stability objective. More intensive supervision leads to better outcomes and greater confidence in the RBNZ, banks and the financial system. Westpac submits that bank distress or failure can occur as a result of a multitude of underlying causes and that it is flawed to think that any one protection mechanism, such as increased capital protection or depositor insurance (both of which are inherently about absorbing the losses from bank failures, rather than preventing those failures), will be effective against all such risks.
- 6.3 The RBNZ's stated increased appetite for enforcement action should be closely linked to its supervisory approach – more intensive supervision will lead to early identification and resolution of many issues before the last resort of enforcement action is needed.
- 6.4 To achieve this, Westpac supports a clearer pathway to enforcement and escalation via a broader range of supervisory and enforcement approaches including:
- (a) "non-formal approaches": including non-enforcement related supervisory methods and tools to achieve prudential outcomes. These form the basis of

much of APRA's work and APRA considers non-formal approaches as "*highly effective*" and a "*timely and resource-efficient way of achieving prudential outcomes without using formal powers*".⁸ Examples of non-formal approaches include supervisory methods and tools, such as prudential and thematic reviews, financial analysis and heightened engagement and reporting requirements.⁹ A series of non-formal approaches also acts as a clearer pathway to enforcement; and

- (b) lower level enforcement outcomes: Westpac supports the FMA's notice of intention tool as best practice for escalation pathway which can bring attention to an issue (and opportunity for firms to work with the regulator to avoid enforcement). Enforcement should be the last option, once other engagements are exhausted. A broader range of lower level outcomes provides the opportunity for proportionality in enforcement response,
- 6.5 Specific treatment of supervision in the RBNZ Act is primarily based on the delegated power in section 74 to register banks and to impose conditions of registration. The Banking Supervision Handbook underpins the current supervision structure. Westpac supports more published guidance and updates to the Banking Supervision Handbook around interpreting requirements, including for the Certificate of Registration regime.
- 6.6 However, supervisory intensity should not be considered in isolation of the RBNZ's other policies and initiatives. For example, if supervisory intensity increases, the need for banks to hold proposed increased levels of capital or for the RBNZ to de-recognise additional tier 1 Capital (AT1) hybrid capital, both as proposed by the RBNZ,¹⁰ is mitigated to the extent that the proposals are premised on current levels of supervision.

Executive Accountability

- 6.7 There are currently three proposals that contemplate the introduction of executive accountability regimes in New Zealand being: the MBIE Options Paper on the Conduct of Financial Institutions; the Credit Contracts Legislation Amendment Bill (proposal for new statutory duties in relation to compliance with the CCCFA by directors and senior managers); and proposals in the Phase 2 Consultation Documents (**proposals**).
- 6.8 We support an Executive Accountability regime provided it is subject to: further consultation on the scope of the regime; the development of a singular scheme, rather than multiple across different regulatory regimes in New Zealand; resolution of conflicts of laws issues between any such RBNZ regime and APRA's BEAR regime in the case of subsidiaries of Australian financial institutions.
- 6.9 There is a need for regulatory coordination in the executive accountability proposals. Key objectives of the Council of Financial Regulators (**CoFR**) include the identification of issues which may impact the regulatory objectives of members and the provision of coordinated responses to these issues. Given the recent addition of

⁸ APRA Enforcement Strategy Review Final Report (29 March 2019) page 7

⁹ Refer footnote 8 page 12

¹⁰ Reserve Bank consultation paper "Capital Review Paper 4: How much capital is enough?" (14 December 2018)

the Commerce Commission and the shared focus on conduct and accountability issues by its members, CoFR should play a coordination role between the proposals.

- 6.10 We accept that, following the precedent of international regimes, this may result in new and stronger powers for the RBNZ with respect to banks, their directors and senior executives.

Resourcing and capability

- 6.11 Westpac proposes that more resourcing and capability is needed for a stronger approach to supervision and enforcement. This should be supported by a more coordinated approach in policy development and engagement with both domestic and off shore regulators. Westpac considers that assessments made by the IMF¹¹ as to RBNZ staff and budget must be addressed, and that additional resourcing is easily justified on a risk/reward analysis.

7. Features of a crisis management system

- 7.1 The proposed crisis management regime will form a critical part of New Zealand's financial safety net, setting out policy and requirements for the recovery and resolution of distressed banks, and will impact other key components of the financial safety net including the development of an effective deposit protection scheme (refer to paragraph 5 above); provision of central bank liquidity support; and appropriate monitoring and supervision to ensure that recovery and resolution strategies can be executed.
- 7.2 Westpac has contributed to, and supports, the NZBA's submissions on crisis management and highlights the following points we consider to be of key importance, including key risks arising from the proposed change are:
- (a) Westpac supports a holistic review of crisis management policy and requirements together with existing resolution strategies and other key components of the financial safety net.
 - (b) Given the complexity of the financial safety net interrelationships, considered thought needs to be given to how new crisis management policy and requirements might impact on, and work together with, existing financial safety net components. Any proposed crisis management regime change should, therefore, not be expedited without the requisite consultation.
 - (c) More particularly, new crisis management regime elements should be considered in the broader context of New Zealand's unique and already existing bank failure resolution policies and requirements, including BS11, OBR and statutory management. All crisis management elements should be designed to work together effectively and efficiently, and in line with any new overarching objectives. For example, flow on impacts that the crisis management regime's new objectives might have on the objectives of existing resolution polices, particularly BS11, requires in-depth analysis and consideration.

¹¹ International Monetary Fund Country Report No. 17/120 *New Zealand Financial Sector Assessment Program: Detailed Assessment of Observation - Basel Core Principles for Effective Banking Supervision* (May 2017) page 37

- (d) The current timeline for the Phase 2 review does not provide adequate time for the development of a new crisis management regime, which will need to be the subject of a separate, detailed consultation. Westpac submits that such a consultation, with appropriate timelines for the subject matter, should be recommended by the Phase 2 review panel.
- 7.3 If all aspects of the financial safety net are not considered in totality, unintended consequences will arise, which could include that:
- (a) The new regime will be governed by a set of defined objectives. However, these may not align with the existing and fundamental objectives for BS11 (**BS11 Outcomes**). BS11 Outcomes may need to be revisited if BS11 is to sit comfortably within a set of governing crisis management objectives. Changes to BS11 Outcomes may result in significant rework for banks, and jeopardise banks' ability to deliver current BS11 projects on time.
 - (b) The Consultation Paper proposes that a new crisis management regime would include recovery planning and testing as well as new resolution powers (in addition to BS11 and OBR). The RBNZ already expects banks to be capable of executing Separation plans and OBR both together and separately, and related resolution planning and testing must achieve this. The addition of new recovery and resolution requirements will further complicate existing resolution planning and testing. Separation plans are required to be finalised by 30 September 2022. If new crisis management requirements impact Separation planning, such late changes might result in significant rework (hence costs) for banks and undermine banks' ability to have their Separation Plans finalised and ready for testing by September 2022.