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Office of the Minister of Finance

Chair,

Cabinet Economic Development Committee

Reserve Bank Act Review – Prudential Regulation of Deposit Takers and Depositor Protection

Proposal

1 This paper seeks in-principle agreement to further prudential regulation and depositor protection arrangements as part of Phase 2 of the Reserve Bank Act Review.

Executive summary

2 The reforms outlined in this paper will strengthen New Zealand's financial system safety net with respect to the role played by deposit taking institutions. Prudential regulation and supervision seeks to promote the stability of the financial system and the soundness of individual regulated entities (such as deposit takers).The prudential regime achieves these objectives through appropriately calibrated rules and requirements, proactive monitoring of the financial health of the individual entities, and an enforcement regime that promotes compliance. It is also critical that, in the event of a crisis, there are clear mechanisms to protect depositors and credible tools for managing the crisis and resolving any failures.

3 The June 2019 in-principle decision (DEV-19-MIN-0161) to harmonise the regulatory regime between banks and non-bank deposit takers has been developed in this paper. This new regime will be consolidated in the creation of a new 'Deposit Takers Act' (DTA). The regulatory regime is expected to capture at a minimum all lenders that offer transactional, savings and term deposit accounts to the public. Further consideration of how the regime will treat lenders who only issue longer-dated secured debt (e.g. finance companies) is needed.

4 I recommend that the Reserve Bank retain a high degree of flexibility in designing the prudential regime and applying it to individual deposit takers, in line with best practice for prudential regulators internationally. Standards will be the primary regulatory instrument under the new framework, which will modernise the regime and allow prudential rules to be disallowed by Parliament under the Legislation Act. Although I expect the new DTA to allow the Reserve Bank to regulate lending standards (such as restrictions on loan-to-value and debt-to-income ratios), there will be further consultation on the use of these powers next year.

5 I intend that the Review will result in a more flexible, graduated enforcement regime for dealing with institutions that have failed to comply with regulatory obligations. This will also allow the Reserve Bank to address emerging concerns in a timely and conclusive manner. To support a more intensive supervisory model, the Reserve Bank should be provided with increased supervisory resources and a power to undertake 'on-site' inspections.

6 I recommend that accountability requirements for directors of deposit takers should be strengthened. Positive duties will be imposed on directors, such as the need to ensure that a deposit taker is run in a prudent manner. I am also recommending that the accountability framework be extended beyond directors to certain senior employees, with obligations cutting across both the prudential and market conduct regulatory frameworks. This latter policy work will be progressed through a cross-agency process separate from the Phase 2 Review.

7 I recommend decisions that further progress the deposit insurance scheme. The scheme should have the objective of protecting depositors and, in so doing, contribute to financial stability. New Zealanders will be able to insure up to $50,000 at a single deposit taker. And the scheme should be funded by levies on deposit-takers, with a guaranteed and pre-arranged funding backstop provided by the Government (if a failure required more money than collected from members at that point). It is desirable to introduce the deposit insurance scheme alongside strengthened supervision and regulation, to mitigate the increase in moral hazard from deposit insurance.

8 Finally, I recommend changes to the crisis management framework in part to reflect lessons learned internationally from the Global Financial Crisis (GFC). As the resolution authority, the Reserve Bank will be provided with a greater range of crisis resolution powers, and clarity about its role and objectives in using these powers. I recommend increasing the range of tools for the orderly resolution of a failed deposit taker, including the addition of a statutory bail-in power (i.e. the ability to write down or convert unsecured liabilities to equity). New safeguards available to creditors will also be established.

9 Further decisions on prudential regulation, crisis management, and depositor protection will be sought from Cabinet next year including:

9.1 specification of the new positive obligations for directors of deposit takers, and related design features to strengthen the individual accountability regime

9.2 the treatment of finance companies who issue longer-dated secured debt within the new regulatory regime, including implications for the scope of deposit insurance

9.3 design features of the deposit insurance scheme required to progress legislation, and whether depositors (or the deposit insurance scheme in their place) should also have preferred access to the assets of a failed deposit taker, and

9.4 the role of the Minister of Finance in crisis management and options for resolution funding.

10 I recognise that the work required to develop the DTA is broad in scope and complex. It will be important to consult with industry on a host of complex issues with important consequences. The Review is aiming for further public consultation in early 2020 to support final Cabinet decisions around July 2020. These timeframes are ambitious, and could be subject to delays if industry engagement raises significant issues that require further consideration. A lengthy drafting and transition period is anticipated, meaning that it will be some years before the Bill is enacted in full.

Background

11 In 2017, the Government announced it would undertake a Review of the Reserve Bank of New Zealand Act 1989 (the Review). Phase 1 of the Review dealt with monetary policy arrangements, resulting in the establishment of a Monetary Policy Committee and the introduction of an economic objective of supporting maximum sustainable employment. Phase 2 of the Review focusses on the institutional structure of the wider Reserve Bank, as well as the Reserve Bank's prudential powers and the arrangements for depositor protection (the focus of this paper).

12 A joint Review team comprising members of both the Treasury and the Reserve Bank is carrying out Phase 2 of the Review. The team is supported by an Independent Expert Advisory Panel (the Panel). The Panel also provides advice directly to me, as appropriate. For Phase 2, the Panel consists of Suzanne Snively (Chair), Malcolm Edey, Girol Karacaoglu, Barbara Chapman, Belinda Moffat, and John Sproat.

13 The recommendations in this paper are decisions I have taken, based on the advice of the Review team, the Treasury, the Reserve Bank, and the Independent Panel.

14 Earlier this year, Cabinet agreed in principle [DEV-19-MIN-0161] to:

14.1 retain prudential regulation and supervision functions as part of the Reserve Bank's responsibilities

14.2 merge New Zealand's two existing prudential regimes for regulating banks and non-bank deposit takers into a single deposit-taking regime, and

14.3 establish a deposit insurance scheme with a coverage limit in the range of $30,000-$50,000.

15 At the same time, a second set of consultation papers was authorised for release. These consultation papers led to a total of 45 formal submissions, alongside a programme of stakeholder engagement undertaken by the Review team. These consultations, and further analysis by the Review team and the Panel, have led to the additional recommendations in this paper.

16 The Review and consultation have also led to an accompanying Cabinet paper proposing final decisions related to the institutional form of the Reserve Bank, including matters such as governance and objectives. In the accompanying paper I recommend that the Reserve Bank of New Zealand Act 1989 (the Reserve Bank Act) be replaced by two pieces of legislation. The first piece of legislation will provide for the institutional form and governance of the Bank ('the Institutional Act'). The second piece of legislation is the new DTA, which will set out the Bank's prudential functions and powers in relation to deposit taking institutions. The Institutional Act reforms alter the form of the Reserve Bank in important ways, such as vesting decision-making rights and responsibility for most matters in a new board. These changes are important context for the changes to prudential powers recommended in this paper, tied to the creation of a new DTA. An update of Cabinet decisions in this paper, and on the Institutional Act (the Review Update), is attached to the accompanying paper. The Review Update will be released at the same time this paper and the accompanying paper are publically released.

Regulatory perimeter

The Deposit Takers Act will create a single regulatory regime for all deposit takers

17 Cabinet has made an in-principle decision to bring the registered bank and licensed non-bank deposit-taker (NBDT) regulatory regimes together into a single 'licensed deposit taker' framework. The majority of submissions to the second consultation supported the in-principle decision on the basis that it will create a more consistent and forward-looking regime, and is necessary to align with any deposit protection arrangements.

18 The regulatory regime is expected to capture, at a minimum, all lenders that offer transactional, savings and term deposit accounts to the public. This perimeter would capture the existing banks, credit unions and building societies. However, given the need to consult with stakeholders such as non-bank deposit takers, the precise definition of a licensed deposit-taker requires further consultation.

19 One remaining issue is how the regime will treat lenders who are reliant on longer-dated secured debt funding (the typical funding model of finance companies). The regulatory perimeter should be sufficiently wide and flexible to address financial stability risks, including emerging risks. My initial view is that finance companies should be prudentially regulated and that the perimeter should be flexible enough to capture entities as a result of financial innovation and FinTech. There is then a subsidiary question of whether finance companies and other entities should be covered by deposit insurance. The Panel also expressed a view that finance companies should continue to be subject to some level of prudential regulation. Officials will engage with stakeholders and consider this matter further during the third round of consultation.

20 The prudential regulation and supervision of deposit takers is primarily undertaken to protect and promote the stability of the financial system as a whole, and to promote the soundness of individual institutions, which together can help to protect depositors from loss (particularly if supported by some form of formal depositor protection scheme – discussed below). Other entities may undertake activities that do not meet the definition of deposit taking but are similar and generate financial stability risks. I expect that the third consultation document will seek feedback on tools to better enable the Reserve Bank to monitor and address these risks that might lie outside the formal deposit-taking perimeter.

Prudential instruments

The setting of prudential requirements should be operationally independent, but with appropriate accountability and oversight

21 A key design question for the DTA is how prudential requirements will be set. Currently the Reserve Bank makes prudential rules for banks mainly through imposing Conditions of Registration (CoRs), whereas prudential requirements for NBDTs are primarily set via Regulations. Key concerns with these approaches include a lack of oversight and transparency in relation to bank CoRs, and the lack of regulatory independence associated with most NBDT prudential requirements being set via Regulations.

22 The technical nature of prudential requirements and the long-term nature of costs and benefits mean most prudential requirements are best set by the Reserve Bank, at arm's length from government. This aligns with international best practice, as articulated in the *Basel Core Principles for Effective Banking Supervision* (the 'BCPs'). As with monetary policy, prudential regulation could be used to generate short term economic

benefits at the cost of accentuating or crystallising longer term risks. Operational independence (with well-defined goals) is seen as the best solution to this 'time inconsistency' problem. In addition, it limits the negative influence on regulation arising from lobbying activity directed at elected officials.

23 I recommend that under the DTA most prudential requirements be set using ‘Standards’, which will be set independently by the Reserve Bank, but which will be disallowable instruments under the Legislation Act. Standards appear to strike an appropriate balance between providing the Reserve Bank the necessary level of flexibility and independence in rule setting, while providing an appropriate level of transparency and Parliamentary oversight, via the Regulations Review Committee.

24 Requirements that have a significant impact on the rights of an individual should be specifically provided for in primary legislation. In particular, while CoRs currently impose ‘fit and proper’ requirements on directors and senior executives of banks, these requirements should be specifically provided for by primary legislation, due to the impact on an individual and the need for appropriate procedural requirements, such as appeal rights. This change would align with the fit and proper requirements that underpin the prudential regime for the insurance sector.

25 I also note that the accompanying Cabinet paper on the Institutional Act reforms recommends matters that the Reserve Bank should have regard to in pursuing its financial stability objective. These matters include a set of principles in legislation, and a requirement for the Government to issue a Financial Policy Remit. The DTA will also likely feature more detailed objectives to further guide the Reserve Bank’s regulation and supervision of deposit takers – for example, a requirement to promote the soundness of individual institutions. This will be part of the consultation next year.

26 Submitters on the second set of consultation papers were supportive of the approach described in this section, which aligns with how prudential requirements are set in Australia and in New Zealand under the Insurance (Prudential Supervision) Act (IPSA).

Standards will need flexibility to deal with the range of deposit-taking institutions, and emerging risks

27 The DTA regime will require the flexibility to deal with all deposit taking institutions from very small NBDTs to the largest banks. This will mean the Reserve Bank should be able (and expected) to construct different rule sets for different classes of deposit taker that are proportionate to the risks involved. The regime should also be flexible enough to be tailored for individual institutions with unique business models or which present risk (e.g. via bespoke licence conditions, exemptions, and potentially institution-specific Standards). The Panel strongly supported giving the Reserve Bank regulatory powers that are flexible and enabling enough to manage an evolving financial system.

28 The DTA will define the scope of matters that the Reserve Bank can set Standards on. I expect that the DTA will enable the Reserve Bank to set Standards in relation to all of the matters that it currently sets CoRs on, although the treatment of lending standards controls will be the subject of further consultation (see below). I also propose to retain the ability for the Minister to add via Regulations additional matters to which Standards can relate, allowing for flexibility in terms of the future scope of requirements.

29 The Review has considered whether the Reserve Bank should be able to regulate terms of lending such as loan-to-value ratio restrictions that aim to limit the damage to the financial system and wider economy from a severe housing market downturn. There are strong arguments for delegating the decision-making for these tools to the prudential regulator, in order to depoliticise policy-making and reduce inaction bias. However, the tools also have distributional effects and can directly impact on other Government objectives such as housing affordability.

30 I expect that under the DTA the Reserve Bank will be able to regulate lending standards for systemic reasons. In the future, this would allow the Reserve Bank to also implement serviceability restrictions on residential mortgage borrowers (such as debt-to-income ratios) if circumstances warrant. However, I have asked for further consultation on this next year, with particular reference to whether the proposed framework would lead the Reserve Bank to have sufficient regard to wider government priorities in the housing area when formulating controls on lending standards.

Supervision and enforcement

The Reserve Bank's prudential supervision is light handed relative to international standards…

31 Supervision and enforcement are tasks undertaken by a prudential authority to monitor the financial health of regulated entities, verify information provided by regulated entities, assess compliance with formal regulatory requirements, and to effect corrective action in the event of non-compliance or to address emerging risks and concerns.

32 Since the 1980s, the Reserve Bank has undertaken less intensive supervision of regulated entities than most international prudential regulators, and made less use of formal enforcement tools with respect to effecting corrective action on the part of registered banks (the formal enforcement toolkit is also more circumscribed than elsewhere, focussing mainly on criminal penalties).[1] This less intensive model is reflected in a longstanding emphasis on self- and market discipline to achieve the Reserve Bank's statutory objectives for prudential policy.

33 While this model has become somewhat less light-handed over time, it is seen as having significant gaps relative to international practice. For

1 Note, the Reserve Bank has undertaken formal enforcement action against insurers and NBDTs under the relevant sectoral legislation, and for the purposes of anti-money laundering under the AML/CFT Act.

example, the banking supervision framework received a 'materially non-compliant' grading by the International Monetary Fund (IMF) against a number of BCPs. Non-compliant assessments in this respect centred on a lack of resourcing for the prudential function, a lack of independent testing of information provided by regulated entities on the part of the Reserve Bank, and the absence of on-site inspections.

34 The majority of stakeholders supported a more intensive supervision model from the Reserve Bank, and the increased resourcing necessary to achieve the accompanying improvement in capacity and capability.

…and its toolkit could be improved.

35 In order to support this change, I recommend that the DTA empowers the Reserve Bank to undertake on-site inspections of any licensed deposit-taker. I expect that the third consultation document will further test the precise scope of this power, and any checks and balances.

36 The current formal enforcement tools available to the Reserve Bank are primarily court-based tools (with powerful criminal penalties), designed to reinforce the framework's emphasis on self-discipline and tied to bank directors 'attesting' to the veracity of six-monthly Disclosure Statements. To-date, no formal court-based actions have been undertaken against registered banks or their directors under the Reserve Bank Act.

37 I recommend that the DTA provides the Reserve Bank with a broader suite of formal enforcement tools, potentially including statutory public notices, infringement fees, enforceable undertakings, and civil penalties. More policy work is required to confirm precisely which additional tools should be added, and their calibration (such as the specific level of penalty attached to any new tool).

38 I also recommend that the Reserve Bank be able to use its powers to issue directions to a deposit taker to help facilitate corrective action, and to de-license a deposit taker without Ministerial involvement (albeit with appropriate thresholds for action).[2] Removing the Minister's role would support an enhancement to the Reserve Bank's operational independence and align with more modern legislation such as IPSA, as well as with international practice.

2 The Review will be examining the specific criteria for revoking a deposit taker's licence. It is likely the appropriate threshold for action would be that the deposit taker has ceased its deposit taking business. Until that time it is appropriate the deposit taker remain subject to Reserve bank regulation and supervision. In addition, the interaction with other licensing regimes will need to be considered (e.g. the new conduct licensing regime that will be administered by the FMA).

More resourcing is needed to support changes to the supervisory and enforcement model

39 I recognise that to support the improvements in the supervisory and enforcement model outlined above, a significant step shift in funding for the Reserve Bank is required. A suitable increase in funding will need to be built into the new Funding Agreement for July 2020 to support the already announced changes by the Reserve Bank for its prudential function. This funding would be informed by advice from the Reserve Bank on the appropriate further enhancements to the supervisory model.

40 I recognise that the precise level of required funding will be a function of internal Reserve Bank deliberations around the parameters of any new supervisory model (the relative mix of off and on-site supervision and related supervisory staff headcount, the required mix of skills and training, and investment in supervisory systems and processes). I also recognise that scaling up supervision will be a multi-year process given the practical constraints on the speed of growth.

Director and executive accountability

I recommend strengthening directors' accountability…

41 Directors of registered banks are currently the focal point for the individual accountability provisions in the Reserve Bank Act. They are faced with criminal liability for making false and misleading attestations in a bank's Disclosure Statement. Conceptually this creates strong incentives for them to provide a thorough oversight role and to take their duties very seriously. It is designed to promote market and self-discipline but there are a number of drawbacks with the regime compared to international practice: there is no guidance from the Reserve Bank to banks as to what constitutes adequate risk management, there is limited verification on the part of the Reserve Bank that attestations are correct, and criminal liability can be disproportionate. Improvements could be made to how banks are providing assurance to both the Reserve Bank and other external stakeholders that they are prudently managing risks.

42 I recommend in-principle that the DTA increase the accountability of the directors of deposit takers by imposing positive duties on directors such as the need to ensure that a deposit taker is run in a prudent manner, acting with honesty and integrity, and dealing with the Reserve Bank in an open and transparent manner. These obligations would be enforced largely under a civil liability framework rather than a criminal one, with criminal sanctions reserved for cases of clear 'intent' or recklessness on the part of directors.

43 These changes will represent a strengthening in the accountability of directors, sharpening their incentives to manage risk and improving the ability of the Reserve Bank to hold directors to account. The third consultation document would test the design and specification of these duties.

…and the development of an integrated prudential-conduct executive accountability regime that includes deposit takers and insurers

44 I am also recommending the development of a formal accountability regime that extends obligations beyond directors to include certain senior employees. The regime will integrate the two key 'peaks' of New Zealand's framework for financial sector regulation – i.e. it will take into account both prudential and market conduct matters. I also envisage that the regime will cover both deposit takers and insurers that are 'dual-licensed' by the Reserve Bank and the FMA. This new 'executive accountability regime' would bring New Zealand broadly in line with similar regimes recently introduced (and still under development) in other jurisdictions such as Australia and the UK. Broadening the scope of accountability recognises the important role that certain executive officers play in affecting outcomes for the institution and the need for the regulator to oversee such personnel, in addition to Board oversight.

45 The Minister of Commerce and Consumer Affairs and I have asked officials to further develop options on how to progress work on an integrated executive accountability regime. This work will take place through a cross-agency process separate from the Phase 2 Review. We expect to receive initial advice outlining the possible timeframes and resourcing requirements for progressing this work, and to subsequently discuss the appropriate prioritisation of this work with the relevant agencies taking into account other policy and legislative initiatives (e.g. the introduction of the new 'fair conduct' licensing regime next year).

Depositor protection

Deposit insurance aims to protect depositors and thereby contribute to financial stability

46 Deposit insurance schemes aim to promptly reimburse protected depositors in a failed deposit taking institution, rather than leaving depositors reliant on the insolvency process (facing delays and uncertainty in recovery). Deposit insurance is near universal in other developed countries. In June 2019, the Government announced its in-principle decision to introduce a permanent deposit insurance scheme (DIS) in New Zealand. I am asking Cabinet to take further in-principle decisions now to advance the design of the scheme.

47 I recommend that the deposit insurer should have the core objective to "protect depositors from loss, and in so doing, contribute to financial stability". Protecting depositors is obviously central to the scheme. The objective also recognises that protecting depositors can contribute to financial stability by enhancing public confidence in the financial system and reducing the likelihood that Governments will opt to bail out all creditors at the expense of taxpayers. It is also important that the scheme is designed to mitigate any increase in moral hazard (i.e. the possibility that high risk institutions grow rapidly as a result of the provision of insurance).

I recommend that the scheme will limit insurance at $50,000, per depositor, per institution…

48 When I announced the in-principle decision to set up a DIS, I also recommended a limit on the maximum coverage of a depositor at a single institution (coverage limit) in the range of $30,000-$50,000. I now recommend setting the coverage limit at $50,000. This limit would fully cover the vast majority of depositors, thought to be 90% or more. The negative short-run impact on industry and/or depositors can be mitigated by allowing longer timeframes to build up industry funding for the scheme.

49 The recommended limit is consistent with guidance from international bodies that the vast majority of depositors should be fully covered, while leaving a large share of the value of deposits exposed to loss. Feedback from the consultation supported a higher coverage limit in line with international practice. Insurance coverage limits in most developed countries are significantly higher (European countries have limits around $175,000 NZD, for example).

50 I recommend that the limit will apply per depositor, per institution. This means that depositors could obtain coverage for more than $50,000 by splitting their savings across accounts held at different deposit taking institutions. Applying the limit on a per institution basis means that deposit takers can readily calculate the insurance coverage of their customers, and that (at the margin) depositors are incentivised to diversify their accounts across the industry. Applying the limit on a per account basis would be problematic, given that depositors could easily increase their coverage by opening multiple accounts at the same deposit taking institution.

51 I envisage that the coverage limit would be set by Regulation, so that it is under the control of the Minister of Finance and may be regularly reviewed without needing to amend primary legislation. When the scheme is in place, it will likely alter depositor behaviour. More data will become available on the proportion of depositors that are fully covered by the limit. This supports the case for reviewing the DIS once it has time to bed in. This could potentially occur as part of a post-implementation review of the new regulatory regime for deposit taking institutions. Reviews of the scheme should assess whether it is meeting its long-run objectives. The durability of the scheme design can be enhanced by setting clear public expectations about coverage levels in advance of a crisis.

…and that deposit takers will fund the scheme, with a Government backstop

52 In addition to the coverage limit, I recommend some further in-principle decisions that will shape future work and provide additional clarity to the public on the scheme:

52.1 As noted above, further work is needed on the scope of the institutions that are licensed as deposit takers. A related issue for further consideration is the products that are in scope for deposit insurance. At a high level, I intend that membership in the scheme will be compulsory for deposit-takers. This will result in a minimum level of regulatory and supervisory intensity in order for an institution to be able to offer insured products, helping to manage any increase in moral hazard from the provision of insurance.

52.2 The scheme will be funded by levies on covered institutions with a backstop provided by the Government. The funding for the scheme should come from levies collected from licensed deposit takers (i.e. a user-pays model where the costs are borne by institutions and depositors benefitting from the scheme). A supplementary guaranteed and pre-arranged Government funding source is necessary to support public confidence in the scheme during periods of financial stress. Any funding provided by the Government would be recouped through recoveries from the failed deposit taker and, if necessary, additional levies on the remaining industry in subsequent years.

Further design features of depositor protection will be subject to consultation next year

53 I intend for the DIS to be advanced in the same Bill that establishes the DTA. This delays the introduction of deposit insurance, but I consider it highly desirable that deposit insurance is progressed alongside the other reforms discussed in this paper. Bringing in deposit insurance before strengthened regulatory and supervisory requirements are in force would expose the DIS to additional risks.

54 Further design features of the scheme will be part of the public consultation in early 2020. This includes the specific deposit products covered, detailed funding arrangements, and the institutional location and governance of the scheme.

55 Depositor preference will also be considered further in the 2020 consultation. If depositor preference is introduced, it would mean that preferred depositors' claims are given priority above the claims of other unsecured creditors in the event of the failure of a deposit taker.[3] Preference for deposits could substantially reduce the potential burden of a failure on the deposit insurance scheme. However, the introduction of depositor preference could also potentially increase wholesale funding costs for deposit takers, or make it difficult for some institutions to raise non-deposit funding.

Bank resolution and crisis management

56 Crisis management underpins financial stability. New Zealand's legislative framework for bank crisis management, being largely based on statutory management, has not been meaningfully reviewed since the late 1980s. In the intervening time, bank resolution and recovery regimes have been fundamentally overhauled internationally.

57 The Review's work has been informed by the international experience during and since the GFC and the international guidance that has emerged from that experience. The Review also consulted with foreign authorities (including UK, Hong Kong, and Australian authorities) and international experts in bank resolution. The Review has referred to and given significant weight to the Financial Stability Board's (FSB's) *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the Key Attributes)[4] plus the resolution regime developed by the UK and administered by the Bank of England.[5]

58 While the Review's work is continuing on several aspects of bank resolution and crisis management, a number of in-principle decisions are sought now to confirm the direction for that further work.

3 A preference for depositors would technically only apply in a liquidation. However, in other resolutions, the resolution authority would be required to have regard to the creditor hierarchy that would apply in a liquidation and, as discussed in the crisis management section below, creditors that are made worse off than they would have been in a liquidation would be compensated *ex post*.

4 One of the key responses to the GFC from the international community was the development of the FSB 'Key Attributes'. The Key Attributes are recognised as setting out an international standard for bank resolution regimes and are endorsed by world bodies such as the IMF. The FSB Key Attributes are increasingly being drawn upon in other jurisdictions' reforms.

5 The UK has been instrumental in spearheading international efforts on developing policy on bank resolvability and is considered to be among the forefront of its international peers in terms of implementing the domestic resolution framework. Being a major financial centre and host of global systemically important banks, the UK regime sets out a number of provisions that will be less relevant to New Zealand. Nevertheless, several basic features of the UK regime (such as resolution objectives and bail-in mechanisms) will be relevant to New Zealand.

Designating the Reserve Bank as the resolution authority for deposit takers

59 Clarity on who exercises resolution powers (and accountability for exercising those powers) is critical to the legitimacy of the resolution regime given its scope for affecting shareholder and creditor rights and the potential re-distributional decisions that may result. A lack of clarity can lead to poor pre-crisis preparedness and delay in responding to a crisis.

60 The existing Act does not explicitly designate a resolution authority function nor does it provide a clear set of resolution objectives for a statutory manager when exercising resolution powers. Better clarity can be achieved by legislation designating the Reserve Bank as the resolution authority for deposit takers and setting out the functions and objectives associated with that role. As part of the Reserve Bank's resolution functions, I am proposing that the Reserve Bank prepare and maintain resolution plans for deposit takers.[6] This function includes identifying preferred resolution strategies and impediments to resolution, and working with deposit takers to remove those impediments where possible. Crucially, deposit takers – particularly the large banks – will be expected to provide substantial input into developing and maintaining resolution plans, reflecting the need for resolution plans to closely reflect the nature of their specific business, for assessment by the Reserve Bank and as the main input to inform the Reserve Bank's resolution planning.

61 Taking into account international good practice guidance for resolution authorities and New Zealand's circumstances, I propose that the Reserve Bank's resolution functions be focussed on:

61.1 preparing and maintaining a plan to resolve each deposit taker in the event of its possible failure

61.2 testing the effectiveness of those plans at regular intervals

61.3 coordinating with other authorities, both in New Zealand and overseas, as necessary to be prepared for the possible failure of a deposit taker, and

61.4 in the event of a deposit taker failure, exercising the powers available to the Reserve Bank consistently with the objectives set out below.

6 Resolution plans aim to achieve an orderly resolution without systemic consequences, so they will be most detailed for large firms. For small deposit takers whose liquidation would not threaten financial stability, the plan may simply be to liquidate.

62 Consistent with good regulatory design principles, if extensive powers are conferred on an unelected body, they should be accompanied by clear statutory objectives governing the use of those powers. Given the intrusive nature of resolution powers in particular, and their potential distributional impacts, it is important that there is sufficient clarity on the outcomes that the Reserve Bank should be aiming to achieve as the resolution authority.

63 I propose the following statutory objectives for the Reserve Bank in performing the resolution authority function:

63.1 Enable all deposit takers to be resolved in an orderly manner.

63.2 Avoid significant damage to the financial system in the event of the failure of a deposit taker, including by maintaining the continuity of systemically important financial functions and preventing contagion.

63.3 To the extent not inconsistent with the objective immediately above:

i. minimise the cost of resolution and avoid unnecessary destruction of value and interference with property rights, and

ii. protect public funds, including by minimising the need to apply public funds to resolve the failure of a deposit taker.

64 The first objective reflects the resolution authority's resolution planning function, which is critical to ensuring an effective resolution regime. The second objective acknowledges that resolution underpins financial stability, particularly through maintaining the continuity of systemically important functions and avoiding contagion. The last objective reflects the idea that those exercising resolution powers are likely to be best placed to help manage fiscal risk to the government if public funds were ever needed to be relied upon in a resolution. Further work will be done on defining 'public funds' to inform final decisions in 2020.

Putting resolution powers directly in the hands of the resolution authority

65 Under the current Act, existing resolution powers (other than directions) can only be exercised by a statutory manager. Statutory management displaces the powers of the existing board and management of an entity and vests them in a statutory manager. Existing resolution powers include incorporating a body corporate under the Companies Act 1993, transferring the whole or any part of a bank in resolution to that body, selling the whole or any part of a bank in resolution, or applying to have a bank in resolution placed into liquidation.

66 Statutory management may not always be required to effect a resolution. Several of the existing powers that are currently available only under

statutory management could potentially be exercised directly by the resolution authority without the need to invoke statutory management.

67 In line with international guidance, I propose that, where practicable, certain existing powers under statutory management be available directly to the Reserve Bank as the resolution authority without requiring that a bank be placed into statutory management. These powers could include setting up a bridge bank[7] or applying for a failed deposit taker to be put into liquidation.

68 A modified form of statutory management under the Reserve Bank's control should, however, still be available as an option to address situations where taking full control of a failed deposit taker is necessary to implement the chosen resolution option. Based on an in-principle decision to provide more flexibility for the Reserve Bank to act outside of statutory management, officials will develop further options and advice on the powers that could be transferred to the Reserve Bank and the future model of statutory management for deposit takers.

Bail-in can offer a credible alternative to taxpayer bailouts of large banks…

69 The GFC demonstrated, among other things (including the need for strong supervision and for banks to be adequately capitalised to materially reduce the risk of failure), the need for resolution authorities to have the tools to resolve failing banks quickly, without destabilising the financial system or exposing taxpayers to loss. The publicly funded bailouts and financial sector guarantees employed in many jurisdictions during the GFC came to be viewed as too expensive and too inequitable to society and too harmful to market discipline.

70 A range of tools are required to resolve a range of banks that vary in size and complexity. One solution developed internationally following the GFC is bail-in. Bail-in is the writing down of unsecured liabilities to absorb losses and/or the conversion of unsecured liabilities into new equity. When shareholders' equity in an entity has been depleted through the absorption of financial losses, bail-in enables further losses to be absorbed (if necessary) and, importantly, the failed entity to be recapitalised to the point where it may be able to meet minimum regulatory requirements and re-enter (or remain in) the financial system with the market's confidence.

71 Bail-in can help return a failed bank to a viable/solvent state, allowing time – if required – for a longer term solution or restructuring to be determined. Achieving this outcome requires the ability to absorb any remaining losses and recapitalise the failed bank – quickly and reliably.

7 A bridge bank is a temporary entity set up by the resolution authority and into which key parts of a failed bank's business are transferred.

72 Stakeholder feedback during the Review was supportive of introducing the bail-in tool, including from banks and members of the legal community who have familiarity with bank resolution issues internationally. The sector's support recognises that there are advantages to New Zealand's banking sector in having resolution tools which reflect international guidance, have become familiar internationally, and are well-understood by institutional investors.

73 Operationalising bail-in, however, requires working through a number of complicated issues, including which liabilities would not be eligible to be bailed in and how the issuance of new shares would interface with other legislation. Bail-in also may not be usable in all situations. Key among those issues is how to enforce the bailing in of debt instruments issued by New Zealand banks under foreign law and whether bail-in can be achieved when conversion or write-down is not included in the terms of an instrument. Other jurisdictions (including Australia, the UK, and the EU) have developed approaches which New Zealand could draw upon. In general, the international experience is that contractual clauses in debt instruments are necessary.

74 I therefore propose an in-principle decision that statutory bail-in powers be added to the options for resolving a failed bank with regulations specifying the types or categories of liabilities that would be excluded from bail-in, while the Review continues to work on second-tier policy parameters.

…supported by international norms on creditor safeguards

75 Respect for property rights is a fundamental principle of insolvency law that allows investors and creditors to identify the risks to which they are exposed, allowing them to be priced and managed prudently in normal business. Certain creditor safeguards in the resolution of a failed bank are considered international best practice and are a common expectation among creditors internationally.

76 Exercising resolution powers in a way that respects the hierarchy of creditors that would apply in liquidation is accepted internationally as good practice. In cases where respecting the hierarchy of creditors is not feasible or where departure from the hierarchy can be justified on financial stability grounds, the principle that creditors should nevertheless be left no worse off than in a liquidation is widely recognised internationally.

77 The 'no creditor worse off than in liquidation' (NCWO) principle is a central element in the FSB Key Attributes. It is strongly promoted by the IMF and has been adopted in one form or another by many jurisdictions.

78 New Zealand is currently an outlier internationally for its lack of safeguards for creditor property rights in a bank resolution. New Zealand's existing statutory management model prevents creditors from exercising their contractual rights by placing a moratorium, with no time limit, on exercising those rights. Statutory management also currently prioritises restoring public confidence and resolving the difficulties of the failed bank as quickly as possible over respecting the creditor hierarchy that would apply in a liquidation – with no compensation to adversely affected creditors.

79 Reflecting international norms on creditor safeguards in bank resolution, I propose that:

79.1 resolutions should be required to be conducted in a manner that respects the creditor hierarchy that would normally apply in a liquidation unless departure from the hierarchy is necessary to maintain the stability of the financial system, including maintaining critical financial functions, and

79.2 an after-the-event compensation mechanism be established to compensate creditors if a resolution left some creditors worse off than they would have been in an ordinary liquidation (the 'no creditor worse off' principle).

80 In circumstances where maintaining the stability of the financial system required some creditors to be worse off than they would have been in a normal liquidation, NCWO will require the payment of compensation. The potential need for such compensation is one of the reasons for ensuring the resolution authority has access to 'resolution funding' of one form or another. The Review will be providing advice and recommendations on resolution funding and the mechanics of NCWO in 2020. I expect this advice will include whether any additional measures are necessary to address the legal risk to the integrity of a bank resolution involving liquidation and the fiscal risk to the Crown arising from the existing voidable transactions provisions available to a liquidator under the Companies Act 1993.[8]

Consultation

81 The following agencies were consulted: the Ministry of Business, Innovation and Employment and the Financial Markets Authority. The Department of Prime Minister and Cabinet has been informed.

82 Workshops and discussions have also been held with Associate Ministers of Finance, the Minister for Commerce and Consumer Affairs and the Minister for Urban Development.

8 Section 292 of the Companies Act 1993 provides that a liquidator can void an insolvent transaction that enables a person to receive more towards satisfaction of a debt owed by the company than the person would receive, or would be likely to receive, in the company's liquidation.

83 Two rounds of public consultation have taken place as part of Phase 2 of the Review. The first round closed on 25 January 2019 and received 67 submissions. The second round of public consultation closed on 16 August 2019 and received 45 submissions. A third round of public consultation is planned for next year but will only relate to matters relevant to the DTA.

Financial Implications

84 This paper has no direct financial implications as policy decisions are still at an in-principle stage. Final policy decisions made later in the Review will have direct financial implications (for example, potentially increasing the operating expenditure of the Reserve Bank to support a broader set of responsibilities). In addition a significant step shift in the resourcing and funding for the Reserve Bank will be required to support a more intensive supervisory and enforcement model. Decisions around depositor protection and crisis management will also have indirect implications (for example, a Government backstop for deposit insurance may create an explicit contingent liability).

Legislative Implications

85 While there are no direct legislative implications arising from this paper, final policy decisions made next year are expected to result in a new 'Deposit Takers Act' which will replace the existing prudential arrangements in the Reserve Bank Act 1989 and Non-Bank Deposit Takers Act 2013.

Impact Analysis

86 A regulatory impact statement is not required at this stage. A regulatory impact statement will be prepared when final policy decisions are sought.

Human Rights

87 There are no human right implications arising from this paper.

Gender Implications

88 There are no gender implications arising from this paper.

Disability Perspective

89 There are no disability implications arising from this paper.

Publicity

90 I recommend that Cabinet's decisions and this paper will be publically released shortly after decisions are made. Cabinet's decisions relating to the Institutional Act and accompanying paper, together with the Review Update, will be publically released at the same time.

Proactive Release

91 I also recommend to proactively release supporting material and advice (such as policy advice reports, Panel papers and presentations) relating to these recommendations.

Recommendations

92 The Minister of Finance recommends that the Committee:

1 note that the prudential framework for deposit takers and depositor protection arrangements, will progress separately from reforms to the Reserve Bank's institutional framework, with final policy decisions intended to be sought in mid-2020

Prudential regulation

2 agree in principle, subject to the further work outlined in paragraph 8 below, that the prudential framework for deposit takers should provide for:

2.1 Standards set by the Reserve Bank as the primary tool for imposing regulatory requirements on deposit takers, with a high degree of flexibility to tailor requirements to individual deposit takers and classes of deposit takers

2.2 requirements that impact on the rights of individuals to be provided for in primary legislation, in particular fit and proper requirements for directors and senior executives

2.3 the scope of matters that the Reserve Bank will be able to set Standards on, with the ability for the Minister to add additional matters to which Standards can relate via Regulations

2.4 increased accountability requirements for directors of deposit takers established through broad positive duties, with civil penalties as the primary sanction for non-compliance

2.5 the Reserve Bank to undertake on-site inspections of any licensed deposit-taker, and any other regulated entity as appropriate

2.6 the Reserve Bank to be able to issue directions to a deposit taker without Ministerial consent but subject to appropriate thresholds, and to delicense a deposit taker without a role provided for the Minister, and

2.7 a more graduated enforcement and penalty framework with a broader range of potential sanctions than the current Reserve Bank Act, such as including statutory public notices, infringement fees, enforceable undertakings, and civil penalties

3 agree in principle, subject to further advice from a cross-agency process separate from the Phase 2 Review, to the development of an integrated prudential-conduct executive accountability regime which extends accountability requirements to include certain senior employees of deposit takers and insurers

4 note that I expect that powers to regulate lending standards will be provided in the DTA in broadly the same way as other prudential requirements, but I have asked for further consultation on these powers next year

5 note that the Reserve Bank intends to use these changes to support more intensive monitoring of deposit takers against prudential requirements, and a greater willingness to address instances of non-compliance, or areas of emerging concern, in a timelier manner

Depositor protection

6 agree in principle, subject to the further work outlined in paragraph 8 below, that:

6.1 the deposit insurance scheme's objective should be to "protect depositors from loss, and in so doing, contribute to financial stability"

6.2 the maximum amount of coverage for a single depositor at a single institution will be $50,000

6.3 membership of the scheme should be compulsory for all licensed deposit-taking institutions

6.4 the scheme will be fully funded by levies on member institutions, and

6.5 the Government will provide a funding backstop to enhance the credibility of the scheme, with any funds provided ultimately recouped from member institutions

Bank resolution and crisis management

7 agree in principle, subject to the further work outlined in paragraph 8 below, that:

7.1 legislation designate the Reserve Bank as the resolution authority for regulated deposit takers

7.2 statutory functions for the Reserve Bank as resolution authority include the following:

i. to prepare and maintain a plan to resolve deposit takers in the event of a possible failure

ii. to test the effectiveness of each plan at regular intervals

iii. to coordinate with other authorities, both in New Zealand and overseas, as necessary to be prepared for the possible failure of a deposit taker, and

iv. in the event of the failure of a deposit taker, to exercise the powers under the DTA consistently with the objectives under the DTA

7.3 the Reserve Bank have the following statutory objectives in performing the resolution function:

i. enable all deposit takers to be resolved in an orderly manner

ii. avoid significant damage to financial system in the event of the failure of a deposit taker, including by maintaining the continuity of systemically important financial functions and preventing contagion, and

iii. to the extent not inconsistent with ii:

a. minimise the cost of resolution and avoid unnecessary destruction of value and interference with property rights, and

b. protect public funds, including by minimising the need to apply public funds to resolve the failure of a deposit taker

7.4 where practicable, existing resolution powers currently available to a statutory manager be available directly to the Reserve Bank as resolution authority

7.5 the Reserve Bank have the ability to restore to solvency or to recapitalise a failed deposit taker by writing down or converting to equity unsecured liabilities (statutory 'bail-in')

7.6 legislation provide for the Governor-General, by Order in Council, to make Regulations specifying types or categories of unsecured liabilities that would be excluded from bail-in

7.7 resolutions be required to be conducted in a manner that respects the creditor hierarchy that would normally apply in a liquidation unless departure from the hierarchy is necessary to maintain the stability of the financial system, including maintaining critical financial functions, and

7.8 an after-the-event compensation mechanism be established to compensate creditors if a resolution left some creditors worse off than they would have been in an ordinary liquidation (the 'no creditor worse off' principle)

8 note that the Review will be conducting further work to develop advice on the prudential, depositor protection, and crisis management regime, and will be conducting a further round of public consultation on these aspects

9 note that there are significant complexities with enacting the recommended resolution framework, particularly operationalising statutory bail in. This will be a key focus of the further work on the crisis management regime outlined above

10 note that the Minister of Finance expects to seek Cabinet approval to release a further consultation document in early 2020

11 note that a significant step shift in the resourcing and funding for the Reserve Bank is required to support the changes recommended in this paper

12 agree that Cabinet's decisions and this paper be publically released

13 agree to the proactive public release of material (such as policy advice reports, Panel papers and presentations) relating to these decisions

Authorised for lodgement

Hon Grant Robertson
Minister of Finance
Date: