The Treasury

Reserve Bank Act Review Phase 2 Review Update Proactive Release

March 2020

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RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

TE TAI ŌHANGA
THE TREASURY

Report: Update on planned Deposit Takers Act and Depositor Protection

Date:	3 October 2019	**Report No:**	T2019/3011
		File Number:	MC-1-7-3-1-13

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Indicate** your agreement to the recommendations **Discuss** outstanding matters with Officials on 10 October	Thursday,10 October 2019

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
David Hargreaves	Principal Advisor, Reserve Bank Act Review – Phase 2	[39] (wk)	✓
Bernard Hodgetts	Director, Reserve Bank Act Review – Phase 2	[39] (wk)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Refer a copy of this report, to the Associate Ministers of Finance and Hon Twyford.

Enclosure: No

Report: Update on planned Deposit Takers Act and Depositor Protection

Executive Summary

This report on the Review of the Reserve Bank Act (the Review) focuses on the Deposit Takers Act. The Deposit Takers Act is intended to contain the Reserve Bank's prudential powers (including crisis management) related to deposit taking institutions like banks, and progress the development of depositor protection. As described below, we consider it highly desirable that these two inter-related issues are progressed together. The recommendations in this report are joint recommendations of the Treasury and the Reserve Bank unless indicated otherwise. It may be useful to read this report alongside the accompanying report on the proposed institutional structure and objectives of the Reserve Bank (T2019/2764).

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, however, further consideration of how to treat lenders who only issue longer-dated debt securities (e.g. finance companies) is needed. We propose to consult on this issue in early 2020, which will have implications for the overall operation of the regime, including the scope of deposit insurance.

We recommend the new regulatory regime for deposit-takers be based primarily around the setting of 'Standards' by the Reserve Bank, rather than the current 'Conditions of Registration' approach. This will modernise the regime and bring prudential rules within the scope of review by Parliament's Regulation Review Committee. Relative to other domestic regulatory regimes, the Reserve Bank should retain a high degree of flexibility in designing the prudential regime and applying it to individual deposit takers, as is best practice for prudential regulators internationally. We propose that lending standards such as loan-to-value ratios (LVRs) should be amongst the areas in which the Reserve Bank will be able to set Standards.

The report proposes that the Reserve Bank also have a more flexible, graduated enforcement regime for dealing with institutions that have failed to comply with regulatory obligations, or to address emerging concerns in a timely and conclusive manner. The Reserve Bank should also be provided with increased supervisory resources to monitor the financial health of individual regulated entities and to assess compliance more comprehensively. A power to undertake 'on-site' inspections will support the independent verification of information provided by regulated entities to the Reserve Bank.

As well as penalising non-compliant institutions, the Reserve Bank would have a wider range of enforcement tools (including civil penalties) that could be applied to the directors of deposit taking entities, who would be subject to a more comprehensive set of accountability requirements. More intensive supervision and enhanced director accountability would be useful building blocks that could be extended into an 'executive accountability regime' that includes both directors and specified senior executives, if needed in the future. We do not recommend doing this now, as those building blocks are not in place and (once in place) may prove sufficient. Moreover, executive accountability regimes are fairly novel and largely untested internationally, and further policy work is needed to assess the merits of creating an integrated accountability regime across both the prudential and financial market conduct peaks of New Zealand's regulatory system.

The report recommends a range of in-principle decisions to advance progress on the deposit insurance regime. We recommend the scheme has the objective of protecting depositors and, in so doing, contribute to financial stability; coverage is limited to $50,000 on a per depositor, per institution basis; membership of the scheme being compulsory for all deposit-takers; and the scheme being levy funded from deposit-takers with a government backstop (if a failure required more money than the fund had collected at that point). Further work is required before deciding whether a depositor preference should be put in place alongside deposit insurance. Other elements of the scheme (such as whether the fund is a separate legal entity or integrated into a larger institution) will be consulted on early next year, focussing on design features that are required to commence drafting legislation prior to the election.

The final substantive section of the report discusses crisis resolution tools for managing the failure of a deposit-taker. The report proposes confirming the Reserve Bank as resolution authority with a greater range of crisis resolution powers, alongside greater clarity about the Reserve Bank's role and objectives in using these powers. Reflecting the lessons learned internationally from the global financial crisis, a key aim of the reforms is to provide a sufficiently wide range of tools for the orderly resolution of a failed deposit taker without severe disruption to the financial system and without relying on taxpayer funds. Two key in-principle decisions being sought here are the addition of statutory bail-in to the resolution toolbox (i.e. the ability to write down or convert unsecured liabilities to equity) and the provision of clear creditor safeguards. Both proposals are consistent with international best practice guidance and received strong support through the Review's consultation process. Further work on crisis management is continuing and will be included in the Review's advice in 2020. This further work will include options for the role of the Minister of Finance in crisis management and options for resolution funding (if funding is ever required in a resolution).

The Reserve Bank remains open to continuing to explore the concept of a bail-in power, but considers that an in-principle recommendation on bail-in is premature, due to the large number of outstanding issues around the design and effect of such a power. For example, why statutory rather than contractual bail-in is preferred, the extent to which classes of liabilities could be included or excluded from the scope of the power via regulations, how a bail-in power fits with the recommended no creditor worse off approach and (if it is adopted) depositor preference, and the value and scope of liabilities that could plausibly be bailed-in compared with the potential hole in a failed bank's balance sheet.

The Reserve Bank is also concerned that any statutory power that purports to be able to bail in liabilities that are not supported by relevant contractual clauses may not be credible. The Reserve Bank notes that the Australian Prudential Regulation Authority (APRA), its Australian equivalent, does not have a statutory bail-in power. Rather its legislation presupposes contractual bail-in. The Reserve Bank considers that aligning with Australia on this issue is likely to be a more practical option.

The Review will provide you with a further report on these matters in mid-October if necessary. Following your feedback on these reports, a Cabinet paper will be prepared in time for consideration by the Cabinet Economic Development Committee on 20 November. As described below, decisions taken would then be reported back publically, with a further public consultation (C3) expected in early 2020.

Independent Panel Views

The Panel is supportive of the majority of the Deposit Taking Act recommendations. The Panel wishes to note views around the regulatory perimeter, regulatory powers, and crisis management.

Regulatory Perimeter
The Panel feels that, given the risks that arose from finance companies and similar activities in the GFC, these entities should be subject to some level of prudential regulation. The Panel recommends further consultation on options for these regulatory requirements, including whether finance companies should be regulated as deposit takers.

Regulatory Powers
The Panel reiterated its previous recommendation that the regulatory powers given to the Reserve Bank need to be enabling and flexible enough to allow the Reserve Bank to manage an evolving financial system. In this regard, the panel suggests not being overly narrow when defining the scope of regulatory powers in legislation.

Crisis Management
The Panel recognises the differences of opinion between the Reserve Bank and Treasury on how quickly to progress certain recommendations. It is pleasing to the Panel, however, that there is broad agreement on the general direction and that the direction is consistent with the 'enabling' concept the panel has advocated – that is, working to provide additional ways to resolve a distressed deposit taker. The Panel supports this direction of travel.

Recommended Action

We recommend that you:

General matters

a **Note** the intended process described in this paper for progressing the Deposit Takers Act (DTA), where the decisions proposed in this paper are taken through Cabinet in November, with further consultation in early 2020, aiming to lead to drafting commencing in the second half of 2020.

Noted

Regulatory framework for deposit-taking institutions

b **Note** that the financial stability objective and decision making principles proposed for inclusion in the institutional Act (T2019/2764 refers) will guide the Reserve Bank's actions under the DTA, supported by subsidiary objectives in the DTA.

Noted

c **Note** that while we expect the 'deposit taker' regime to capture lenders that offer transactional, savings and term deposit accounts to the public, we propose to consult on the appropriate treatment of lenders that only issue longer-dated debt securities such as finance companies.

Noted

d **Agree in principle** that the RBNZ should have stronger tools for monitoring non-deposit taking (e.g. wholesale funded) lenders for financial stability risks.

Agree/disagree

e **Note** that we will provide you with further advice on matters relating to non-deposit taking lenders, such as reporting and macro-prudential requirements, and powers to designate them into the deposit-taking regime.

Noted

f **Agree in principle** that the legislation for deposit-takers should use Standards as the primary tool for imposing regulatory obligations on deposit takers, with the empowering legislation allowing the Reserve Bank a high degree of flexibility to tailor Standards to individual deposit takers and classes of deposit takers.

Agree/disagree

g **Note** that we expect to recommend defining the scope of matters that Standards may relate to (e.g. the capital, liquidity, and risk management framework of an institution) in a more prescriptive way than the current Act.

Noted

h **Note** that we will consult on procedural requirements for the promulgation and imposition of standards in the third consultation document to be released in early 2020.

Noted

i **Agree in principle** that macro-prudential policy will be empowered by the new Act in the same way as other prudential requirements, including giving the Reserve Bank the ability to control lending standards like loan-to-value ratios (LVRs) through Standards.

Agree/disagree

j **Agree in principle** that the DTA include significantly increased accountability requirements for directors of regulated entities, focused on duties such as ensuring the entity is run in a prudent manner, with civil penalties as the primary redress.

Agree/disagree

k **Note** that the Review Team considers that a more comprehensive 'executive accountability' regime applying to both directors and senior employees would best be considered once we have more experience with the proposed enhanced obligations on directors, and more intensive supervision has deepened our understanding of how responsibility is best divided amongst directors and senior executives.

Noted

l **Agree in principle** that the Reserve Bank be provided with the power to undertake on-site inspections of any licensed deposit-taker, and any other regulated entity as appropriate, either as a generic power in the Institutional Act, or specified separately in the relevant sectoral legislation.

Agree/disagree

m **Agree in principle** that the DTA provide the Reserve Bank with power to issue directions to a deposit taker without Ministerial consent but subject to appropriate thresholds, and to deregister a deposit taker without a role provided for the Minister.

Agree/disagree

n **Agree in principle** that the DTA allow for a more graduated enforcement and penalty framework with a broader range of potential sanctions than the current Reserve Bank Act, potentially including statutory public notices, infringement fees, enforceable undertakings, and civil penalties.

Agree/disagree

o **Note** that the Review considers that these new powers should be used by the Reserve Bank to undertake more intensive monitoring of deposit takers against prudential requirements, and to support a greater willingness to address instances of non-compliance, or areas of emerging concern, in a timelier manner.

Noted

Depositor protection

p **Agree in principle** that the deposit insurance scheme should pursue the objective to "protect depositors from loss, and in so doing, contribute to financial stability", which may be supplemented with supporting text either within this objective or elsewhere in the legislation.

Agree/disagree

q **Agree in principle** that, given the proposed range of $30,000-$50,000, the maximum amount of coverage for a single depositor at a single institution be $50,000.

Agree/disagree

r **Note** that stakeholder feedback supported coverage limits that are closer to international norms (significantly higher than that currently proposed).

Noted

s **Note** that the review team believes it is desirable for the Minister to take in principle decisions on some additional high-level aspects of the deposit insurance scheme now (set out immediately below). These decisions would provide a stronger foundation for making the coverage limit decision, and assist with communicating the announcement of the coverage limit in November.

Noted

t **Agree in principle** that the membership of the scheme should be compulsory for all licensed deposit-taking institutions.

Agree/disagree

u **Agree in principle** that the scheme will be fully funded by levies on member institutions.

Agree/disagree

v **Agree in principle** that the government will provide a funding backstop to enhance the credibility of the scheme, with any funds provided ultimately recouped from member institutions.

Agree/disagree

w **Note** that the Review Team has produced a roadmap of future policy work required to implement the deposit insurance scheme, including further consultation on key design elements in February 2020, such as the specific deposit products covered, detailed funding arrangements, and the institutional location and governance of the scheme.

Noted

x **Note** that the Review Team recommends deferring the decision on depositor preference, to allow more time to engage with concerns raised by industry and undertake more analysis.

Noted

y **Note** that the Review Team recommends that deposit insurance should be introduced alongside the new regulatory and supervisory legislative framework for deposit-taking entities. This means that deposit insurance may not be fully operational for some time, late 2022 at the earliest.

Noted

Bank resolution and crisis management

z **Agree in principle** that legislation designate the Reserve Bank as the resolution authority for regulated deposit takers.

Agree/disagree

aa **Agree in principle** that statutory functions for the Reserve Bank as resolution authority include the following:

(1) To prepare and maintain a plan to resolve each deposit taker in the event of its possible failure

(2) To test the effectiveness of each plan at regular intervals

(3) To coordinate with other authorities, both New Zealand and overseas, as necessary to be prepared for the possible failure of a deposit taker

(4) In the event of the failure of a deposit taker, to exercise the powers under this Act consistently with the objectives under this Act

Agree/disagree

bb **Agree in principle** the following statutory objectives for the Reserve Bank in performing the resolution function (subject to drafting):

(1) [Ensure that] All deposit-takers can be resolved in an orderly manner.

(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.

(3) To the extent not inconsistent with (2):

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

Agree/disagree

AND, EITHER

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

(Treasury recommendation)

Agree/disagree

OR

iii. minimise the need to apply public funds to resolve the failure of a deposit taker.

(Reserve Bank recommendation)

Agree/disagree

cc **Agree in principle** that several existing resolution powers currently available to a statutory manager should be available directly to the Reserve Bank as resolution authority (e.g. the power to apply for a deposit taker to be put into liquidation).

Agree/disagree

dd **Note** that further work will be undertaken on whether the Reserve Bank should be able to directly exercise other powers currently available to a statutory manager and matters related to the moratorium under statutory management.

Noted

ee **Note** that the Review proposes that statutory management be retained as an option in the event that the deposit taker met the conditions for being placed into resolution and the Reserve Bank considers that taking full control of the deposit taker is necessary to implement the chosen resolution strategy, and that the Review will provide further advice on the nature of the statutory management option in 2020.

Noted

EITHER

ff **Agree in principle** that:

(1) 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'), enabling the deposit taker to continue providing, without interruption, systemically important financial functions, and

(2) 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 statutory bail-in.

(Treasury recommendation)

Agree/disagree

OR

gg **Agree** not to take this decision now, with further work to be undertaken on whether the Reserve Bank should have a bail-in power, and if so, how it should be designed.

(Reserve Bank recommendation)

Agree/disagree

hh **Agree in principle** that resolutions be required to:

(1) 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, in either case —

(2) seek to ensure that no creditor incurs losses greater than would have been incurred in an ordinary liquidation (the 'no creditor worse off' [NCWO] principle) through the provision of after-the-event compensation.

Agree/disagree

ii **Note** that, based on the above in-principle recommendations, the Review will provide further advice in 2020 on remaining areas of bank resolution and crisis management listed in paragraph 160:

Noted

Other matters: administration of deposit taker legislation

jj **Note** that a decision remains outstanding on administration of the Reserve Bank's sectoral legislation such as the proposed Deposit Takers Act, that a decision will be required in 2020 to inform the drafting process, and that the Review team will provide further advice on this matter.

Noted

Bernard Hodgetts
Director, Reserve Bank Act Review – Phase 2

Hon Grant Robertson
Minister of Finance

Report: Update on planned Deposit Takers Act and Depositor Protection

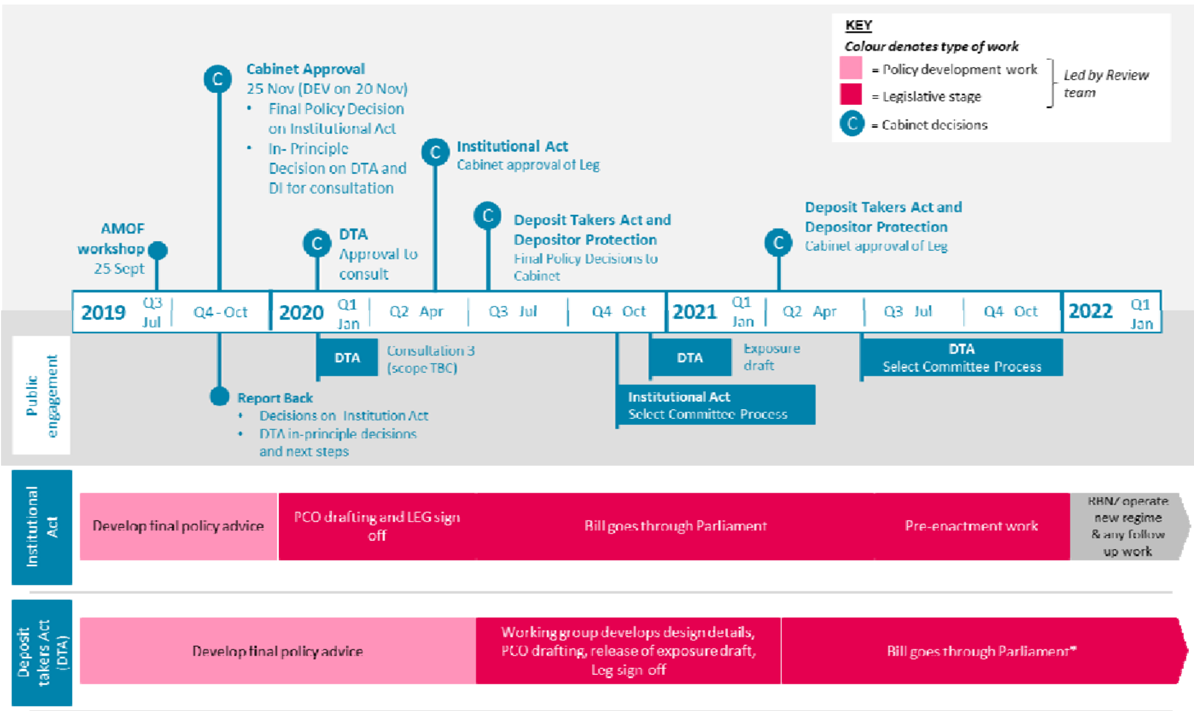
Purpose of Report

1. The purpose of this report is to propose further in-principle decisions on the new prudential regulation legislation for deposit takers (DTA), including work on depositor protection, and describe the principal remaining issues and expected process for resolving them.

Timing for decisions and further consultation

2. Following your feedback on the in-principle decisions proposed in this report, we will prepare a draft Cabinet paper for Ministerial and cross-party consultation. This material will be provided to your office on 29 October 2019. Following Cabinet consideration of the paper in late-November 2019 we would propose to publish a public brief update on these in-principle decisions and next steps on the DTA at the same time as the full set of decisions on the Institutional Act is published.

3. As noted in our 19 September 2019 Aide Memoire (T2019/2956 refers), we are proposing to proceed to a final round of public consultation on remaining issues for the DTA in February 2020. This approach responds to Reserve Bank concerns about the capacity of the sector to engage in further consultation this year and provides additional opportunity to test and develop proposals through targeted consultation in the interim. We expect this consultation paper to focus on testing various elements of the design of the new regime, such as the treatment of smaller deposit takers. We will engage with your office on the timeframes for finalising this consultation material, noting that Cabinet approval to consult will be required shortly after Cabinet committees recommence in 2020.



* Timeframe indicative and Deposit Takers Act assumed to include depositor protection.

2

4. This approach should enable you to seek final policy decisions from Cabinet on the DTA in July 2020, prior to the likely pre-election period. The drafting process could then proceed over the likely election period, enabling the release of an exposure draft in late 2020 and the introduction of legislation in the second quarter of 2021. Presuming a parliamentary process of around a year, the Bill could potentially be enacted in the first half of 2022. We note that a lengthy transitional period is likely to be required before the new DTA fully comes into force (allowing, for example, for secondary legislation to be finalised and entities to transition into the new licensing regime), although it would be possible to commence different aspects of the DTA at earlier stages.

5. The timetable assumes that deposit protection legislative measures (including the insurance scheme) are progressed alongside the new DTA. We consider this is critical as there are important interrelated policy decisions (such as the perimeter of 'deposit taking', which will likely determine eligibility for the insurance scheme) and any insured entities will need to be subject to an appropriate level of supervision. Introducing a deposit insurance scheme earlier would be complicated and potentially risky.

6. On the other hand, the relatively long timeframe before formal insurance is in place also raises issues. If an entity failed during the transitional period, there might be confusion or protests from any depositors that faced loss as a result. We propose to provide related suggestions for public communications prior to the November report back.

7. We note that there continues to be a number of risks associated with these timeframes. In particular, there appears to be limited sector capacity to engage on these issues, given the volume of other reform that the Government is progressing. There are also a range of relatively complex and technical issues that will need to be resolved that will require intensive engagement with both other government agencies and the sector over the next six months. We have also yet to engage formally with the Parliamentary Counsel Office on drafting timeframes.

Analysis

Objectives for the Deposit Takers Act

8. The Review team's first consultation considered the possibility of removing prudential regulation from the Reserve Bank and setting up a separate regulator instead, but ultimately recommended these powers remain with the Reserve Bank. The accompanying paper on the Institutional Act (T2019/2764) describes the governance arrangements proposed for the Reserve Bank, and the recommended financial stability objective.

9. T2019/2764 recommends the financial stability objective being accompanied with some legislative principles that guide the pursuit of that financial stability objective (e.g. the desirability of seeking to ensure that costs imposed through regulatory actions, including compliance costs, are justified by the benefits). We also envisage the DTA providing additional sub-objectives to guide the use of prudential powers, such as to:

    (a) promote the safety and soundness of deposit takers

    (b) promote public confidence in the financial system, and

    (c) mitigate risks that arise from the financial system.

10. The Reserve Bank is intended to be operationally independent in exercising prudential regulation powers, but have its high-level objectives set by parliament and the executive. T2019/2764 recommends that the Minister of Finance be required to issue a financial policy remit which can supplement the legislated objectives above and provide matters that the Board should regard as relevant to the Board's understanding of the Reserve Bank's financial stability objective.

Regulatory Perimeter

Cabinet has agreed in principle to shift to a single regulatory regime for deposit takers

11. Following the first round of consultation on Phase 2, Cabinet made an in-principle decision to bring the bank and NBDT regulatory regimes together into a single 'licensed deposit taker' framework. The decision was based on an assessment that a single licensed deposit taker framework has three key advantages over the status quo:

    (a) **Increased regulatory efficiency** – maintaining two regulatory regimes adds complexity to the regulatory system, and introduces the risk of the regimes diverging.

    (b) **Regulatory neutrality** – currently, firms undertaking similar activities are not treated the same way. For example, NBDTs do not have access to the same disclosure and governance exemptions as banks, and they cannot use certain terminology. This can create the perception that NBDTs are 'second-class' firms, reducing their ability to compete.

    (c) **Growth compatibility** – the current NBDT regime is the likely location for challenger or new entrant deposit takers, but may not be well suited to new entrants with innovative business models.

12. There is also a strong case that the design of the deposit-taking perimeter should align with the design of any depositor protection scheme (discussed further below). Competitive neutrality has typically been one of the core principles of depositor protection schemes.

13. Consultation document 2A sought feedback on two key questions relating to the deposit-taking perimeter:

    (a) How should the boundary of the deposit-taking perimeter be set?

    (b) Should the regime include some differentiation of rules for different types of deposit-taking firms?

14. The majority of submissions, including the NZBA, 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.

Firms that take 'deposits' should be subject to the regulatory regime…

15. The regulatory regime is expected to capture all lenders that offer transactional, savings and term deposit accounts to the public. This would capture the existing banks, credit unions and building societies.

16. There are, however, questions about how best to regulate lenders who only issue longer-dated debt securities, such as finance companies. Submissions argued these entities should not be categorised as deposit takers as they offer investment products

that should be differentiated from deposits and not subject to deposit insurance. We are conscious, however, of the risks associated with inadequate regulation of this business model, as highlighted by the finance company collapses between 2006 and 2012.

17. We are therefore proposing to consult on future regulatory arrangements for finance companies as part of the early 2020 consultation. We will provide you with further advice on a potential approach as this develops.

…but further consultation is needed on how to treat smaller deposit takers

18. We note that a notable minority of submissions raised concerns that the costs of compliance could be prohibitive for smaller deposit-takers, such as credit unions and building societies. Submitters generally noted that significant flexibility would be required to accommodate both large banks and small NBDTs in a single regime, although some argued that there should not be materially different rulebooks for different classes of deposit takers.

19. We will be engaging further with the NBDT sector over the next two months to develop a potential approach to the regulation of deposit takers that seeks to balance the need to ensure the soundness of insured deposit takers against the important competition and financial inclusion role that the sector plays.

Other lenders should be monitored for financial stability risks

20. Consultation document 2A also discussed the Reserve Bank's role in relation to non-deposit taking (e.g. wholesale funded) lenders. In particular, it sought feedback on whether the DTA should establish an 'outer perimeter' of lenders that would be monitored by the Reserve Bank for financial stability risks. It also asked whether the Reserve Bank should be empowered to:

    - designate lenders as deposit takers in order to avoid regulatory arbitrage (for example, where the economic substance of the lender's business is very similar to deposit taking), and

    - apply macro-prudential requirements to non-deposit taking lenders in response to financial stability risks.

21. A majority of submitters were supportive of these proposals, although concerns were raised by some submitters about overlap with the Commerce Commission's regulation of consumer credit.

22. The Review recommends that the DTA provide the Reserve Bank with stronger tools for monitoring non-deposit taking lenders for financial stability risks. We will provide you with further advice on the approach to designation powers and the ability of the Reserve Bank to set macro-prudential requirements for these entities prior to our next consultation.

Prudential Instruments

23. C2 included consultation on options for the primary instrument used by the Reserve Bank to impose regulatory obligations on banks, including the status quo (Conditions of Registration – CoRs), Standards (disallowable instruments under the Legislation Act 2012), and regulations made by Orders in Council. Stakeholders that expressed an

opinion overwhelmingly preferred that Standards be used as the primary instrument, and we recommend taking this in-principle decision now.

24. At present disclosure rules for registered banks are set through Orders in Council rather than the CoR that are used for almost all other prudential requirements. Disclosure rules are also subject to a different liability framework. This difference is hard to justify. The Review Team recommends that disclosure requirements be set by the same instrument as other prudential requirements for deposit takers – i.e. Standards.

Prudential regulation should be operationally independent, but with appropriate accountability and oversight

25. Standards appear to strike a balance by providing the Reserve Bank the necessary level of flexibility and independence in rule setting, while providing an appropriate level of transparency and Parliamentary oversight. The technical nature of prudential requirements and the long-term nature of costs and benefits mean prudential requirements are best set by the Reserve Bank, at arm's length from government. Setting rules through a legislative instrument such as a Standard provides an important level of legitimacy, particularly given the potential consequences of a breach (civil and criminal sanctions). While the Reserve Bank would be empowered to set Standards on specified matters without Ministerial approval, Standards (unlike CoRs) would be disallowable instruments, subject to review by the Regulations Review Committee.

26. One reason to delegate regulatory decisions to an independent regulator is their ‘minor and technical nature’. In contrast, the matters dealt with by prudential rules are relatively major decisions. However, it is strongly seen as international best practice to allow the key rulemaking decisions to be taken independently by the prudential regulator. For example, this is part of the first of the 29 Basel Core Principles for effective banking supervision. As with monetary policy, prudential regulation could be used to generate short term economic benefits at the cost of longer term risks, and operational independence (with well-defined goals) is seen as the best solution to this ‘time consistency’ problem. As noted above, domestic stakeholders agreed with this approach (preferring Standards to an instrument like Regulations which would be under ministerial control).

27. We intend to consult further on procedural requirements for Standard-setting in C3. These are likely to include requirements to consult and undertake regulatory impact analysis.

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

28. The DTA regime will require the flexibility to deal with all 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 broad classes of deposit taker. The regime should also be flexible enough to be tailored for individual institutions with unique business models (e.g. via bespoke license conditions, exemptions, or potentially institution specific standards).

29. The DTA will define the scope of matters that the Reserve Bank can set Standards on. We consider this should be done in a more specific way than in the current act, where certain enabling provisions have been used in an increasingly broad way since they were introduced. However, to provide future flexibility, we consider it should remain possible for the Minister to add additional matters to the Reserve Bank's purview via a Regulation.

30. Powers to set macro-prudential requirements (especially lending standard policies like LVRs and debt-to-income (DTI) ratios that have strong distributional effects) could be seen as less appropriate to delegate to an independent regulator. However, where a central bank is the prudential regulator (as in New Zealand), it is normal internationally for the central bank to set macro-prudential policy. This leads us to recommend that the scope of matters on which Standards can be set include empowering provisions for macro-prudential policies including lending standards. While there are arguments for involving other agencies (particularly with lending standards) we consider that this can be achieved through consultation requirements.

31. Stakeholders tended to express support for the way macro-prudential policy has been applied. There was very little support for removing LVR powers, and conversely quite a lot of support for giving the Reserve Bank express authority to use DTIs. Some submitters suggested macro-prudential policy should have been applied more aggressively, with broader objectives (e.g. aiming to systematically reduce private credit growth, especially into housing). The Review considers this would be too broad an objective for a prudential regime. The sub-objective suggested above, "mitigate risks that arise from the financial system" would instead empower macro-prudential policy to lean against housing credit flows only where they are judged to be creating a financial stability risk.

Director liability and accountability

Current director accountability rules have practical deficiencies

32. Through disclosure rules – a subset of the broader prudential rulebook for banks that includes CoRs – there is currently a fairly tight link between two of the three 'prudential pillars' emphasised by the Reserve Bank (the self and market discipline pillars). Registered banks are required to publish a *Disclosure Statement* every six months that includes financial accounts, as well as information on credit ratings, capital adequacy and other prudential requirements. These disclosure requirements are tied to an 'attestation regime' that applies to board directors (and the NZ CEO of an overseas incorporated bank – i.e. a branch operating In New Zealand). Directors attest that the bank has systems in place to monitor and control adequately the banking group's material risks; that those systems are being properly applied; and that the bank has complied with its CoRs.

33. Registered banks and their directors are faced with criminal liability for false and misleading *Disclosure Statements*, with individual liability tied only to those that sign the *Disclosure Statement*. In addition, there is civil liability if persons that subscribe for debt securities in reliance on a false and misleading *Disclosure Statement* suffer losses.

34. Conceptually the attestation regime creates strong incentives on directors to provide a robust oversight role for their bank by identifying and remedying instances of misconduct, given the potentially severe penalties at play. However, in practice there are a number of issues with the current framework:

    (a) The Reserve Bank provides no guidance or prudential benchmark as to what constitutes adequate risk management – directors may not be clear whether they are attesting to the standard required by the Reserve Bank

    (b) The Reserve Bank does limited verification that attestations are correct (i.e. no second guessing)

(c) Criminal liability can be disproportionate (e.g. prosecution for mistakes in *Disclosure Statements*), and

(d) Directors could avoid liability and related sanctions if they were aware of breaches but did not sign the *Disclosure Statement*.

35. Chapter 1 of Consultation Document 2B asked stakeholders to consider three options that could potentially improve the personal liability and accountability framework for registered banks (and by extension for the new deposit-takers regime):

(a) An 'enhanced status quo' that would preserve current arrangements, but be supplemented by operational changes such as the Reserve Bank setting out its expectations in relation to risk management, as well as board composition and performance

(b) A 'reframed attestation regime', that while preserving the focus on directors, would decouple from disclosure requirements and shift the liability framework largely to a civil regime, and

(c) A 'senior managers' or 'executive accountability regime' that would build on changes in options 1 and 2, but extend accountability beyond directors to senior office holders within the institution.

36. The third option would align with accountability regimes recently introduced in a number of jurisdictions such as Australia and the UK.

37. Almost all stakeholders who provided feedback on the liability provisions of the current Reserve Bank Act support a rebalancing away from criminal sanctions to civil penalties, and limiting the former to deliberate or reckless conduct. Furthermore, the majority of submissions supported the introduction of a 'senior managers-type' accountability regime. A number qualified their support by noting the importance of creating an <u>integrated</u> regime for prudential and financial market conduct regulation and the need for clear guidance on expectations, and that a long lead-in time may be required. A number of submitters also noted the range of different existing liability frameworks for both directors and executives across both existing and proposed legislation and argued for a focus on consistent and integrated obligations.

38. A small number opposed imposing direct accountability on executives, instead preferring enhancements to the status quo and a focus on director's obligations. Several bank submissions suggested that changes should aim to provide transparency to regulators and to promote accountability within institutions, rather than providing grounds for additional personal liability on directors and executives.

Increased director accountability seems the best near-term choice

39. The Review recommends option 2 above as the legislative foundations for a strengthened focus on director accountability. This would impose a set of 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. [33]

and deposit takers would need to provide certain information to the Reserve Bank in order for it to assess whether directors are fulfilling their duties appropriately (such as board minutes etc.).

[33]

41. Option 2, [33] would represent a significant improvement on the status quo and would sharpen the incentives on directors. [33]

42. The Review does not recommend the introduction of a senior manager's accountability regime (option 3) at this point. The 'Strengthened director accountability regime' (see Tables 1 and 2 below), coupled with other changes such as improvements to the supervision and enforcement model (see relevant sections below) represent a significant resourcing impost, both for the Reserve Bank and industry. These changes and others from Phase 2 should be allowed to bed-in before a more extensive executive accountability regime is contemplated. This would provide time to assess international experience with such regimes, which are relatively new and untested.

43. BEAR – the Banking Executive Accountability Regime – was introduced in Australia in mid-2018 and focussed on deposit-taking institutions that are regulated and supervised by APRA (banks, building societies and credit unions). Changes to the regime are already being contemplated in light of the Hayne Royal Commission on Misconduct in the banking, insurance and superannuation sectors, illustrating the somewhat fluid nature of this new approach. The Hayne Report recommended that BEAR be extended to all entities regulated by APRA – i.e. including insurers and superannuation schemes. The Government's response went even further, proposing the extension to all financial services regulated by ASIC (the Australian equivalent of the FMA). A related extension is that BEAR will be jointly administered by APRA and ASIC, with ASIC charged with overseeing those parts that concern consumer protection and market conduct, and APRA those related to prudential aspects of the regime. In parallel, APRA is proposing that it be given the ability to impose civil penalties on accountable persons, a feature currently absent in BEAR. APRA plan to review BEAR in the second half of 2021.

44. Proposed changes in Australia associated with the role of ASIC, coupled with stakeholder feedback, provide another reason to take a more gradual and proportionate approach in New Zealand. Stakeholders have emphasised that poorly aligned obligations and reporting requirements would significantly increase complexity and compliance costs across New Zealand's 'twin peaks' structure for financial sector regulation. Executive accountability has been considered as part of the conduct reforms being led by MBIE, but work on this has been deferred pending the outcomes of the Reserve Bank Act Review. Careful and coordinated consideration of how an integrated regime would work in practice is needed (including the fact that it would likely need to extend to insurers to address conduct issues).

Table 1: Features of a Strengthened director accountability regime and BEAR-type framework compared

	Status quo	**Strengthened director accountability regime** *(indicative)*	**BEAR-type framework** *(indicative)*
Focus of accountability	▪ Board directors of registered banks.	▪ Board directors of all licensed deposit takers. ▪ [33]	▪ Board directors & specified senior executives of all licensed deposit takers (and possibly insurers).
Registration & suitability checks	▪ No registration requirement. ▪ 'Fit & proper' checks (negative assurance) by RBNZ on directors (& some senior executives) on appointment (i.e. one-off).	▪ No registration requirement. ▪ [33] ▪	▪ Registration of 'accountable persons' including both directors and senior executives with RBNZ. ▪ Registration could include formal approval by RBNZ of accountable persons.* ▪ On-going fit & proper requirements on deposit takers/insurers.
Obligations	▪ Generic obligations on directors under Companies Act 1993. ▪ Specific attestation requirements tied to signing *of Disclosure Statements.*	▪ Positive duties imposed on directors (in addition to existing duties) such as ensuring institution is run in a prudent manner, acting with honesty & integrity, and being open/honest with RBNZ. ▪ [33]	▪ Accountability obligations imposed on both the institution & accountable persons, including those tasked with controlling a specific function. ▪ Could be quite prescriptive with respect to specific accountable persons (e.g. CFO, CEO, chair of Board).
Accountability maps & statements	▪ None.	▪ [33]	▪ Private reporting to RBNZ describing an entity's accountability arrangements.
Remuneration	▪ No RBNZ requirements.	▪ [33]	▪ Certain features of senior executive remuneration structures prescribed (e.g. reporting of proportion of variable remuneration).
Sanctions	▪ Criminal sanctions on directors for contraventions of attestation requirements. ▪ Applicants to director & senior executive positions may be rejected on basis of fitness & propriety [note RBNZ can't remove directors on fit & proper grounds once appointed].	▪ Civil sanctions on directors for failing to meet obligations (criminal penalties in egregious cases). ▪ [33]	▪ Institution faces civil sanctions for failing to meet accountability requirements. ▪ Reduction in variable remuneration of an accountable person for failure to comply. ▪ Accountable persons face civil penalties for failing to meet obligations.** ▪ Accountable persons removed by RBNZ permanently from role, or disqualified from serving in similar capacity.

* APRA does not approve accountable persons under its BEAR framework – this is left to the regulated entity.
** Not currently available to APRA.

Table 2: Potential strengths and weaknesses of a BEAR-type framework and Strengthened director accountability regime

	Strengths	**Weaknesses**
BEAR-type accountability framework	▪ Acknowledges limits of oversight by directors by rebalancing accountability to senior executives more directly responsible for outcomes. ▪ Helps regulated entities provide internal clarity on accountability arrangements and helps RBNZ understand actual accountability arrangements at a given institution. ▪ Provides a degree of consistency across industry vis-à-vis RBNZ prescribed accountable positions and responsibility. ▪ Deferral of remuneration helps align senior executive incentives with longer term soundness of their institution.	▪ Executive accountability regimes relatively new globally, and frameworks unproven. ▪ Require considerable resources to implement and monitor compliance – costs on both RBNZ and industry. ▪ Difference in business models across institutions implies identifying and describing senior executive roles could be difficult in practice. ▪ Attaching significant personal liability to senior executives may result in risk aversion, particularly in larger institutions. ▪ Calibrating size of fines may be difficult in practice for both entity and individuals (directors & senior executives). ▪ Could risk giving appearance that RBNZ 'running' the day-to-day business (moral hazard). ▪ Introduces the possibility of merit reviews.
Strengthened director accountability regime	▪ Sanctions are imposed on the persons who committed the breach (directors). ▪ [33]	▪ Require an increase in resources to implement and monitor compliance – costs on both RBNZ and industry. ▪ [33] ▪ Calibrating size of fines may be difficult in practice for both entity and directors. ▪ Introduces the possibility of merit reviews. ▪ The severity of potential sanctions on directors may engender excessive risk aversion.

Supervision and enforcement

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

45. 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.

46. The Reserve Bank has an unusual supervisory model by international standards. The Reserve Bank does not typically validate information provided to it by regulated entities through independent testing or verification – preferring instead to rely on the assurances provided by director attestations, in the case of prudential requirements for registered banks.

47. The Reserve Bank's supervisory model is structured around desk-based ('off-site') monitoring and insights gained through face-to-face meetings with banks' boards and senior management. The Reserve Bank does not undertake 'on-site' supervision which involves going to a bank's premise to obtain independent verification that banks have adequate policies, procedures and controls, and to determine whether information reported by banks is reliable. As a consequence the supervisory function is very lightly resourced as on-site inspections require a significant commitment in terms of capacity and capability.

48. The Reserve Bank sees itself as a 'relationship-led' supervisor that aspires to build and maintain a constructive dialogue with regulated entities. The counterpart to this is that the Reserve Bank is not an 'enforcement-led' regulator; if a bank is non-compliant with any prudential requirement, or a risk arises, the Reserve Bank focusses as a first step on using moral suasion to develop a forward-looking solution.

…and its toolkit could be improved.

49. While most prudential authorities elsewhere are not enforcement-led, they typically have a wider suite of tools to effect corrective action than that currently available to the Reserve Bank. The Reserve Bank has a number of supervisory and court-based tools (with powerful criminal penalties), with the latter meant to reinforce the Reserve Bank's emphasis on self-discipline – tied to bank director's role in 'attesting' to the veracity of six-monthly *Disclosure Statements*. To-date, no formal court-based actions have been undertaken against banks or their directors under the Reserve Bank Act (there have been actions under other legislation such as the NBDT Act).

50. In their recent 'audit' of New Zealand's financial sector regulatory frameworks, the IMF Financial Sector Assessment Programme (FSAP) identified a number of gaps in the Reserve Bank's supervisory model vis-à-vis international standards. For example, the Reserve Bank received a 'materially non-compliant' grading against a number of *Basel Core Principles for Effective Banking Supervision* (the 'BCPs'). Non-compliant assessments in this respect centred on a lack of resourcing for the prudential function, a lack of independent testing by the Reserve Bank, and the absence of on-site inspections. The IMF also argued that enhanced verification (the ability to detect non-compliance) needs to be complemented by a more comprehensive rulebook, including rules and expectations in relation to key risks such as credit risk. Together this should provide the basis for a more proactive enforcement strategy.

51. In response to our recent consultation, a majority of stakeholders argued that the Reserve Bank needed to increase the intensity and intrusiveness of its supervisory model, supported by a more graduated suite of enforcement powers. A clear message from stakeholders was the need for the Reserve Bank to address an apparent lack of resourcing in order to improve the underlying capability and capacity to perform its prudential responsibilities, including supervision.

52. Stakeholders emphasised a number of problems with the current model including a lack of assurance arising from the bank director attestation process; lack of a thorough understanding of the business of regulated entities from Reserve Bank supervisory staff; an inability to respond in a timely manner to approvals, authorisations and other requests from supervised entities; lack of alignment with international standards such as the BCPs; and a disproportionate enforcement regime.

53. While support for changes was fairly broad based, this was often qualified in several respects. For example, stakeholders suggested:
    (a) changes to the intensity of supervision needed to be considered in light of other changes to the safety net (such as higher capital or the introduction of deposit insurance)
    (b) a significant increase in supervisory and policy staff would be challenging over the short term, and
    (c) any increase in the intensity of supervision should not undermine current incentives for banks and their directors to manage their institution prudently.

54. The Review is proposing a set of recommendations that will provide the basis for a supervisory and enforcement framework that will align with international 'best practice' and compliance with global standards such as the BCPs. That is, a model and approach that is intrusive, proactive and forward looking, adaptive and comprehensive.

55. Shifts in this direction are already underway, given recent pronouncements from the Reserve Bank that it needs to increase the intensity of supervision and that it needs to start second guessing attestations and independently verify compliance with prudential requirements. In sum, the Reserve Bank already recognises that it needs to be more sceptical and have a greater willingness to act in response to emerging concerns or non-compliance. The following set of recommendations will secure the legislative basis for this paradigm shift.

56. The first recommendation is to empower the Reserve Bank to undertake on-site inspections of any licensed deposit-taker (under the proposed Deposit Takers Act), and for such a power to be applicable to other sectors the Reserve Bank regulates (e.g. insurers). More policy work is required to define the precise scope of this power, and any checks and balances, but the prior would be for a fairly broad and empowering provision. Although this policy work will be undertaken in the context of the DTA, our starting point is that a generic on-site power best fits within the proposed Institutional Act.

57. The Review is mindful that decisions on the intensity of supervision and the calibration of the model are an operational matter for the Reserve Bank. This includes how the Reserve Bank would use any new on-site inspection power. That said, the Reserve Bank should have regard to any 'risk appetite' views expressed by the Minister in a *Remit* or other vehicle such as feedback on the *Statement of Intent*.

58. Treasury is of the view that in order to fully align with international standards the Reserve Bank should consider developing and implementing a supervisory model based on regular/periodic inspections of individual firms, guided by a systemic risk assessment where larger and more systemically important firms are inspected on a more frequent cycle relative to smaller ones.

59. To support the paradigm shift in supervision and enforcement, the Review recommends enhancing the operational independence of the Reserve Bank by removing the Minister's role under the current Reserve Bank Act in consenting to directions, and deregistering a bank, respectively. Neither role is consistent with other legislation such as IPSA or the NBDT Act, nor does it line up with IMF FSAP recommendations. The recent case of dealing with insurer CBL under IPSA illustrated the benefits of issuing directions without ministerial consent as the Reserve Bank was able to act swiftly and effectively. Appropriate thresholds would need to be built into the relevant provisions for the exercise of direction and deregistration powers.

60. That said, there may be a case to differentiate the scope of both direction and deregistration powers to distinguish between business-as-usual supervision, and more extraordinary situations where a role for the Minister may have some merit (e.g. in the context of crisis management and resolution). Further policy work will be needed to develop this as an alternative option to the preferred recommendation of the Review.

61. In terms of effecting corrective action, the Review recommends that the Reserve Bank have a broad suite of formal enforcement tools at its disposal, reinforced by the removal of Ministerial consent for the use of direction powers proposed above. Broadening the toolkit provides the Reserve Bank more credible options to change the behaviour of firms, helping to address non-compliance with more formality and sensitivity to individual circumstances. Formal enforcement actions also serve a wider deterrence purpose since they are generally public and can therefore help set expectations for the industry as a whole.

62. Additional enforcement tools would complement other changes tied to the Review such as a much improved ability to detect and identify non-compliance issues in the first instance (via independent verification and on-site inspections), and potentially a wider set of regulatory benchmarks (e.g. risk management requirements or guidance).

63. 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), and this would follow from advice and engagement with LDAC, the Ministry of Justice and other relevant stakeholders. Moreover, this work will need to dovetail with the proposed changes to the attestation regime described in the 'Director liability and accountability' section above, and any new civil penalties for director duties.

64. The Review expects that the Reserve Bank would need to reconsider its enforcement strategy in light of both public pronouncements indicating a greater willingness to act, and the potential new tools it would have at its disposal. This will require transparency on how the Reserve Bank would use any new powers and under what circumstances, with publication of a new *Statement of enforcement approach*. Note, the Review is recommending that the new Institutional Act should require the Reserve Bank to publish various *Statement of Approaches* for its regulatory functions to help provide guidance and certainty for stakeholders.

65. The Review recognises 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. The Review therefore recommends a suitable increase in funding be built into the new Funding Agreement for July 2020 to support the already announced changes by the Reserve Bank for its prudential function, and that this is based on advice from the Reserve Bank on the appropriate further enhancements to the supervisory model.

66. 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). The Review also recognises that scaling up supervision will be a multi-year process given the practical constraints on the speed of growth.

Depositor Insurance

67. In June 2019, the Government announced its in-principle decision to introduce a permanent deposit insurance scheme (DIS) in New Zealand. The establishment of a DIS means that, in the event a deposit taker fails, protected depositors will not need to join the insolvency process to try to recover their money. Instead, these depositors will be protected from loss (up to eligible amounts) and will get access to their money promptly.

68. This section provides recommendations for further in principle decisions on the design of the scheme, to be announced in the public update planned for November (and drawing on stakeholder feedback from the second round of consultation).

Protecting depositors is a clear goal of deposit insurance…

69. A foundational aspect of the DIS are the objectives that it should pursue. The objectives of the DIS will play an important role in influencing how the scheme is designed and, once the scheme is operational, how those responsible for the scheme will work to ensure the objectives are met.

70. Certainty and prompt payment significantly improve the wellbeing of insured depositors in the event of a deposit taker failure, compared to the uncertain and lengthy process as part of a standard liquidation. Financial stress would be reduced markedly for some households that rely on deposits to fund critical transactions, such as paying their rent/mortgage, buying food, etc. And protected depositors are not made to pay for the realisation of risks that were beyond their control, and are difficult to monitor even for sophisticated creditors with large amounts of money at stake.

…and by protecting depositors, deposit insurance schemes can also contribute to financial stability.

71. By protecting depositors, the DIS can also contribute to financial stability by:

    (a) Enhancing public confidence in the financial system: protected depositors have less incentive to withdraw their deposits when the financial condition of their deposit taker is in question. This will in turn reduce the likelihood of a widespread run of retail depositors, which could destabilise the financial system.

    (b) Improving the credibility of the resolution regime: explicitly protecting depositors enhances the prospect that governments will use available resolution tools, rather than bailing out all creditors at the expense of taxpayers. A more credible resolution regime reduces the implicit guarantee on financial institutions, strengthening the incentives for uninsured creditors to monitor risk.

72. On the other hand, the provision of insurance can blunt incentives for insured depositors to monitor risks (moral hazard), potentially undermining these financial stability benefits. Although it is questionable whether ordinary depositors have the expertise or resources needed to actually apply discipline on financial institutions, it is plausible that some depositors seeking higher returnsrespond to an insurance regime by shifting their deposit to riskier institutions.

73. It is important to recognise that the DIS is only one element of the financial safety net. It works together with, and relies on, other elements – especially prudential regulation, supervision, and resolution frameworks – to maintain financial stability.

The recommended objective would combine depositor protection and the contribution to financial stability

74. We recommend that the deposit insurer should have the core objective to:

    "*protect depositors from loss, and in so doing, contribute to financial stability"*

75. This objective could be supplemented with supporting text in primary legislation providing more specific guidance on how the objective links to the schemes design and operation. This guidance could specify how depositors are to be protected and how the scheme can be designed to maximise its contribution to financial stability:

    (a) Ensuring certain and prompt payout for depositors in the event of a deposit taker failure

    (b) Promoting public confidence in the financial system during periods of financial stress

    (c) Supporting a credible resolution framework, thereby reducing the likelihood of taxpayer funds being used to bailout all shareholders and creditors, and

    (d) Minimising any impact of the scheme in reducing the incentives of depositors and deposit takers to manage their own risks.

76. This recommended objective is consistent with the Government's views on the role of deposit insurance in New Zealand. It is also consistent with stakeholder feedback. A majority of submitters supported objectives that reflected the role of the DIS in both deposit protection and in contributing to financial stability.

The coverage limit decision requires judgement and is based on limited information

77. When the Government announced its in-principle decision to set up a DIS, it also proposed a limit on the maximum coverage of a depositor at a single institution (coverage limit) in the range of $30,000-$50,000.

78. There is no 'right' number for the appropriate coverage limit, and a judgement must be made after weighing the various factors at play. There are both costs and benefits of providing higher coverage.

79. Given the uncertainty involved in calibrating the coverage limit at this point in time, we recommend that the coverage limit decision be reviewed after the insurance regime has bedded in. This would allow for an assessment of how depositors have responded to the availability of deposit insurance, and take into account better measurement of how many depositors are covered. A regular review of whether the scheme is meeting its objectives, including whether the coverage limit is appropriate, should also be an on-going feature of the framework.

The Review recommends a $50,000 coverage limit

80. In assessing the appropriate coverage level within the in principle decision range, we believe the following considerations should be taken into account:

    (a) percentage of accounts by number and value that are covered – the International Association of Deposit Insurers (IADI) suggests that the vast majority of depositors should be fully protected, while leaving a substantial proportion of the value unprotected

    (b) the 'type' of depositor that would be fully protected

    (c) the impact in mitigating the risk of a retail run and/or blunting the incentives of depositors to monitor risks

    (d) recognition that depositors with amounts above the coverage limit are able to obtain additional coverage by opening new accounts at another deposit taker

    (e) institutions will pay insurance premiums as a percentage of their total insured deposits, which may be passed on by deposit takers to depositors;

    (f) governments may be unwilling to support a deposit insurance payout if a sizeable number of depositors or certain types of depositors are not fully protected, and

    (g) depending on the size of a failed bank and the size of the associated deposit insurance payout, the deposit insurer may need to borrow from the Crown to fulfil its payout obligations.

    We note that considerations e. and g. are dependent on the proposed design features of the DIS recommended below.

81. The following table provides a quantitative and qualitative assessment of these considerations under possible coverage limits between $30,000 and $50,000 (in $5,000 increments) based on available data from registered banks (i.e. not including current NBDTs). We have also included a $10,000 and $100,000 limit for comparison. Based on our assessment of these factors, the Review recommends a deposit insurance coverage limit of $50,000. The rationale for recommending a $50,000 limit instead of, say, a $30,000 limit is explained in more depth below.

Consideration	Deposit Insurance Coverage Limit						
	$10,000	**$30,000**	**$35,000**	**$40,000**	**$45,000**	**$50,000**	**$100,000**
% of household deposit **accounts** fully protected[1]	~82%	~91%	~92%	~93%	~93%	~94%	~97%
% of value of insured deposit **accounts** to total deposits[2]	~19%	~35%	~38%	~41%	~43%	~45%	~60%
Type of depositor covered	A significant proportion of savers and some vulnerable customer groups wouldn't be fully protected under low limits.						
Mitigating run risk	A $50,000 coverage limit (vs. $30,000) increases the value of household deposits covered from 35% to 45%, suggesting a potentially material benefit.						
Blunting depositor incentives to apply discipline on banks	Impact is likely to be low at coverage levels that broadly match the average customer.						
Ability for depositors to obtain additional coverage at other institutions	Could suggest a lower limit is reasonable given additional coverage is available at other institutions, although creates an inefficient administrative cost for these depositors.						
Amount of insurance premiums paid by institutions	A higher limit will most likely result in greater premiums paid by insured institutions (and indirectly by their depositors). The negative impact on industry profitability and economic activity can be managed through longer timeframes to reach the target fund size.						
Political credibility/willingness to support deposit insurance payout	Governments may be less willing to use resolution tools at lower coverage levels as a greater number of depositors will not be fully protected. This could make less desirable alternatives such as bailout or increasing the coverage limit 'on the day' more attractive.						
Potential need for deposit insurer to borrow from the Crown	A higher limit may result in a larger deposit insurance payout, which may require the deposit insurer to temporarily borrow (even more) from the Crown to meet this payout requirement.						

[1] Based on aggregated data of from a representative sample of banks (more granular data than currently available).
[2] Ibid.

A $50,000 limit increases the contribution to financial stability…

82. Currently available data suggests that a $30,000 limit covers 91% of deposit accounts. This number increases to 94% of accounts under a $50,000 limit. However, these figures are at best a proxy for the actual coverage levels that will result under the scheme, for two reasons:

    (a) Many customers have multiple accounts, resulting in lower coverage levels than suggested by the accounts data at the same bank. Discussion with industry suggests that, indicatively, a $50,000 limit would result in 90% of *depositors* being fully covered, or around 85% of customers under a $30,000 limit.

    (b) Customers will adjust their behaviour once deposit insurance becomes available, thereby increasing coverage levels. The size of this effect will depend on public awareness of the scheme. Splitting accounts will require time and effort for depositors, and may disrupt long-term customer relationships.

    It is important to recognise that some customers without full coverage will still have most of their deposits insured.[3]

83. The vast majority of deposit accounts are transactional accounts with low balances, primarily used to fund weekly expenses. Balances are significantly higher for other customer groups, which pushes the average customer balance to well above $30,000.4 Some vulnerable customer groups will have large deposits, including older customers that are living off their savings and customers saving for their first home. Discussions with industry suggest around 35% of customers that are older than 65 years would not be covered at a $30,000 limit.

84. A $50,000 limit will increase the proportion of potentially vulnerable groups that will be protected. With lower coverage limits, governments may opt to bailout the failed institution or increase the coverage limit 'on the day' – both of which would undermine the credibility of New Zealand's deposit takers resolution regime, and result in an increased implicit guarantee being priced in by uninsured creditors. This means that a $50,000 limit will reduce some of the political unwillingness to support a resolution for a distressed deposit taker, compared to a $30,000 limit.

85. A $50,000 limit is also likely to have the benefit of further mitigating retail run risk. Although the number of protected customers is broadly similar to a $30,000 limit, the value of household deposits covered increases from 35 to 45% if the coverage limit rises from $30,000 to $50,000. This means that there is less scope for a retail run to severely damage funding availability. [Note that measuring the value of deposits covered under the future regime is subject to the same uncertainties as measuring the number of customers covered discussed above.]

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[3] For example, only $30,000 of an $80,000 deposit will be exposed to loss under a $50,000 coverage limit.

[4] Our estimate of the average customer balance is $45,000, derived by dividing total household deposits by the population that is older than 15 years old.

86. A substantial proportion of deposits by value remain at risk under all coverage limits within the in-principle range, suggesting that there remain incentives for large and more sophisticated depositors to monitor risks. A $50,000 limit is unlikely to cause a significant reduction in risk monitoring by insured depositors of their current institution.[5] However, higher coverage limits could cause a shift of deposits to riskier deposit-taking institutions that may offer higher returns. This impact could be mitigated by more intensive supervision of deposit takers and/or setting the levy for the scheme based on the riskiness of member institutions.

…and the additional costs of insurance can be managed through longer timeframes.

87. Higher coverage limits will increase the size of the insured deposit base, requiring more funding from industry. A common rule of thumb used by deposit insurers is that the fund accumulated by the scheme should target 2% of insured deposits. This indicates that shifting from a $30,000 to a $50,000 coverage limit would increase the size of the funding required from industry from $5 billion to $6.5 billion. This could result in more costs being passed on by deposit takers and/or a reduction in industry profitability under a $50,000 limit.

88. Any negative impact of higher coverage limits on short-run economic activity can be mitigated through longer timeframes to build up required funding (either before or after a deposit taker has failed). For example, the funding for a $50,000 coverage limit could be built within four years using a 50 basis point levy. If the timeframes are shifted out to eight years, the impact would either be a 25 basis points decline in deposit rates for insured depositors (if banks fully pass on the costs) or a 4% reduction in before tax industry profit (if banks don't pass on any of the increase).

89. The Government backstop proposed below means that fiscal risk is another aspect that needs to be considered as part of the coverage limit. Modelling by the Review Team suggests that, under a $50,000 limit, the failure of a systemic bank would cause Government debt/GDP to increase by 2.1%, or by a negligible amount if a preference for insured depositors is introduced (see next section). This cost would be recouped from industry in subsequent years, and is almost certainly much smaller than the potential alternative of bailing out all creditors.

Stakeholders supported a significantly higher coverage limit.

90. The majority of stakeholders that commented on the coverage limit preferred a significantly higher coverage limit than the in-principle decision range. Several submissions noted that this range is low by international standards, and a limit closer to international norms would be desirable (many OECD countries have coverage limits of around $150,000). This concern featured strongly in submissions from the public, and interest groups representing the public (such as Consumer New Zealand and the Te Arawa Federation of Maori Authorities). The expectation from submitters that higher coverage limits should be available suggests that higher limits would further enhance the political credibility of the future regime.

[5] A survey conducted by the Review Team suggested that 9 out of 10 households are not aware that there is currently no deposit insurance in New Zealand, suggesting that they are currently not monitoring their institution more intensively due to the lack of deposit insurance.

91. While recognising that the coverage limit decision is not straightforward, several expert and industry stakeholders noted that a limit more in line with international norms would improve the ability of deposit insurance to contribute to financial stability. The NZBA and several individual banks pointed out that the relatively low coverage limits provided for under the in principle decision would increase the risk that deposit insurance would fail to prevent bank runs or support public confidence, and that a low limit could result in an increased reliance on account splitting, with resulting administrative costs for banks and customers.

We also recommend making further in-principle decisions on a number of high level features of the DIS …

92. In addition to the coverage limit, the Review recommends that the Minister take additional in-principle decisions on some high-level design features that would further shape the scheme:

   (a) *Reiterating that the coverage limit will apply on a per depositor, per institution basis, consistent with what was announced at the 24 June 2019 press conference that followed the announcement of the DIS*. Adopting a single customer view for the coverage limit will not necessarily constrain depositors with higher balances as they will be able to obtain more coverage if they diversify their exposure at other deposit takers. It will, however, prevent a situation where depositors can easily obtain high coverage through opening multiple accounts at a single institution, thus rendering the limit impractical or pointless.

   (b) *Membership in the scheme will be compulsory for institutions licensed as deposit-takers.* This decision is closely related to the regulatory boundary for deposit taking institutions. Aligning these boundaries will result in a minimum level of regulatory and supervisory intensity in order for an institution to qualify for the DIS, helping to manage any increase in moral hazard from the provision of insurance. The possibility of charging institutions a risk-based levy to help manage moral hazard will also be considered in future work. . We note that all debt products issued by deposit-takers will not necessarily be covered by the insurance scheme (e.g. retail bonds).

   (c) *The scheme will be funded by covered institutions with a backstop provided by the Government (i.e. a government guarantee).* An effective DIS must have sufficient resources available to pay out insured deposits. The funding for the scheme should come from industry, so that those benefiting from the insurance are the ones that pay for it (i.e. a user-pays model). Lessons from the Global Financial Crisis suggest that a supplementary Government backstop is necessary to support public confidence in the scheme, especially in the event of the failure of a systemically important institution. The provision of Government funding should be subject to clear conditions set out in legislation, and be recouped through special ex post levies on the remaining industry in subsequent years, (if necessary after recoveries from the insolvency estate).

   We believe that taking these decisions now will help communicate the implications of the coverage limit decision to the public in November.

…along with a roadmap for future policy work.

93. Even after these decisions are taken, there remains a considerable work programme ahead to introduce a DIS. An international rule of thumb is that it takes two years to introduce deposit insurance. But, as noted above, there are additional complexities in introducing deposit insurance at the same time as the rest of the regulatory framework is being reviewed. The Review Team currently estimates that it will take until 2022 before the DIS legislation will be implemented, and possibly longer before the scheme is fully in place.

94. The Review Team has produced a roadmap of the future policy work required to implement deposit insurance in New Zealand (table 1). The roadmap aims to expand on the interplay among key variables that should be considered in designing the DIS consistent with the scheme's objectives.

95. We propose to publish this roadmap in November. If you prefer, this could be turned into a formal terms of reference for your approval and publication.

96. Further design features of the scheme will be part of the public consultation in February 2020, including the specific deposit products covered, the mandate/function of the scheme, its role in the safety net, detailed funding arrangements, and the institutional location and governance of the scheme. This will enable you to take final decisions on the design of the scheme in July 2020 that are necessary to begin drafting legislation.

97. There is also extensive work to operationalise a DIS. Many of the detailed rules of the scheme – such as setting a differential or risk-based fee structure, if desired – are likely to be contained in regulations. And work is also required to develop the proposed data and systems infrastructure that will allow prompt payment in the event of failure. Both aspects of a DIS will require significant engagement with industry, in light of the system changes/investment that may be required.

Table 1: Roadmap of future work on the DIS

	Explanation	In-principle decisions proposed	Decisions for June 2020	Subsequent work
Scope of deposits covered	Determine deposit products that are eligible for insurance.	$50,000 limit on a per customer, per deposit taker basis	Any deposit products excluded, such as FX, related party, interbank and other financial institutions sophisticated enough to assess risks.	Detailed rules, such as the possibility of rules to include "temporarily high balances" that may arise from, e.g. sales of property.
Funding	Funding mechanisms should be sufficient to ensure prompt payout. Industry funding relieves pressure on public finances when a deposit taker fails.	Funding provided by industry, with supplementary Government backstop.	Amount of prefunding via industry levies, and whether the levy charged should be tailored based on risk level. Specific conditions and funding mechanism for backstop.	Precise levy amount and criteria for review.
Membership	All members in the scheme be subject to effective regulation and supervision; generally limited to banks and those engaged in retail deposit-taking activities.	Compulsory membership for licensed deposit takers.	Whether bank branches are covered or not.	Incorporating DIS requirements as part of conditions of license for deposit takers
Institutional location and governance	Should be guided by an appropriate degree of operational independence from politicians and industry, and supporting cooperation with the rest of the financial safety net.	None	DIS could be housed within the Reserve Bank; set up a standalone entity; or have its functions shared across Treasury/RBNZ.	Address conflicts of interest and accountability amongst the safety net players.
Payout mechanism	A payout is the most high profile activity of a deposit insurer. Best practice provides that depositors have access to their funds within 7 days from the insured bank's failure.	None		Data and systems infrastructure required to support single customer view.
Mandate	Options include confining the mandate to reimbursing insured depositors of a failed deposit taker, or taking an active role in resolution.	None	Focus on making payments to depositors to avoid duplication of Reserve Bank's supervision and resolution functions.	

Deposit preference

98. Depositor preference refers to the situation where preferred depositors' claims are paid out before the claims of other unsecured creditors, in the event of the failure of a deposit taker. Preference is achieved by permanently altering the legal framework of claims to effectively 'rank' depositors higher than other unsecured creditors. Depositors, or the deposit insurance scheme representing them, would potentially lose money only if all shareholders and other unsecured creditors have lost all their money first.

99. In the wake of experiences from the GFC a number of jurisdictions have reformed their depositor protection schemes, and this has included supplementing deposit insurance with preference.[6] A major benefit of a preference for insured depositors would be to increase the insurance scheme's recoveries, and so reduce the financial burden it faces in the event of a payout. Depositor preference also puts other general creditors, such as wholesale investors, further down the queue in the event of a bank failure. This may have the benefit of increasing the incentive to monitor the risk profile of the deposit-taking institution, but could also result in a higher cost of wholesale funding and greater incentives for these investors to run during a crisis.

There was mixed stakeholder feedback on depositor preference

100. Submissions were fairly even divided on whether a deposit preference should be introduced alongside deposit insurance. Some of those in support of depositor preference mentioned that many NBDTs already have such a provision, and that market discipline will be enhanced by this formalisation.

101. A number of banks and the NZBA noted the potentially higher costs of wholesale funding that could be associated with preference. There was also concern that depositor preference could impact smaller banks disproportionately. Due to their more limited use of unsecured wholesale funding, these banks may have to pay a higher premium to attract deposits, relative to larger banks, and might face prohibitive costs of accessing wholesale debt markets. Some submitters noted that they were opposed to adding complexity to New Zealand's creditor hierarchy, and were concerned about unintended consequences of depositor preference.

The Review recommends deferring a final decision

102. The Review recommends deferring any decision on depositor preference. Although work to date suggests that there are significant benefits associated with a preference scheme, further time is required to better understand stakeholder concerns, and to produce more substantive analysis for your consideration. A particular area of focus will be to undertake more analysis of whether any preference should cover insured deposits only, all deposits, or some form of tiered mechanism (where insured deposits rank above uninsured deposits, which in turn rank above other unsecured creditors).

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[6] At the end of 2013, 62 of 99 deposit insurers reported to the IADI that they had some form of depositor preference in their jurisdiction. Subsequent changes to introduce depositor preference in the UK and EU will have increased this proportion significantly.

Bank resolution and crisis management

103. Crisis management fundamentally underpins financial stability and has a significant influence on a range of prudential policies and potential capital and funding instruments. New Zealand's approach to crisis management, being largely based on statutory management, has not been meaningfully reviewed since the late 1980s, despite the Law Commission noting its flaws.[7] In the intervening time, bank resolution and recovery regimes have been fundamentally overhauled internationally.

104. The bank resolution and crisis management part of the Review is focussed around achieving three broad objectives:

    (a) Providing greater clarity as to the resolution regime for deposit takers. Clarity includes:

        i. who is able to exercise resolution powers;

        ii. when resolution powers can be expected to be exercised;

        iii. what objectives resolution should aim to achieve, and

        iv. what safeguards creditors can expect.

    (b) Ensuring a sufficiently wide range of tools is available for the orderly resolution of a failed deposit taker without severe systemic disruption and without relying on taxpayer funds

    (c) Ensuring the government is able to prudently manage fiscal risk and Crown balance sheet implications in situations where taxpayer funds are at risk

105. The Review's work has been informed by the international experience during and since the GFC and the internationally-recognised best practice guidance that has emerged from that experience. The Review also consulted with foreign authorities and international experts in bank resolution. In addition to the Financial Stability Board's (FSB's) *Key Attributes of Effective Resolution Regimes for Financial Institutions (*the *Key Attributes)*, the Review has found the resolution regime developed by the UK and administered by the Bank of England to be particularly helpful. New Zealand not only shares common legal traditions with the UK, but the UK has been at the forefront of bank resolution regime reform in response to the challenges of failed banks both during and since the GFC.

106. The vast majority of submissions that commented on the crisis management topic were highly supportive of the proposed direction, including submissions from banks and legal firms with expertise in resolution and insolvency, as well as former Reserve Bank Deputy Governor Grant Spencer. One of the key themes in submissions was strong support for the Review's approach to align where appropriate with international good practice as captured in the FSB's *Key Attributes.*

Delivering a credible resolution regime that aligns with international good practice

107. The bank crisis management framework has the potential to protect but also significantly negatively impact the wider economy in the event of a bank failure. Resolution and crisis management involves important issues around interference with shareholder and creditor property rights in the name of protecting financial stability and the public interest. Fortunately, in the last decade much of the developed world has organised itself (especially through the G20) to undertake extensive policy work in this

[7] Law Commission (2001) *Insolvency Law Reform: Promoting Trust and Confidence*, May.

area, producing substantial good practice guidance and actual reforms in many jurisdictions for the Review to draw on.

108. The GFC demonstrated that placing a failed bank into ordinary insolvency can have damaging consequences for its customers, the rest of the financial system, and the wider real economy. To prevent these wider spill-overs, many governments bailed out institutions using public funds. The crisis demonstrated a need for resolution regimes that enabled authorities to resolve failing banks quickly, without destabilising the financial system or exposing taxpayers to loss. Publicly funded bailouts and financial sector guarantees came to be viewed as too expensive and too inequitable to society, and too harmful to market discipline. Special bank resolution tools were required.

109. One of the key responses from the international community was the development of the FSB *Key Attributes*. They are recognised as examples of good practice and are endorsed and promoted by world bodies such as the IMF. As a result, the *Key Attributes* are increasingly being drawn upon in other jurisdictions' reforms.

110. However, what is seen as good practice internationally is arguably more than just good practice for New Zealand. Alignment with international good practice will become increasingly important if New Zealand's framework is to work with other jurisdictions. Several submitters in the second consultation round made a point of reminding the Review that, with New Zealand's four largest banks[8] being foreign-owned, New Zealand's resolution regime needs to support cooperation and coordination with foreign resolution authorities, and the Australian authorities in particular.

111. Indeed, the trans-Tasman dimension has been at the forefront of the Review's thinking on crisis management and has been prominent in the minds of the Independent Expert Advisory Panel. Coordinating the resolution of a 'big four' bank with the home authority needs to be a fundamental requirement of New Zealand's resolution regime. The Review's findings include that making progress in agreeing trans-Tasman resolution strategies with Australian authorities will require bringing New Zealand into line with a number of international best practices, especially those relating to bail-in and creditor safeguards.

112. The in-principle decision already made by Ministers to introduce deposit insurance is similarly fundamental to supporting a credible resolution regime that does not rely on taxpayer bailouts. In the case of the failure of smaller deposit takers, deposit insurance can provide credible means to protect the interests of depositors – whether through direct and quick insurance pay-outs or by supporting the transfer of the deposit book to a healthy institution – without further government/taxpayer intervention.

113. In the failure of a large, systemically important bank providing financial services critical to the functioning of the wider economy, deposit insurance plays an equally important role in helping to maintain public confidence and avoid contagion. In terms of the resolution itself, though, there is ultimately a stark choice between supporting those banks with taxpayer funds and all the moral hazard issues that come with doing so, or finding credible alternative means to financially stabilise those banks. The GFC impressed upon jurisdictions that bore the brunt of the crisis the need to have credible alternatives to bailouts.

114. The Review similarly finds that additional tools and powers are required in the legislative framework to provide New Zealand with credible alternatives to bailouts.

[8] Accounting for 82 percent of New Zealand's banking system, or 85 percent if the non-locally incorporated branches of the parent banks are included.

This view was also taken by the IMF in its 2016/17 FSAP review of New Zealand.[9] A range of tools are required to resolve a range of banks that vary in size and complexity. A key option in the toolbox for resolving medium to large institutions would be 'bail-in' – the ability to write down or convert unsecured liabilities to equity.

115. For bail-in to be credible, though, other aspects of the regime and of the wider safety net have a role to play (for example, the protection from bail-in that deposit insurance provides to unwitting but insured depositors). In the same way that different arms of the financial safety net work together to support each other, so, too, do different parts of a crisis management regime (for example, creditor safeguards) work to support the regime's overall functionality and credibility.

116. The Review seeks a number of in-principle decisions to confirm the direction of reform in key areas. These in-principle decisions set the foundation stones for the crisis management reforms. Decisions on these foundation stones are sought now so that they may form the basis of work to continue on related second-tier policy work in those and other areas through the remainder of Phase 2.

Formally designating the Reserve Bank as the resolution authority

117. Clarity in 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 as officials scramble to agree on a strategy and how it should be executed.

118. The Review recommends that legislation formally designate the Reserve Bank as resolution authority for banks and other regulated deposit takers. The Reserve Bank has appropriate operational independence from political interference to perform the resolution authority role (situations justifying political involvement can be managed on an exceptions basis). The Reserve Bank is also able to take advantage of synergies with its prudential supervision role (e.g. understanding a deposit taker's structure, its business operations, the critical services it provides, and the underlying cause of failure).

119. The Review will be providing further advice in 2020 on whether the resolution function should be situated in a division of the Reserve Bank structurally separate from the supervision function.

…with resolution functions set out in legislation

120. Clarity on the functions of a resolution authority is critical for ensuring a credible resolution regime and for understanding what is expected of the Reserve Bank in performing that function. Taking into account international good practice guidance for resolution authorities and New Zealand's circumstances, the Review recommends that resolution functions be specified around resolution planning (that is, while regulated entities are healthy), including planning with foreign authorities (especially for New Zealand's foreign-owned banks), as well as exercising resolution powers.

…and clear statutory resolution objectives

[9] IMF (2017) *New Zealand FSAP: Technical Note – Contingency Planning and Crisis Management Framework*.

121. Good regulatory design demands that conferring extensive powers on an unelected body be accompanied by clear statutory objectives governing the use of those powers. The intrusive nature of resolution powers in particular and their potential distributional impacts demands clarity of the outcomes that the Reserve Bank should be aiming to achieve as the resolution authority.

122. Also, the Reserve Bank's overarching financial stability objective on its own is not sufficient for the resolution function as resolution powers also need to be exercised in relation to deposit takers which are not systemically important. Clarity on the expected outcomes in these cases would nevertheless be no less important for the stakeholders concerned and their confidence in the resolution regime.

123. The Review recommends the following statutory resolution objectives (subject to drafting):

(a) [Ensure that] All deposit takers can be resolved in an orderly manner.

(b) 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.

(c) To the extent not inconsistent with (2):

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.

124. The first objective was not included in the recent consultation exercise but has been included here as an *outcomes* objective following further reflection on the desire to have an objective that reflects the resolution authority's resolution planning function. The resolution planning function is critical to ensuring an effective resolution regime and needs to be at the forefront of the resolution authority's mind during normal times.[10]

125. The second objective acknowledges that resolution fundamentally underpins financial stability, particularly through maintaining the continuity of systemically important functions and avoiding contagion. The proposed wording of both (ii) and (iii)(a) reflect the FSB *Key Attributes'* recommended objectives and the Bank of England and EU resolution objectives.

126. The Review notes that objective (iii)(b), relating to public funds, also reflects UK and EU resolution objectives and 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.[11]

127. However, the Reserve Bank considers that the objective of minimising the need to apply public funds to resolve the failure of a deposit taker better focusses on the

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[10] Being able to be resolved in an orderly manner could take a number of forms; for a small deposit taker it could be as simple as having depositors paid out by insurance with the entity being wound down through normal insolvency procedures.

[11] The Review also considered other options for managing fiscal risk in resolution, particularly using a statutory manager's terms of appointment or the terms of a government guarantee. These options were found to either carry undesirable legal risk or had previously proven to be ineffective at fiscal risk management.

Reserve Bank's role in a resolution vis-à-vis the Minister of Finance – i.e. the Reserve Bank does not have the power to put public funds at risk (only the Minister of Finance can decide to do that), and that some of the powers for the Minister of Finance in a resolution may highlight the other tools available for them to manage the Crown's exposure once public funds have been put at risk (e.g. powers to direct the Reserve Bank for that purpose).

128. The second round of consultation included a resolution objective of protecting insured depositors, with a note that such additional depositor protection (additional to that provided by deposit insurance) may not be necessary. The Review found that, if the in-principle decision to introduce deposit insurance is confirmed, then it is unclear that an additional resolution objective to protect insured depositors would be warranted, particularly when there is already an objective to ensure the continuity of systemically important functions and to prevent contagion. A depositor protection resolution objective has not therefore been included in the above proposed objectives at this stage.

Putting resolution powers directly in the hands of the resolution authority

129. Under the current Act, existing resolution powers (other than directions) can only be exercised by 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.

130. Statutory management can be a significant and complicated intervention in the affairs of a private entity and may not always be required to effect a resolution. New Zealand's brand of statutory management is also non-standard in terms of international norms which, according to leading legal advisors to the industry, creates uncertainty with international parties and imposes additional transaction costs on industry to address that uncertainty.

131. The Review sees the existing compulsion for statutory management as a potentially unhelpful and an unnecessarily costly and counter-productive aspect of the existing legislative framework. Several of the existing powers that are available only under statutory management could potentially be exercised directly by the resolution authority without the need to invoke statutory management.

132. Submissions from the bank sector support the view that the appointment of a statutory manager may constitute an unnecessary additional step if the resolution function is situated in an adequately resourced division of the Reserve Bank with the appropriate knowledge and skills.

133. Further, stakeholder feedback so far, particularly from the banking and the legal sector, point to serious concerns – both within New Zealand and from international banks – with New Zealand's version of statutory management as an intervention tool for banks. These concerns apply both to statutory management under the Reserve Bank Act and statutory management under the Corporations (Investigation and Management) Act 1989 (CIMA). Both have similarly broad powers with few of the safeguards recommended in international good practice guidance. The industry's concerns echo those raised previously by the Law Commission.[12]

[12] See footnote 7.

134. In line with international best practice guidance, the Review proposes that several existing powers under statutory management be available directly in the Reserve Bank as the resolution authority without requiring that a bank be placed into statutory management. A modified form of statutory management under the Reserve Bank Act should, however, still be available as an option to address, for example, the situation of a failed entity's board being unable or unwilling to assist in the resolution of the entity, provided that:

- the entity has met the conditions for being placed into resolution, and
- the Reserve Bank considers taking fully control of a failed entity is necessary to implement the chosen resolution option.

135. The Review will provide further advice and recommendations on statutory management, including advice to address concerns with the application to banks of statutory management under CIMA, in 2020 following further discussion with key stakeholders. The FMA and MBIE have raised concerns about removing the application of CIMA statutory management from banks. The Review will work through these concerns with the agencies in an effort to achieve a consensus view.

Bail-in offers a credible alternative to taxpayer bailouts of large banks

136. 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 can meet minimum regulatory requirements and re-enter (or remain in) the financial system with the market's confidence.

137. In the case of systemically important banks where an open bank resolution strategy is likely to be required, the resolution regime needs to provide for the ability to return a failed bank to a viable/solvent state while a longer term solution is determined. Achieving this outcome requires the ability to absorb any remaining losses and recapitalise the failed bank – quickly and reliably. In the absence of an equity injection from the existing owners or a third party, the Reserve Bank Act does not provide for recapitalisation or direct loss absorption powers without an injection of taxpayer funds. The failure of a systemically important deposit taker would therefore likely require taxpayer support (in the absence of additional owner support) under the current legislative framework.

138. In the post-GFC era, statutory bail-in is an internationally-recognised option for the orderly resolution of a bank that must be resolved in an open state to avoid destabilising the financial system or interrupting critical financial functions and without exposing taxpayers to loss.

139. Stakeholder feedback was supportive of introducing the bail-in tool. Support was particularly strong 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 best practice, which are now a familiar part of banking systems internationally, and are well-understood by institutional investors.

140. The wide support perhaps also recognises the positive aspects of a credible bail-in tool for banks and the public alike – by reinforcing market discipline and avoiding impositions on taxpayers and the damaging moral hazard that expectations of taxpayer support brings. A bail-in option with pre-positioned liabilities, together with deposit insurance, should minimise if not eliminate expectations for taxpayer bailouts of any failed deposit taker.

141. The only qualification among some submitters who supported bail-in was that depositors should be excluded from its scope. The Review is cognisant of the potential destabilising effect that an across-the-board bailing in of unsecured liabilities could have on the credibility of, and preparedness to use, the statutory bail-in tool. In some countries such as the UK, certain unsecured liabilities are expressly excluded from being bailed in. Further, bail-in-able liabilities have been structured in the UK so as to provide a high level of assurance that normal depositors would always be made whole in a resolution (if not through deposit insurance then through ensuring that sufficient subordinated debt instruments are available in a bank's capital structure to recapitalise the bank through bail-in).

142. Expressly excluding certain types of liabilities from bail-in can therefore strengthen the credibility of the tool. Exclusions could include operating liabilities, derivatives, short-term debt, and depositors.

143. Bail-in, however, is not a silver bullet. Operationalising bail-in requires working through a number of complicated issues. Key among those issues is how to enforce the bailing in of debt instruments issued by New Zealand banks under foreign law. Other jurisdictions with bail-in have also considered this issue. A common approach (e.g. the EU, including the UK, and Hong Kong) is to require certain bond contracts to include explicit contractual terms giving effect to domestic resolution powers. Some jurisdictions (again including the EU/UK and Hong Kong) also have powers to allow the local resolution authority to recognise foreign resolution actions.

144. The IMF has advised the Review that "recognition under foreign law may be more likely if the domestic resolution regime is consistent with international standards, especially the creditor safeguards. While both approaches [contractual approach or mutual recognition, as described above] are untested in practice, the EU contractual approach has been the subject of significant legal and practical implementation work in major jurisdictions, from which the New Zealand authorities could draw upon."

145. Bail-in has been used in one form or another in the resolution of several failed banks internationally in recent years. It has had its challenges as jurisdictions learn how this option is best empowered, prepositioned, and executed to be successful. The international bank resolution community led by the FSB continues to develop best practice guidance based on these lessons learned and detailed policy work. There is a substantial and growing body of work and expertise internationally to draw upon in implementing the bail-in tool.

146. Recognising that bank resolution is a continually evolving art and that there are second-tier policy layers to bail-in that will likely need to evolve from time to time, the Review team's proposed approach is that primary legislation set out an empowering framework with appropriate safeguards, with certain second-tier policy parameters (such as which liabilities should or shouldn't be eligible to be bailed in) being set out through regulations.

147. As bail-in involves interference with creditor property rights, it should only be used where the disruptive impact of normal insolvency proceedings on critical financial services or the wider financial system warrants the departure from those normal proceedings.

148. The Review's advice, supported by the Treasury, is therefore that an in-principle decision be made that the Reserve Bank have the ability to write down and convert unsecured liabilities of a failed bank into equity (statutory bail-in) where the failed deposit taker cannot be wound up under normal insolvency proceedings without destabilising the financial system or interrupting critical financial services. Further work will be undertaken on second-tier policy issues, such as bail-in procedures and options for dealing with redress claims.

149. It is also recommended that legislation enables the Governor-General, by Order in Council, to make regulations specifying types or categories of liabilities that are excluded from bail-in. A separate consultation exercise can then be carried out with the sector to determine which liabilities should be excluded through those regulations.

150. The Reserve Bank considers the above characterisation (paragraphs 138-140) materially oversells the benefits and understates the problems associated with a statutory bail-in tool. In particular, a framework where there are 'pre-positioned liabilities' in essence simply delivers another layer of capital – the work has not been done to show why this is a better solution than more capital using conventional means.

151. The Reserve Bank remains open to continuing to explore the concept of a bail-in power, but considers that an in-principle recommendation on bail-in is premature, due to the large number of outstanding issues around the design and effect of such a power. For example, why statutory rather than contractual bail-in is preferred, the extent to which classes of liabilities could be included or excluded from the scope of the power via regulations, how a bail-in power fits with the recommended no creditor worse off approach and (if it is adopted) depositor preference, and the value and scope of liabilities that could plausibly be bailed-in compared with the potential hole in a failed bank's balance sheet.

152. The Reserve Bank is also concerned that any statutory power that purports to be able to bail-in liabilities that are not supported by relevant contractual clauses may not be credible. The Reserve Bank notes that APRA, its Australian equivalent, does not have a statutory bail-in power. Rather its legislation presupposes contractual bail-in. The Reserve Bank considers that aligning with Australia on this issue is likely to be a more practical option.

…supported by international norms on creditor safeguards

153. Certain creditor safeguards in a resolution are considered international best practice and are a common expectation among creditors internationally. 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.

154. Exercising resolution powers in a way that respects the hierarchy of creditors in liquidation is accepted internationally as good practice. This principle is particularly important where interference in property rights is likely, such as with bail-in. 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 and is arguably necessary for maintaining the international credibility of a jurisdiction as an investment destination.

155. 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 (as are the *Key Attributes* generally) and has been adopted in one form or another by many jurisdictions. NCWO underpins the international credibility of a country's bank resolution regime.

156. New Zealand is currently an outlier internationally for its lack of safeguards for creditor property rights in a bank resolution. Some of the strong criticisms of New Zealand's existing statutory management-based resolution regimes (whether under the Reserve Bank Act or under CIMA) include the degree of flexibility permitted for a statutory manager to depart from the creditor hierarchy and the lack of creditor safeguards for when there is a departure from the creditor hierarchy or when creditors are left worse off than they would have been in a normal liquidation. The only 'safeguard' that could potentially be available – the voidable preference provisions available to a liquidator

under the Companies Act 1993 – would present an untenable legal risk to the integrity of a bank resolution and a significant fiscal risk to the Crown.

157. Reflecting international norms on creditor safeguards in bank resolution, the Review advises that resolutions should be required to:

(a) 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, in either case —

(b) seek to ensure that no creditor incurs losses greater than would have been incurred in an ordinary liquidation (NCWO).

158. In certain circumstances, NCWO may require the payment of compensation to affected creditors. 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 in 2020.

159. The need for NCWO compensation (and the risk of legal challenge to a bail-in generally) can, however, be minimised by ensuring that sufficient unsecured liabilities are available to readily and reliably absorb losses and recapitalise a bank through bail-in, and that such liabilities are unquestionably subordinated to other liabilities. Pre-positioning resolution in this way is where prudential regulation settings (especially capital requirements) and the resolution authority's planning function can play an important role in supporting the credibility of a resolution regime.

Additional and second-tier recommendations will follow in April/May 2020

160. The Review is continuing work on other aspects of bank resolution and crisis management including:

(a) procedural and legal requirements to support creditor safeguards and the 'no creditor worse off' principle

(b) early intervention and other recovery and resolution powers

(c) triggers for putting a deposit taker into resolution

(d) the role of the Minister of Finance

(e) statutory management form and procedures

(f) resolution funding, including providing liquidity for banks in resolution and a permanent legislative authority under the Public Finance Act 1989 to approve capital expenditure in a financial emergency (similar to the existing authority to incur expenditure in a civil defence or public health emergency)

(g) powers to temporarily suspend bank disclosure requirements

(h) legal safeguards and redress to prevent resolutions being unwound by judicial action

(i) transparency and accountability requirements for the use of resolution powers, and

(j) whether statutory management under the Corporations (Investigation and Management) Act 1989 should continue to apply to deposit takers.

161. This work will be undertaken with on-going sector and agency engagement and will be brought together to complete the Review's recommendations on the crisis management framework in April/May 2020.

Other matters: Administration of the deposit-taker legislation

162. Administration of legislation refers to performing the role of the government's lead policy advisor on primary legislation (Acts). Administration of Reserve Bank legislation has been considered by the Review team because of its implications for the relationship between the Reserve Bank and the Minister of Finance. Assigning administration of legislation requires consideration of matters such as who is best-placed to advise the Minister, maintain an appropriate free and frank relationship with the Minister and other government departments, meet the obligations of stewardship of legislation, and ensure coherency with the Crown's wider legislative framework.

163. The Review Team, the Reserve Bank, and the Treasury have agreed that the Treasury should administer the proposed Institutional Act. A recommendation to this effect is included in the Review's companion report on the Institutional Act (T2019/2764).

164. Agreement and a decision remains outstanding on administration of the Reserve Bank's sectoral legislation such as the proposed DTA. A decision will be required in 2020 to inform the drafting process. The Review will provide further advice to you in the April/May on final decisions for the DTA.