



# Safeguarding the future of our financial system

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Glossary document

*Consultation 3*

Phase 2 of the Reserve Bank Act Review

March 2020



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# Glossary

## Abbreviations, acronyms and key terms

**Activities-based regulation** – regulation of entities based on the fact that they undertake certain activities, such as taking deposits.

**ADI** – authorised deposit-taking institution. An institution authorised by the Australian Prudential Regulation Authority to carry on banking business, such as a bank, credit union, or building society.

**Administrative instrument** – an instrument that allows for the implementation, within the legal framework, of the actions or decisions of a regulatory body.

**AML/CFT** – anti-money laundering and countering financing of terrorism.

**APRA** – Australian Prudential Regulation Authority. The prudential regulator of the Australian financial services industry.

**Asset** – a resource controlled by a person or enterprise (an ‘investor’) from which future economic benefits are expected to flow to the investor. Cash, bank deposits, and KiwiSaver funds are common ‘assets’ held by New Zealanders. An instrument held as an asset by an investor is a ‘liability’ for the institution that has issued the instrument. For example, cash held by New Zealanders is an asset to them but is a liability of the Reserve Bank, while bank deposits are assets for deposit holders but liabilities for the banks holding the deposits.

**Attestation regime** – the way the Reserve Bank underpins self-discipline by placing responsibility for prudent outcomes with directors of registered banks. Directors attest in public disclosure statements that their banks are adequately managing risks, and whether the banks have complied with their conditions of registration.

**Bail-in** – a restructuring mechanism that enables loss absorption and the recapitalisation of a bank in resolution or the effective capitalisation of a bridge bank through the cancellation, write-down or termination of equity, debt instruments, and other senior or subordinated unsecured liabilities of the bank in resolution, and the conversion or exchange of all or part of such instruments or liabilities into or for equity in or other instruments issued by that bank, a successor (including a bridge bank) or a parent company of that bank.

- **Statutory bail-in** involves the use by authorities of discretionary statutory powers to bail in liabilities.
- **Contractual bail-in** involves the triggering of clauses in a debt instrument’s contract to automatically bail in the liability.

**Bail-out** – any transfer of funds from public sources to a failed bank or a commitment by a public authority with a view to sustaining a failed bank (for example, by way of guarantees) that results in benefit to the shareholders or uninsured creditors of that bank, or the assumption of risks by the public authority that would otherwise be borne by the bank itself, where the value of the funds transferred is not recouped from the bank, its shareholders and creditors or, if necessary, the

financial system more widely, or where the public authority is not fully compensated for the risks assumed.

**Basel Committee on Banking Supervision (BCBS)** – the primary global standard setter for the prudential regulation of banks, and a forum for regular cooperation on banking supervisory matters. It has 45 members comprising central banks and bank supervisors from 28 jurisdictions. New Zealand is not one of these jurisdictions. The Basel Committee produces the Basel Core Principles.

**BCPs** – Basel Core Principles for effective banking supervision. BCPs are used by the IMF in their Financial Sector Assessment Programmes. The BCPs were first issued in 1997, and last updated in 2012 to reflect lessons from the GFC.

**BEAR** – Banking Executive Accountability Regime. An executive accountability regime implemented in Australia in mid-2018. Administered by APRA and applying to directors and certain senior employees of authorised deposit-taking institutions.

**Bridge bank** – an entity created by authorities to operate a failed bank until a buyer can be found for its operations.

**Capital** – in the banking context, capital refers to the type of funding that a bank uses to finance its assets. ‘Common Equity Tier 1’ capital primarily includes ordinary shares and retained earnings. ‘Additional Tier 1’ capital includes preference shares. ‘Tier 2’ capital consists mainly of long-dated subordinated debt. Capital is not cash reserves or money set aside for an emergency.

**Capital ratio** – an amount of capital (expressed as a ratio of capital to exposures/investments) that regulated entities must hold in order to protect against losses on those exposures/investments.

**CIMA** – Corporations (Investigation and Management) Act 1989.

**Civil monetary penalty** – a financial penalty imposed by a court according to rules of civil procedure and evidence (also called a civil ‘pecuniary’ penalty).

**Closed resolution** – the resolution of a failed bank in a manner that does not keep the bank operating as a going concern. Parts of the bank may be transferred to another owner with other parts passed on to another type of management vehicle or liquidated. Compare with ‘Open Bank Resolution’.

**Conditions of registration (CoRs)** – a set of criteria that banks registered in New Zealand must meet in order to refer to themselves as banks. A registered bank’s conditions of registration are controlled by the Reserve Bank, and are the primary way that prudential requirements are applied. CoRs are designed to promote banking system stability by constraining, but not completely removing, banking risk in certain key areas.

**Contagion** – a situation where difficulties facing one participant in the financial system spread to other participants.

**Countercyclical capital buffer (CCYB)** – a macro-prudential tool imposed by a regulator, which requires banks to maintain higher levels of capital (or face limits on their ability to pay dividends).

**Covered bond** – a bond where the holder’s right to payment is secured by specific assets, known as ‘collateral’.

**Creditor** – someone who has lent money to a firm, which the firm has undertaken to repay. For example, a depositor is a creditor of a bank. In contrast, a shareholder is an owner of a bank.

**Creditor hierarchy** – the order in which creditors or classes of creditors are paid out in a liquidation.

**Creditor property rights** –

- in relation to a debt and a creditor prior to liquidation, the right to be repaid on time without deduction and without being subordinated to another competing claim of equal rank.
- in relation to a debt and a creditor during the course of a liquidation, the right to share in the proceeds of the liquidation in accordance with the rules set by the applicable insolvency laws.

**Crisis management** – a process by which authorities deal with an unexpected and disruptive event (or the risk of a disruptive event) that threatens the stability of the financial system (e.g. the failure of a major bank).

**Crown (the)** – the meaning of ‘the Crown’ varies according to the context in which it is used. Generally, it describes executive government conducted by Ministers and their departments. It does not normally include organisations that have their own corporate identities, such as state-owned enterprises. The Reserve Bank is not part of the Crown.

**Crown entity (as used in this document)** – a Crown-owned organisation, a legal entity in its own right that has been established under legislation as a “statutory entity” and is subject to the Crown Entities Act 2004. Crown entities perform functions on behalf of the Government at varying degrees of independence from the Government.

**Crown Retail Deposit Guarantee Scheme (CDGS)** – an emergency measure to support the financial sector implemented by the New Zealand Government during the GFC. The CDGS was put in place in October 2008 and ended in December 2011. At its peak the scheme covered 96 institutions, including 12 banks, 60 NBDs, and 24 investment firms. The Government paid out \$2 billion to 42,000 depositors under the scheme. The largest single pay-out was for South Canterbury Finance (\$1.6 billion), one of nine failures under the scheme.

**De minimis (as used in this document)** – an optional function that could protect small bank deposits under OBR.

**Debt instrument** – a bond or other form of liability creating a contractual obligation on the issuing institution that the bond must be repaid. These instruments are traded in debt markets.

**Debt security** – a right to be repaid money or paid interest on money that is lent or deposited with a person. Examples include deposits, debentures, and bonds.

**Debt-to-income limits (DTI)** – limits on loans relative to borrower income. May be part of a lender’s risk management policies, or imposed by a regulator as part of macro-prudential policy.

**Decision-making Principles** – considerations set out on in legislation to guide decisions made under the law (such as when the Reserve Bank writes detailed rules for regulated entities).

**Deemed liability** – an ability to make an individual liable for contraventions of regulatory requirements or law made by a corporate entity.

**Delegated legislation** – rules made under an empowering provision in primary legislation that create, alter or remove the rights or obligations of all, or a class, of the public. For the purposes of this consultation document, the term ‘delegated legislation’ captures both ‘legislative instruments’ and ‘disallowable instruments’ under the Legislation Act 2012.

**Deposit preference** – laws or rules which mean that deposits in a deposit taker are given priority for repayment ahead of general unsecured creditors (such as wholesale investors in the deposit taker). Deposit preference would apply in a liquidation and would also influence decision making if a bank was placed into resolution.

**Deposit taker** – a financial institution that takes deposits, such as a bank or NBDT. Deposit takers are commercial entities that act as interfaces between lenders and borrowers, for example by collecting deposits from the general public and extending loans to households and businesses.

**Depositor** – someone who has money in a deposit account with a bank or NBDT. This person becomes a creditor to the institution holding their deposit, and the institution is contractually required to repay them.

**Derivatives** – financial instruments whose value is derived from other underlying assets. Derivatives can be an important mechanism for financial institutions to manage their foreign exchange exposures.

**Differential Pricing Scheme** – for Deposit Insurance, a levy system which charges higher levies to riskier deposit-taking institutions.

**Directions (as used in this document)** – statutory tool used by the Reserve Bank requiring a specific action on the part of a regulated entity.

**Disallowable instrument** – delegated legislation that must be presented to Parliament and can be disallowed by Parliament.

**Enforceable undertakings** – commitments given to and accepted by the regulator from a regulated entity that are enforceable in court.

**Enforcement** – corrective action undertaken by a prudential authority to address financial institutions’ non-compliance with regulatory requirements, or to address any emerging areas of concern (before formal non-compliance). Tools include formal powers such as court-based action, as well as various supervisory actions such as persuasion, more supervisory oversight, and changing licence conditions.

**EQC** – Earthquake Commission. A Crown entity that compensates for natural disaster damage to residential land and buildings.

**Equity** – in the context of ownership (and resolution), the shareholders’ stake in a company.

**Failing bank** – a bank that is, or is likely to become, unviable. For example, a bank may be unviable because it is unable to honour its debts and liabilities, or because it is in breach of its conditions of registration.

**Financial cycle** – the process where financial markets fluctuate from upturns/booms to downturns/disruptions over time. The financial cycle can affect real economic activity (and the economic cycle).

**Financial market** – a generic term for markets in which financial instruments are issued, invested, and traded, and where those who have a surplus of funds lend to those who have a shortage. The four main financial markets trade in foreign exchange, debt or bonds, shares or equities, and derivatives. These can be broken down into subsets – for example, the ‘money market’ is a market for short-term debt using instruments that generally have a maturity of up to one year.

**Financial policy** – the approach, decisions, choices, and rules related to the regulation, supervision, and oversight of the financial system. Financial policy seeks to achieve various outcomes for the financial system, including financial stability, efficiency, and the protection of consumers. Note that in the case of the Reserve Bank, financial policy includes prudential supervision policy, macro-prudential policy, and crisis management policy.

**Financial Policy Remit** – a document issued by the Minister of Finance to the Reserve Bank setting out matters the Reserve Bank should have regard to when considering the financial stability objective and the purposes of the sectoral Acts (the goals of the regime).

**Financial regulation** – the laws and rules that govern what various participants in the financial system can and cannot do. Regulation is necessary because of the existence of various market failures that prevent the financial system achieving socially optimal outcomes on its own. Regulation seeks to achieve various outcomes which often include financial stability, efficiency, and the protection of consumers.

**Financial safety net** – a set of five distinct but mutually supportive regulatory tools and powers that help keep banks safe and sound. The financial safety net comprises regulations, prudential supervision and monitoring, system liquidity support, deposit protection, and resolution.

**Financial sector** – the collective class of financial system participants (e.g. banks and insurers).

**Financial system** – the network of participants in an economy that collectively undertake various finance-related functions and activities. A financial system includes financial institutions (such as deposit takers and insurers), markets, market infrastructures, and the people who use them.

**FinTech** – technology-enabled innovation in financial services that could result in new business models, applications, processes, or products with associated material effect on the provision of financial services.

**FMA** – Financial Markets Authority. The New Zealand government agency responsible for promoting fair, efficient, and transparent financial markets by enforcing securities, financial reporting, and company law as they apply to financial services and securities markets. The FMA also regulates securities exchanges, financial advisers and brokers, auditors, trustees, and issuers, including issuers of KiwiSaver and superannuation schemes.

**FMI** – Financial Market Infrastructure. A channel through which financial transactions are cleared, settled, and recorded, including payment systems and trading platforms. FMIs are the ‘plumbing’ of the financial system, providing services critical to the smooth functioning of financial markets.

**FMI Bill** – legislation currently progressing through Parliament designed to support the regulation and supervision of systemically important FMIs.

**FMS** – financial markets supervisor. A private sector company that supervises licensed non-bank deposit takers. FMSs are licensed by the FMA.

**FSAP** – Financial Sector Assessment Programme. An IMF programme that seeks to identify the strengths and vulnerabilities of countries' financial systems (including regulatory frameworks, which it assesses against various international standards, including those for banks, insurers, FMIs and securities markets. It also seeks to determine how key sources of risk are being managed. The most recent FSAP mission to New Zealand was in 2016/17.

**FSB** – Financial Stability Board. An international body with membership comprising the G20 countries (New Zealand is not a member). It has a mandate to assess the vulnerabilities affecting the financial system, identify and oversee action to address them, and promote cooperation and information sharing among authorities responsible for financial stability.

**FSR** – Financial Stability Report. A six-monthly Reserve Bank report required by legislation reporting on the soundness and efficiency of the financial system and containing the information necessary to enable an assessment of the Reserve Bank's activities in pursuing its prudential purposes.

**GDP** – gross domestic product. A measure of the value of economic production in the economy.

**GFC** – global financial crisis. An event that occurred between mid-2007 and early 2009 and was a period of extreme and widespread stress in global financial markets and banking systems. The GFC was an example of systemic risks crystallising and damaging the financial system and wider economy.

**Governance** – the system by which an organisation is controlled and operates, and the mechanisms by which it, and its people, are held to account. Governance captures who makes policy and regulatory decisions, who makes organisational decisions, and how decision-makers are held to account.

**IADI** – International Association of Deposit Insurers. A forum of 83 deposit insurance scheme managers that was formed in 2002 to share knowledge and promote international cooperation on deposit insurance systems. IADI works with the Basel Committee on Banking Supervision to develop guiding principles for effective deposit insurance systems.

**IMF** – International Monetary Fund. An international organisation of 189 member countries established to ensure the stability of the international monetary system. Its remit includes the system of exchange rates and international payments, as well as all macro-economic and financial sector issues that affect global stability.

**Independence** – in relation to a public institution such as the Reserve Bank, the provision that ensures the institution can carry out its tasks and duties without political interference.

**Independent Expert Advisory Panel** – a panel appointed by the Minister of Finance to provide independent and expert advice on the Review of the Reserve Bank Act.

**Infringement notices** – notices for a subset of criminal offences that do not result in criminal conviction. Typically used by the regulator for minor compliance-type contraventions.



**Insolvency** – when the value of a firm’s assets falls below the value of the liabilities it owes, and the firm is therefore unable to pay its debts. An insolvent firm is a ‘failing’ firm.

**Investor** – someone who has invested their money in a financial institution. Anybody providing funds to a financial institution in whatever form is an investor, from shareholders to depositors to professional investors in more sophisticated debt instruments.

**IPSA** – Insurance (Prudential Supervision) Act 2010.

**Issuer** – an entity that issues, and therefore becomes obligated for, a security or other financial instrument. For example, a bank that writes a debt in exchange for funding is the ‘issuer’ of that debt.

**Key Attributes of Effective Resolution Regimes for Financial Institutions** – a set of 12 attributes developed by the FSB and endorsed by the OECD as an international standard for bank resolution regimes.

**LDAC** – Legislation Design and Advisory Committee.

**Lender of last resort (LoLR)** – the central bank acting in its function to provide emergency liquidity assistance to a solvent financial institution facing temporary liquidity problems, in order to maintain the soundness of the financial system.

**Lending standards** – rules banks use when deciding whether to lend to prospective borrowers. They may include limits on loans relative to collateral (such as loan-to-value limits) and loans relative to borrower incomes (such as debt-to-income limits). May be influenced by regulation.

**Levy** – a charge imposed on a particular party or group, as a proxy for those that benefit from a specific good or service or regulation.

**Liability** – a debt or legal obligation to be repaid, by either cash or another type of financial instrument. Examples include customer deposits held by banks, and bonds and other debt securities issued by banks. As previously noted, one entity’s asset is another entity’s liability.

**Liquidation** – the process of closing a firm where the assets are sold (realised) and the proceeds allocated to creditors and shareholders in accordance with the hierarchy of claims.

**Liquidity** – the capacity to sell an asset quickly and easily without significantly affecting the price of that asset. ‘Liquidity’ is also sometimes used to refer to assets that are highly liquid.

**LVR** – loan-to-value ratio. A tool used by financial sector regulators to influence lenders’ credit policies and the availability of loans to borrowers, by specifying the proportion of an asset’s value that may be financed through borrowing.

**Macro-prudential policy** – the use of prudential tools (such as capital buffers and loan-to-value restrictions) to manage the system-wide (systemic) risks that can develop during boom-bust financial cycles. Macro-prudential policy aims to promote greater financial system stability by building additional resilience in the financial system during periods of rapid credit growth and rising leverage or abundant liquidity, and by dampening excessive growth in credit and asset prices.

**Market discipline** – one of the three pillars of the Reserve Bank’s prudential framework. It refers to the way in which market participants influence a financial institution’s behaviour by monitoring its risk profile and financial position.

**Monetary policy** – action undertaken by a central bank to affect the cost of money and credit to meet objectives such as price stability and maximising sustainable employment. While monetary policy is generally implemented using a policy interest rate (such as the Official Cash Rate), it can also involve the use of extraordinary measures such as quantitative easing/asset purchasing.

**Moral hazard** – a situation where one party has an incentive to take risks without taking responsibility for or having to bear the consequences, for themselves and society. For example, expectations of a Government bail-out creates moral hazard by encouraging financial institutions to take more risks than they would otherwise.

**MoU** – memorandum of understanding. A non-binding agreement or expression of common understanding between two or more parties.

**Name-based regulation** – regulation of entities based on their use of certain restricted words (e.g. ‘bank’).

**NBDT** – non-bank deposit taker. An institution that carries on the business of borrowing and lending money, or providing financial services, or both, but is not a registered bank. Examples of NBDTs are some finance companies, credit unions and building societies. NBDTs are currently prudentially regulated by the Reserve Bank under the Non-bank Deposit Takers Act 2013. The Reserve Bank does not, however, supervise this sector. Supervision is undertaken by trustees, who are in turn supervised by the Financial Markets Authority.

**NCWO** – ‘no creditor worse off’ than in liquidation. The principle that no creditor should incur greater losses than they would have incurred if an institution had been wound up under normal insolvency proceedings. ‘NCWO compensation’ is financial compensation to a creditor whose actual incurred losses are greater than what they would have incurred in liquidation.

**Non-zero-failure banking regime** – an approach to banking regulation that is used in all advanced economies, including New Zealand, whereby banks are allowed to fail.

**OBR** – Open Bank Resolution. A Reserve Bank policy designed to help manage a bank failure. Open bank resolution more generally is a strategy whereby authorities stabilise and resolve a failed bank in such a way that it is able to continue operating as a going concern, providing continuity of the bank’s critical functions and services. Compare with ‘closed resolution’.

**Off-site supervision** – a set of supervisory activities undertaken by a prudential authority at its premises (also called desk-based monitoring). It is typically used to complement on-site supervision. The Reserve Bank relies on off-site supervision to monitor and assess regulatory compliance.

**OIA** – Official Information Act 1982.

**On-site supervision** – a set of supervisory activities undertaken by the prudential authority at the premises of financial institutions. It is used to obtain independent verification that a financial institution has adequate policies, procedures and controls in place. It is also called an on-site inspection or

examination. The Reserve Bank does not undertake on-site supervision, instead relying on off-site supervision.

**Parliamentary appropriation** – the authority (in the form of an Act) of Parliament to expend public money.

**Payment and settlement systems** – a type of FMI. Payment and settlement systems support the exchange of payments for products and services. They may be cash payment systems (such as the Reserve Bank’s Exchange Settlement Account System) or securities settlement systems.

**Pecuniary penalty** – monetary penalty for fine, rather than imprisonment. Can be imposed under either civil or criminal proceedings.

**Phase 1** – the first phase of the Review of the Reserve Bank Act. The outcomes of Phase 1 updated the Reserve Bank’s high-level objectives for monetary policy, adding employment to the price stability objective of the Reserve Bank and providing for a committee decision-making model for monetary policy decisions (the MPC).

**Phase 2** – the current phase of the Review of the Reserve Bank Act. It is primarily focused on a comprehensive review of the financial policy provisions of the Reserve Bank Act that provide the legislative basis for prudential regulation and supervision, and has also considered the broader governance arrangements of the Reserve Bank.

**Prudential regulation** – rules that support the prudent operation of financial entities licensed by the prudential authority. In New Zealand, prudential regulation focuses on the soundness and efficiency of the financial system by imposing regulatory requirements at the level of individual institutions. Capital requirements, liquidity requirements, and disclosure requirements are among the prudential requirements currently implemented by the Reserve Bank.

**Prudential supervision** – a set of activities directed at both individual financial institutions and the wider financial system. Activities include licensing individual entities, collecting and analysing information, assessing compliance with prudential regulatory requirements, and cooperating and coordinating with other domestic and international agencies.

**Recapitalisation** – the restoration of a firm’s depleted financial resources following a significant loss or asset write-down.

**Regulated entity** – a financial service provider falling within the scope of the Reserve Bank’s supervisory and/or regulatory powers. This currently captures registered banks, NBDTs, and insurers.

**Regulations Review Committee** – a committee of Parliament that applies technical scrutiny to delegated legislation.

**Regulator** – a body mandated by the Government to oversee a particular industry or sector. The Reserve Bank is the prudential regulator for the financial sector in New Zealand.

**Regulatory framework** – a system of rules and requirements that govern the way regulators and regulated entities interact. The financial sector regulatory framework is made up of regulatory requirements, guidance, and memoranda of understanding.

**Regulatory leakage** – the shifting of activities to products, markets or entities so that they fall outside the regulatory perimeter.

**Regulatory perimeter** – the group of firms or entities that are subject to a regulatory regime.

**Remedial notice (and plan)** – statutory tool that requires a regulated entity to remedy a breach, or state how it will remedy a breach, of a regulatory requirement.

**RFC** – registered financial corporation. RFCs are a category of regulated entity in Australia that are in the business of borrowing and lending but are exempt from the requirement to become authorised deposit-taking institutions. While RFCs are not prudentially regulated they are subject to reporting, monitoring, disclosure and other regulatory requirements. The Australian Prudential Regulation Authority places a number of restrictions on the retail activities of RFCs.

**Reserve Bank of New Zealand** – New Zealand’s central bank, established in 1934. The Reserve Bank manages monetary policy to maintain price stability, promotes the maintenance of a sound and efficient financial system, and supplies New Zealand banknotes and coins.

**Resolution** – the restructuring and/or orderly wind-down of all or part of a deposit taker’s business in a way that adequately safeguards the public interest.

**Resolution authority** – a public authority that, either alone or together with other authorities, is responsible for the resolution of banks established in its jurisdiction (including resolution planning functions).

**Retail depositors** – households and small businesses with deposit accounts. Retail depositors are not professional investors or wholesale creditors.

**Settlement system** – a system or arrangement for effecting settlements (the making of payment or the transfer of the title to, or an interest in, personal property) or processing settlement instructions, and includes a payment system. A payment system is used for transferring funds.

**Shareholder** – someone who has invested money in a firm to become a partial owner of that firm.

**SOI** – Statement of Intent. A statutory accountability document setting out the strategic objectives that an entity intends to achieve in the future reporting period and other matters intended to promote the public accountability of the entity.

**Statutory management** – one of several legal mechanisms available in New Zealand to deal with a failing bank, set out in the Reserve Bank Act.

**Statutory manager** – an individual appointed by the Governor-General (on the advice of the Minister of Finance in accordance with a recommendation of the Reserve Bank) to run a commercial bank in the interest of the New Zealand public when the bank is failing. The statutory manager has wide powers to deal with the failing bank, such as assuming all powers of the board and management, and exercising many of the powers of a liquidator. The statutory manager may choose to suspend or make payments to creditors, or organise to sell the bank.

**Statutory public notices** – formal notices issued by a regulator under legislation to an individual regulated entity, or to the sector more generally.

**Systemic risk** – the risk that issues at one point in the financial system (perhaps due to operational disruption or a participant’s financial difficulties) will cause issues at other points in the system, generating spill-over effects that could threaten the wider operation and stability of the system and have negative consequences for the real economy.

**The Treasury** – the Minister of Finance’s policy department and the Government’s lead economic and financial adviser.

**Twin peaks** – a model of financial regulation where financial market conduct and prudential regulation are separated.

**Unsecured creditor** – someone owed money (e.g. by a financial institution or consumer) where the debt is not backed by specific assets. In the event of failure, unsecured creditors will be paid out from a general pool of assets. In contrast, some funding (such as covered bonds) is secured with specific assets.

**Wholesale investor** – professional (non-retail) financial market participant, such as a sophisticated investor in capital market instruments or participant in interbank money markets.