The Treasury

Reserve Bank Act Review Phase 2 Consultation 3 Submission Information Release

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16 October 2019

To
Phase 2 of the Reserve Bank Act Review
The Treasury
PO Box 3724
Wellington

From
Simon Jensen

By Email

Phase 2 of the Reserve Bank of New Zealand Act 1989 ("RBNZ Act") Review

I am making this Submission in a personal capacity. This submission does not represent the interests of any clients but are my personal views.

This follows an earlier submission I made in August 2019, and like that submission is intended to focus on aspects of the third consultation where my experience may be relevant. I am happy to expand on any comments made in this letter either in person or separately if that is helpful.

At the outset I would like to acknowledge the quality of the work and thinking which has gone into the consultation paper "Safeguarding the future of our financial system: Further consultation on the prudential framework for deposit takers and depositor protection March 2020" ("third consultation"). I believe it is probably the best consultation document that I have read.

While I have followed the format of the third consultation, I have not attempted to answer all of the questions contained in it. I have just focused on key areas where I thought my experience could be helpful to the review team.

PURPOSES OF THE DEPOSIT TAKERS ACT

In general, I agree with all of the comments on the purposes of the Deposit Takers Act in Chapter 2 and in particular:

(a) the core objective of protecting and promoting the stability of New Zealand's financial system;

(b) the ability of the Reserve Bank of New Zealand ("RBNZ") to focus on micro level considerations relating to the resilience of individual deposit takers (certainly an omission from the current regime);

(c) broadly, the proposed decision-making principles; and

(d) the ability for the Minister of Finance to use a Financial Policy Remit (which I assume will be similar to the power under the Non-Bank Deposit Takers Act 2013 ("NBDT Act") for the government to issue a government policy statement).

I do, however, have two comments to make on the purposes of the Deposit Takers Act:

(i) it seems slightly anachronistic to have a Deposit Takers Act without a purpose relating to "depositors"; and

(ii) I believe that the Financial Policy Remit should be proactively used - and simply not relied upon as a back-stop (as seems to have been the case with the power to issue a government policy statement under the NBDT Act).

Commentary

Depositor Objective

I believe people put money in banks because they expect it to be safe. People who deposit money in banks are typically not making investment decisions but are trying to protect their savings. It is naive to expect depositors to exercise any form of discipline over banks. When teaching a stage 3 law class (of whom approximately 75% had also done a finance degree), none of them believed that they could understand bank disclosure statements sufficiently to make an informed investment decision. If this group feel incapable of doing so there is little hope for the non-tertiary educated, and particularly the elderly. I believe that bank depositors expect the RBNZ to be looking after their interests. Furthermore, I understand the inclusion of a depositor protection objective would be consistent with a number of comparable jurisdictions to New Zealand. I believe we should just accept the moral hazard exists and acknowledge the role in protecting depositors in the purposes of the Deposit Takers Act.

Financial policy remit

I believe that New Zealand government should have a vision for what it would like the New Zealand banking system to look like in 5, 10 and 20 years' time. The fact that it is not clear how fintechs, globalisation or indeed localisation following the pandemic could affect the banking system should not be an excuse for at least attempting to have a vision.

Since prudential regulation was changed in 1986 (with the first version of the RBNZ Act which was later replaced in 1989), there have been massive changes to the New Zealand banking system with, as far as I am aware, no real assessment as to whether those changes were good or bad. For example, since 1986 we have seen a large loss of domestic ownership of our financial system with the loss of, at least, the following domestically owned banks:

- ASB;
- BNZ;
- Trust Bank (including all of the regional banks included in it);
- Postbank;
- Rural Bank;
- Westland Bank;
- Countrywide Bank; and
- United Bank.

All of these banks have, effectively, ended up in Australian ownership – as did The National Bank of New Zealand when it was sold to ANZ in 2003.

As a consequence we now have a banking sector heavily dominated by Australian banks. This has happened simply through market forces – without any government view as to whether it was a good or bad thing. Indeed, it was not until 2003, when the National Bank of New Zealand was put up for sale, that the RBNZ Act was amended to give the RBNZ the power to approve a bank sale effectively having regard to the impact of the bank sale on the New Zealand financial system. This was after the horse had bolted.

As a result New Zealand now has a banking system which in terms offshore ownership is probably most closely correlated with Eastern European countries, whose banking systems are often dominated banks from Western Europe (and was a symptom of the collapse of the Iron Curtain).

Australian Ownership

There is no doubt that there have been a number of positives for New Zealand arising from the Australian ownership of a substantial part of its banking system along with a number of negatives. My attempt to summarise them is:

Pros

(i) The New Zealand subsidiaries of Australian banks have had a lower cost of funding because their credit ratings include the implicit support of their parent (and probably also the implicit support of the Australian government). This has meant they have been able to raise funds as AA- rated entities as opposed to BBB+ which they probably are on a stand alone basis; and

(ii) Anecdotally, those banks have had access to capital in times of crisis at short notice (such as during the global financial crisis which, in part, justifies their higher ratings).

Cons

(i) I understand that the New Zealand banks are amongst the most profitable banks in the world, so the parents of those banks have been well rewarded for their investment in New Zealand subsidiaries;

(ii) The Australian parent banks are all subject to regulation by APRA in Australia which does include constraints on levels of capital that they can provide to the New Zealand subsidiaries in a crisis and on inter-connected lending;

(iii) The boards of the Australian banks have an overarching duty to act in the best interests of the parent bank and a natural bias to support Australian operations first. This has in the past been manifested by:

    (a) more aggressive tax structuring in New Zealand than Australia;

    (b) a greater propensity to allocate the capital to investment in Australia and the Australian business than New Zealand;

    (c) outsourcing arrangements more beneficial to the Australian parent than its subsidiaries;and

    (d) lower levels of resource (relatively) for New Zealand operations especially during cost cutting across the group.

While the RBNZ is conscious of these risks and has introduced policies and conditions of regulation to mitigate them (in particular its outsourcing policy) there are natural constraints on how effective those policies can be.

In short, I believe that contemporaneously with the introduction of the Deposit Takers Act a review should be undertaken by Government of the structure of the New Zealand banking sector and what, if any, changes it believes are appropriate. That should be included in an initial Financial Policy Remit.

I would like to think (without prejudging it) that the outcome would be that New Zealand should have greater domestic ownership and capability and the RBNZ should introduce policies designed to facilitate that.

REGULATORY PERIMETER

I support option 2 on the basis that it would be simpler and better to have a single regime – and that is more likely to remove the "second class" entity problem identified in the third consultation. It does, potentially, pose some challenges for the RBNZ in providing the same level of support to small deposit takers as it does to larger banks (and this may even need some form of fiscal support for the RBNZ from the Crown).

At the risk of compromising the simplicity of single deposit taker regime I believe that the review team should consider a graduated approach to prudential supervision (similar to that which I understand is used in Canada) where supervision is divided broadly into the following categories:

(a) domestic systemically important banks (DSIB's) who would be subject to the most intense form of supervision based on the systemic risk they pose to the financial system as a whole;

(b) standardised – which would apply to most other banks currently registered;

(c) small deposit takers (as you have suggested in the consultation document) with, say assets of less than $2 billion; and

(d) restricted deposit takers – being those (other than branches or subsidiaries of offshore banks) with less than $50 million in assets and who have been registered for less than 2 years. This would mitigate against the risk the regime is arbitraged by opportunistic new entrants.

I do, however, believe there are some other challenges in creating a "level playing field", in particular in relation to:

(a) bank branches; and

(b) wholesale lenders.

While the ability for the RBNZ to designate parties within the perimeter could in part deal with the issue, I believe how it does this should at least be considered before a Deposit Takers Act is finalised, with a threshold probably based on asset size before a wholesale funded bank branch or wholesale leader becomes prudentially regulated.

Commentary

Branches

New Zealand currently has two banks operating substantial stand alone branches in New Zealand being:

- Citibank; and
- HSBC.

There are also, at least, seven banks that are dual registered, ie operate both through subsidiaries in New Zealand and through branches.

In the case of non systemically important banks those branches are subject to specific dual registration rules that constrain size of operations in those branches.

As noted in the third consultation banks operating solely as branches in New Zealand are subject to more light handed regulation than locally incorporated banks. For example, the open bank resolution policy and liquidity rules do not apply to them. They can continue to operate as branches until they reach $15 billion of liabilities (or if depositors have a preference in their home jurisdiction $200 million of retail depositors).

It is not entirely clear (to me) why branches should be more light handedly regulated than subsidiaries simply because of their legal form when those entities produce separate branch accounts and can operate their business separately from other parts of the bank group. Principles of private international law should give sufficient certainty about location of assets such that, for example, the OBR policy could be applied to the New Zealand business (which a statutory manager could transfer to a local entity even under the existing regime). There should be a principle of competitive neutrality on regulatory costs and burdens between branches and locally incorporated banks.

I believe that the RBNZ strongly discourages new entrants into the New Zealand banking market from entering as branches. My understanding is, the two Indian banks and three Chinese banks that have set up in New Zealand in the last decade have all been told that they should set up as subsidiaries. This puts them at a competitive disadvantage as against the established global banks that are able to operate solely as a branch in New Zealand. If legal form matters for off-shore banks, then it should be expressly recognised in the Deposit Takers Act (even if the existing standalone branches are grandfathered).

Wholesale lenders

Bank branches which operate in New Zealand operate as wholesale funded operations. It would appear that, legally at least, the only reason they are required to register as banks is because they use the word "bank" in their name. If using the name bank is removed as the basis for registration under the Deposit Takers Act, then none of the dual registered banks will need to register (as long as they don't take any retail deposits) unless, as suggested in the third consultation, you provide a separate registration requirement for foreign bank branches.

Currently if a bank were to incorporate a subsidiary which did not include the word bank and fund that entity entirely on wholesale markets there would be no need for that entity to be registered. Indeed, in substance, I believe that this is the case with Shinsei Bank which recently acquired UDC. It is able to operate that entity in New Zealand without any requirement for registration. Indeed, because it is not subject to prudential supervision there is not even any cap on the size of operations (or indeed any other wholesale funded entity that does not use the word "bank"). Theoretically New Zealand could have a wholesale funded entity with a lending portfolio the same size as a domestic systemically important bank which would not need to be registered.

While I acknowledge that the ability to designate an entity as subject to the Deposit Takers Act is a safety net, I believe there does need to be some clarity on when designation power would be used and, indeed, why wholesale funded branches of banks should be treated differently from other wholesale funded entities – particularly in respect of the application of macro prudential policy. Some options may be to:

(a) have a size limit above which all foreign bank branches and wholesale funded entities must be registered (eg, if they are above the threshold for small deposit takers); and

(b) have an opt in option for foreign bank branches that wanted to be registered.

STANDARDS AND LICENCING

I support the use of:

(a) the use of standards as a primary regulatory tool; and

(b) (broadly) the principles relating to flexibility and licencing.

In this context I simply reiterate the comments made in my earlier submission about:

(a) the benefits of professionally drafted standards (as opposed to conditions of registration), particularly given the criminal consequences of non-compliance;and

(b) the importance of standards being legislative instruments and subject to the interpretation provisions of the Legislation Act 2012.

LIABILITY AND ACCOUNTABILITY

In principle, I support the approach to liability and accountability set out in Chapter 5 and in particular support:

(a) a more considered approach being taken to civil and criminal liability for breaches of the Deposit Takers Act. I believe the work done in developing the Financial Markets Conduct Act ("FMC Act") should be the appropriate starting point for such a liability regime. Given New Zealand's commitment to a "twin peaks" model of financial regulation there should be as much consistency between the approaches taken by the prudential and conduct regulators as possible. Currently the director liability provisions in the RBNZ Act are still based on the old Securities Act (which have been largely discredited) and the NBDT regime contains a blunt approach of making directors criminally liable for everything; and

(b) the expansion of the liability regime to executives – particularly because executives are engaged fulltime in the business and therefore better placed typically than boards to ensure compliance.

There is, however, one matter not addressed in Chapter 5 which is a legacy issue that I believe should be addressed in the Deposit Takers Act. It is a relatively technical matter that relates to the liability of directors in following directions given to them by the RBNZ.

Commentary

A number of years ago the NZBA expressed concern that bank directors following directions given to them by the RBNZ under the RBNZ Act could be in breach of their directors duties under the Companies Act. My recollection was that this was accepted by the RBNZ, with some reservations (mainly about which law would trump). However, a commitment was made to address the issue which does not appear to have been followed through.

The issue is that the RBNZ is only likely to be issuing directions to a bank and its directors, if that bank and its directors have not agreed to take that action voluntarily. In all likelihood such a decision will probably have been made because a board did not consider that course of action was in the best interests of the company.

Accordingly, if they are subsequently required to take that action by the RBNZ, it seems reasonable that they should be exempt from liability under the Companies Act for following directions they did not believe were in the best interests of the company/bank.

While I acknowledge it is a situation that is highly unlikely to arise it still does seem as though this could be an opportunity to remove the technical risk.

SUPERVISION AND ENFORCEMENT POWERS

Again, in principle I support the suggestions set out in Chapter 6.

I believe it is important that New Zealand adopt a more orthodox approach to prudential supervision (as I acknowledge it is doing).

For New Zealand's credibility in global markets it is important that its central bank is complying with as many of the 29 principles that the Bank of International Settlements sets out for Central Banks as possible – unless there are good legal or market reasons for a different approach to be adopted in New Zealand.

The only specific comment I have in relation to supervision and enforcement relates to breach. I agree that breach reporting should be covered in the Deposit Takers Act rather than through a standing Section 93 Notice.

Commentary

Breach Reporting

I believe that the breach reporting provisions should be modelled on those contained in the FMC Act – and in particular include a materiality threshold.

Given New Zealand's "twin peaks" approach to financial regulation there should be consistency between our conduct and prudential regulation – unless there are compelling reasons for a different approach. I can see no such compelling reasons to differ on breach reporting. Any attempt by the prudential regulator to impose a more onerous regime on its regulated entities could result in a more "legalistic" approach being taken by the regulated entities with the consequential loss of the informal information channels that, I understand, currently exists between banks and the regulator on non-material matters.

RESOLUTION AND CRISIS MANAGEMENT

I strongly support:

(a) the review of the existing crisis management and resolution powers of the RBNZ which are now 30 years old and were not tested during the global financial crisis in New Zealand. However because crisis management and resolution powers were tested elsewhere (particularly the UK), there are lessons we can learn; and

(b) the importance of having a single regulator responsible for resolution – with the logical regulator being the prudential regulator, the RBNZ.

There are however a number of comments which I have relating to the detail of what is proposed.

Commentary

Resolution Authority

While I agree that it is important to have a single institution responsible for resolution and recovery and that institution should be the RBNZ, I do believe that there could be value in establishing an informal resolution group (perhaps in substitution for statutory management advisory committee). That group could be:

(a) chaired by the RBNZ;

(b) consist of officials from the RBNZ and Treasury (given the fiscal impact of any likely bank resolution); and

(c) potentially include some private sector representatives (eg. former bankers with treasury or risk experience, accountants with insolvency experience, lawyers with financial regulation expertise).

That group could oversee the development of more detailed policies relating to recovery and resolution and be responsible for ensuring that the regulator was sufficiently prepared to deal with a failure of either:

(a) a domestic systemically important bank;

(b) a medium sized bank; or

(c) a small deposit taker.

Recovery and Resolution Plan

I believe that the Deposit Takers Act should include a formal requirement for the RBNZ to put in place recovery and resolution planning measures based on the Financial Stability Board's key principles. This could, and should, for domestic systemically important banks at least, include all of the proposed resolution tools identified in figure 7.1 namely:

(a) bail-in;

(b) transfer to bridge bank;

(c) transfer to purchaser;

(d) liquidation;

(e) asset management vehicle.

This will, of necessity, require new policies to replace the outsourcing policy (unfortunately named because most of it is, in fact, part of a recovery and resolution policy); and open bank resolution policy (also unfortunately named because it is actually a form of bail-in (and open bank resolution means other things in an international context)). However, even though the policies would need to be replaced much of the work relating to prepositioning and the ability to separate from a parent is still likely to form the backbone of any formal recovery and resolution policy for the DSIBs, and hence it is not wasted.

Liability of Statutory Manager

A statutory manager, appointed under the Corporations (Investigations and Management) Act ("CIM") incurs liability personally and has a Crown indemnity for liability incurred (section 62). The Crown indemnity that existed for a statutory manager appointed under the RBNZ Act was removed in 2003 when personal liability for obligations incurred by a statutory manager was also removed (sections 145 and 146).

I believe it is critical that this support is reinstated under any new statutory management regime. It may, effectively, obviate the need for a formal Crown guarantee which is an inherent part of the RBNZ's open bank resolution policy (and almost certainly likely to be required by any statutory management if a bank is to continue any form of operations after the appointment of a statutory manager).

Certainty of Account Balances

Any statutory management regime needs to give a statutory manager certainty as to the financial position of the deposit taker at the point of statutory management. My recollection was that at the time of the implementation of the open bank resolution policy, the RBNZ accepted that there were problems in determining the exact balance of bank accounts which would be subject to a haircut at the point of statutory management because payments may have been posted to customer accounts that were still subject to dishonour (and therefore only contingent liabilities of a deposit taker to its customer). There was an intention to include provisions in the RBNZ Act to give the statutory manager the ability to, for example, declare that all amounts posted to accounts at the time of statutory management were liabilities and subject to a hair-cut. I believe that the introduction a Deposit Takers Act should be used as an opportunity to clarify this position.

Receivership for Small Deposit Takers

I note that there is a comment in chapter 6 that liquidation may be the appropriate way of dealing with the failure of smaller deposit takers. I believe that the RBNZ should endeavour to preserve the receivership option which is currently available in respect to smaller non bank deposit takers through their trust deeds. The ability to appoint a receiver could be incorporated in the Deposit-Takers Act. It could be modelled on the provision which is contained in the FMC Act which gives the FMA powers to appoint a receiver in certain circumstances. As with the position with statutory management proposed for banks, the power to appoint a receiver should vest solely with the RBNZ in respect of a prudentially regulated deposit taker. This would seem consistent with the suggestion (on page 37 of the third consultation) that resolution of small deposit takers could be dealt with under the Receivership Act. It is just that the right resolution authority will be the RBNZ not FMA as it will have a much closer understanding, as prudential regulator, of the financial position of small deposit takers.

DEPOSITOR PROTECTION

I am pleased to see that the Government has accepted the need for New Zealand to introduce a deposit insurance scheme (and so we will no longer be the only country in the Financial Stability Board without one).

Insurance Cap

I am however disappointed that an "in principle" decision has been made to cap the insurance at $50,000 per depositor. This amount is substantially out of line with key comparative jurisdictions such as:

(a) Australia - AUD250,000;

(b) UK - £85,000;

(c) Europe – 100,000 euros; and

(d) Canada - CAD700,000.

I attach an article I co-authored with more background on this

I believe the Minister of Finance should review the position and get further advice from the Treasury on whether the limit is appropriate. I think it is particularly important that the Minister's advice in respect of deposit insurance comes from the Treasury given its wider fiscal impact and other political considerations and the RBNZ's long-held scepticism about deposit insurance.

Depositor Preference

I believe that the question of depositor preference should be considered further. However, the issue is complex, particularly for smaller deposit takers who would have already given security in favour of their depositors.

Given the greatest fiscal risk in relation to deposit insurance arises in relation to the DSIBs and the fact that DSIBs have more wholesale funding that most other deposit takers (and hence the preference will have more value), consideration could be given to introducing retail depositor preference just for DSIBs.

While I suspect they will argue that it would increase funding cost to them, Australia has had a deposit preference in place for at least 50 years and, as far as I am aware, there is no evidence that it has increased the cost of wholesale funding to the large Australian banks. Indeed, Westpac's New Zealand depositors had a statutory preference until 2006 (section 23, Westpac Banking Corporation Act) and, as far as I am aware, there is no evidence it put Westpac at a disadvantage to other New Zealand banks.

Furthermore, even if it did increase the cost of wholesale funding, that many be a reasonable price to pay for mitigating the risk to the New Zealand tax payer (particularly while a deposit insurance scheme fund grows) and may act to "level the playing field" with other entities in New Zealand.

Yours sincerely

Simon Jensen