The Treasury

Reserve Bank Act Review Phase 2 Consultation 3 Submission Information Release

February 2021

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Bank of New Zealand's submission to Treasury and the Reserve Bank of New Zealand on:

Consultation Document 3 of the Phase 2 Reserve Bank Review

23 October 2020

1 Introduction

1.1 Bank of New Zealand ('BNZ') has prepared this submission in response to Consultation Document 3 of the Phase 2 Reserve Bank Review ('Consultation Document').

1.2 BNZ recognises the significance of the Consultation Document as providing a "once in a lifetime" opportunity to shape the future prudential framework for deposit takers and welcomes the opportunity to make its submission.

1.3 BNZ is aware New Zealand Bankers Association ('NZBA') has made a comprehensive submission on the Consultation Document. BNZ has contributed to, and supports, that submission.

1.4 The focus of this submission is narrower and is intended to highlight the key aspects of the Consultation Document that we believe need further highlighting.

Should Treasury or the Reserve Bank of New Zealand (RBNZ) have any questions in relation to this submission, please contact:

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2 Chapter 2: Purposes of the Deposit Takers Act

2A Do you agree with the proposed purposes? If not, what changes would you propose to the purposes? Are there any other purposes that we should be considering?

2.1 We agree with the primary purpose of the Deposit Taker's Act being to protect and promote the stability of New Zealand's financial system. However, we consider that efficiency should be added to the purposes as follows:

The purposes of the Deposit Takers Act are to

a) promote the safety and soundness of deposit takers

b) promote public confidence in the financial system

c) promote the maintenance of an efficient financial system

d) mitigate the risks that arise from the financial system

and in doing so, contribute to protecting and promoting the stability of New Zealand's financial system.

2.2 Without the inclusion of "efficiency" as a purpose, the sole focus for the financial system appears to be "safety". This seems at odds with the regime's over-arching purpose as currently expressed in s 1A of the RBNZ Act and proposed for the new Reserve Bank Bill which is concerned with how well the financial system performs its functions in a holistic manner i.e. "to promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy". To achieve this ambition, a safe financial system will not be enough. A highly functioning financial system should also aspire to enable maximum productivity with minimum wasted effort i.e. be efficient as well as safe. This point is discussed in much greater detail in the NZBA submission which we strongly support.

2.3 We do not consider the proposed decision-making principles are an effective substitute for including efficiency as a purpose.

3 Chapter 4: Standards and Licensing

4A Do you agree that the proposed scope of standards is appropriate? If not, what changes would you suggest?

3.1 We broadly support the proposed scope of the standards as set out in chapter 4 of the Consultation Document.

3.2 We understand the proposed approach is for the standards to cover the range of matters currently provided for via the current Conditions of Registration (CoR) but with more clarity and specificity where required. Given this, we would not expect a significant change in the nature of the obligations, but rather, clearer drafting and a more transparent basis for them, which we consider to be a good outcome.

3.3 However, we would welcome an opportunity to provide input into the work programme to draft the new standards as there are complexities in making this transition. For example, currently bank "obligations" are contained in the wording of the CoR which is usually quite specific. In contrast, the related banking standard (in most cases) does not provide for obligations, but rather guidance. The indicative scope of prudential standards set out in Table 4.1 of the Consultation Document suggests that many of the existing standards may become obligations, which potentially significantly expands the scope of existing bank obligations. If this is the intention, there should be a clear materiality threshold or approach to breaches of these obligations to ensure that there is a difference between a significant breach (such as a breach of capital ratio) and a minor or technical breach such as a contract on the BS11 compendium being out by $100. This is important because:

a) significant time is spent at the bank Board, Executive and Management levels, as well as the Reserve Bank, when dealing with any non-compliance - we would not expect the intention is for this to increase materially because of a change to the form of the banking standards; and

b) given non-compliance needs to be disclosed, it is likely to be confusing for readers as to the significance of any breach as they cannot easily distinguish a significant breach from a minor or technical one. We do however note the RBNZ's proposed changes to breach reporting that are running parallel to this consultation and which we support as a means of ensuring the most relevant and material breaches are elevated for public disclosure.

3.4 We consider that the new structure provides a good opportunity to make a clear delineation between the 'hard rules' (as appropriate to standards) and 'guidance'. It is preferable that several of the current standards are retained as guidance only rather than moved to standards. This would be similar to APRA's approach.

General licensing comments

3.5 The Consultation Document proposes that licence conditions:

a) be more limited in scope;

b) only be used to set requirements in relation to matters on which a standard has not be set for a particular class of deposit taker; and

c) to provide for restrictions on the scope of licences.

3.6 From the Consultation Document, it appears that licence conditions may not be subject to the same scrutiny in drafting as the standards will be. On that basis, we support the approach as set out in paragraph 2.5 above, provided the scope is not extended and the proposed content of licence conditions is provided for in legislation.

3.7 In general, we support increasing the transparency of the requirements (standards and licence conditions) that apply to each bank by setting these out in a central register. However, we do not think this should extend to notices of non-objection. Often non-objection notices set out commercially sensitive information related to the detail of how

the bank operates. It is also not clear that there is any public benefit in disclosing these – as all non-objections will be granted under the standards anyway. The public is unlikely to have any interest in the bank specific detail of how those standards are being applied.

4K Do you agree with the proposed approach to de-licensing? If not, what changes would you suggest?

3.8 We support the removal of the Minister of Finance from the process for deregistering a bank. However, given the significance of this action we do think the tests need to be objective and, where there remains a role for interpretation (e.g. a change in the controlling interest of the deposit taker that has left it materially weaker), there needs to be a process for appeal.

4 Chapter 5: Liability and accountability

5A Do you agree with the general categorisation of the contraventions that should give rise to criminal and civil liability in the Deposit Takers Act?

4.1 Yes, we agree with this approach. BNZ submits that criminal liability should be limited to breaches of regulatory requirements that involve reckless intent or deceptive-type behaviour only.

5B Do you agree with the specification of the new positive duties for directors of deposit takers?

4.2 In principle BNZ supports the proposal to impose positive duties on directors. However, we submit that further thinking is required in the formulation of these duties to take account of the following:

a) **Coordination with other executive accountability regimes**: these duties should be coordinated with other executive accountability regimes including those under the Financial Markets Conduct Act 2013 (FMCA), and proposed laws regarding conduct of financial institutions and expanded director obligations on directors to ensure that creditors comply with their obligations under the Credit Contracts and Consumer Finance Act 2003 (section 59B). We also think it is very important that the defences that were agreed in the FMCA in relation to director liability should all be adopted in the Deposit Takers Bill for consistency.

Banks and their boards have to deal with all these accountability regimes in their totality and, ideally, holistically – in this regard the upcoming executive accountability/BEAR policy work is a further opportunity to focus on this at a governance level and ensure that the regimes are delivering on their stated purposes and on 'joining up' the banks' efforts with those of their regulators in doing so.

b) **Further guidance on the requirement to take reasonable steps to ensure that the deposit taker is being run in a prudent manner:** It is important the duty to take reasonable steps does not result in "pushing upstream" management responsibility for the bank's compliance responsibilities and risks. Directors should be able to rely on reasonable due diligence steps having been taken to confirm that the executive teams

are across compliance and risk obligations i.e. 'due diligence' defences should be available.

Further, and as noted above, the new statutory purpose in s 1A of the RBNZ Act to "promote the prosperity and well-being of New Zealanders, and a sustainable and productive economy" implies a focus at the governance and senior level of banks on effectively performing their role in the economy – as opposed to being engaged in detailed knowledge of compliance and risk requirements. This aim should be reflected in the guidance as to what this duty requires.

As an alternative, we consider that a similar duty to that in place under the Australian BEAR regime may have this better cast. That imposes a duty for directors to take reasonable steps in discharging their responsibilities to prevent matters from arising that would adversely affect the prudential standing or prudential reputation of the entity.

c) **Considering the inclusion of a forward-looking obligation or principle for directors that aligns with the Reserve Bank purpose i.e. that bank directors have a role in promoting the prosperity and well-being of bank customers, and a sustainable and productive bank.** This would support a broader role for directors in the wider economy and recognises that banks are operating in a dynamic environment and face fundamental transformations that would be better supported by ambitious guiding principles and not stifled by a harsh penalty regime and is also consistent with the Governor's views on banks being courageous.

In relation to regime objectives, a good analogy here is the recognition in ss 3[1] and 4[2] of the FMCA that the best protection for investors, and promotion of the economy and economic wellbeing, arises from the creation of a strong capital market – the same should apply to the banks' dual (and unique) roles in the investment and credit channels for NZ.

A closely related point is what sort of person you want to attract to governance positions in banks – a risk averse and 'in the weeds' focus will not necessarily be consistent with attracting and retaining the sort of people who will be needed as banks confront the big forward-looking transformations and challenges. This is compounded by the proposed increased risk of personal liability and (as discussed below). We have real concerns that these factors may result in highly capable individuals being deterred from accepting bank directorships in New Zealand.

5C Do you agree that directors should not be indemnified or insured against loss in the performance of their duties?

[1] Section3 provides: "The main purposes of this Act are to— (a) promote the confident and informed participation of businesses, investors, and consumers in the financial markets; and (b)promote and facilitate the development of fair, efficient, and transparent financial markets.

[2] This Act has the following additional purposes:(a)to provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products or the provision of financial services:(b)to ensure that appropriate governance arrangements apply to financial products and certain financial services that allow for effective monitoring and reduce governance risks:(c) to avoid unnecessary compliance costs: (d)to promote innovation and flexibility in the financial markets.

4.3 BNZ supports an approach to director indemnification and insurance that aligns with the Companies Act 1993 and FMCA. BNZ does not support the proposed carve-out that prevents director indemnification of personal financial losses from unsuccessfully defending any proceedings relating to the new positive duties. The three new director duties go further than section 131 of the Companies Act (the duty to act in good faith and in the best interests of the company). For instance, duties relating to prudential running of the business go well beyond a "best interests" analysis and may be subject to interpretation. Preventing indemnification for such matters may leave directors personally exposed for decisions that, at the time, were made in good faith but (with the benefit of hindsight) were found not to meet the required standard.

4.4 We also query whether this will assist in focusing directors' minds on what they should be focused on. There is a risk that boards will react to civil penalties by focusing on compliance and double signoffs resulting in a compliance tick box exercise taking time away from more important governance matters. The approach seems to be punitive rather than getting the best out of financial system.

4.5 In this regard it is instructive that the more highly evolved structure of the FMCA is directed not so much at protection of boards/senior leadership teams, as getting the best out of them – i.e. as a positive policy matter they should be protected where they act in good faith and competently in furtherance the regime's objectives.

4.6 It is also important to ensure the NZ director / executive accountability regime is tailored / proportionate to the characteristics of the NZ market, given that some of the "macro" issues that arose in other jurisdictions (e.g. high short term remuneration incentives driving a focus on short term wins rather than long term outcomes) are not as pronounced in NZ, and/or are mitigated with in other ways (such as reputational risk in a very small senior governance environment in NZ).

4.7 BNZ also notes RBNZ is calling on the New Zealand banking industry to show "courage" in its dealings with customers and has further articulated that courage "is displayed by a bank when it operates with a consistent and transparent risk appetite through good times and bad, as one would expect from any trusted long-term partner." BNZ strongly supports this goal and considers it is important to call out the inherent difficulty in being asked to make brave and courageous decisions when facing personal liability for getting it wrong, without an ability to be insured or indemnified.

5D Do you see any specific issues with the relationship between the existing director duties in the Companies Act and the new duties being proposed here?

4.8 In principle we think that the director duties under Companies Act should work well with the proposed positive duties. The fundamental requirement of a bank's shareholders is that they want the subsidiary to be a responsible and sustainable bank, so interests are aligned practically. Theoretically it is possible to have a conflict where one or other bank is not under the control of a Board i.e. statutory management. Accordingly, we think that policy makers should consider how the duties play out in when a bank is in crisis. For example, one issue that we have identified is that RBNZ could give the bank a direction that we need to follow, but there is no safe harbour from liability for either the board (if

they breach directors duties following that direction) or the bank itself if it has to breach its contractual commitments to follow the direction.

5E Do you agree that deemed liability should be retained for false and misleading disclosure?

4.9 BNZ supports this proposal on the basis that it aligns with the deemed director liability regime in the FMCA which is well understood and managed.

5 Chapter 7: Resolution and crisis management

7A What are your views on the proposed triggers for placing a deposit taker into resolution and exercising resolution powers?

5.1 BNZ has a strong preference for an objective test for non-viability e.g. capital floor, and preferably assessed by an independent party. This would provide objectivity and transparency to the market.

7B What should be the scope of statutory bail-in in New Zealand? What liabilities should be expressly included or expressly excluded? How should deposits be treated?

5.2 BNZ's view is that OBR and bail-in cannot effectively operate together, and not alongside depositor protection. We consider there needs to be a very clear hierarchy/waterfall in terms of the tools available for the RBNZ and when/to what they will apply. The Consultation Document appears to suggest that NZ is looking at having all three tools available at that RBNZ's discretion (depositor preference, bail-in and OBR) leaving investors with no certainty as to the approach that the RBNZ is likely to take. This approach would make NZ a much less attractive investment prospect as it would introduce significantly more complexity to the investment decisions, and less certainty about recovery in the event of a failure.

5.3 From an investor perspective, simplicity of the crisis management regime is absolutely critical in assessing the attractiveness of an issuance. The market for wholesale debt issuance is highly competitive and banks have small windows of opportunity to explain their product and the regulatory environment in which they are issued. If the resolution and crisis management regulatory regime is too complex for investors to readily understand, they simply will not invest. There needs to be a recognition that increased optionality increases compliance complexity and introduces less certainty into the overall regime

5.4 In terms of what liabilities should be included or excluded, we have a slight preference for the UK model because it appears simpler. The key is that investors have a clear understanding of their position in insolvency that is aligned with the No Creditor Worse Off principle. We consider that the scope of liabilities that are able to be bailed-in need to be thought through in the context of how this may impact market access offshore. A significant divergence in a NZ regime will be counterproductive for NZ issuers who rely on offshore creditors for funding.

7C Should statutory bail-in have retrospective application?

5.5 BNZ does not support the retrospective application of statutory bail-in. This would mean that existing investors and creditors potentially subject to bail-in would not have been able to price the risk of bail-in into their decision-making at the time of making their investments.

5.6 BNZ strongly supports the following statement in the consultation document:

> "For bail-in to be a credible and orderly resolution option, it is essential that there is ex ante transparency on the scope of bail-in. This enables investors and creditors to assess the risks associated with, and the pricing of, liabilities potentially subject to bail-in. The FSB's Principles on Bail-in Execution recommend that resolution regimes clearly define the scope of instruments and liabilities to which statutory bail-in could be applied".

7F Do you agree that deposit takes should only be subject to one statutory management and resolution regime?

5.7 We strongly support unifying the statutory management and resolution regime of the Reserve Bank Act and CIMA into a single regime for the reasons discussed in detail in the NZBA submission.

6 Chapter 8: Depositor protection

8A What are your views on the benefits and costs of a preference for insured depositors compared to no preference?

6.1 BNZ does not support preference for insured depositors as it would add a new class of preferential creditors above covered bonds and RMBS to the legal hierarchy, it would increase the cost of wholesale funding especially in the eyes of wholesale investors.

6.2 BNZ agrees with the following statement in the consultation document:

> "In summary, a preference for insured depositors has the benefit of increasing recoveries to the deposit insurer from a failed deposit taker and would potentially strengthen market discipline applying to deposit takers. However, the introduction of preference could reduce the supply of non-deposit funding, create additional risks associated with concentrating losses on non-preferred creditors, and disproportionately affect small deposit takers. In addition, the increase in recoveries to the deposit insurer under a preference might not be relevant in the long run because of the deposit insurer's ability to levy premiums on its members."

ENDS