The Treasury

Reserve Bank Act Review Phase 2 Consultation 3 Submission Information Release

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SAFEGUARDING THE FUTURE OF OUR FINANCIAL SYSTEM

Further consultation on the prudential framework for deposit takers *and depositor protection*

Submission form

To have your say on these important issues, please answer the questions below and send this form by email to rbnzactreview@treasury.govt.nz by 5pm on 23 October 2020.

To get more information on these topics and the wider Reserve Bank Act Review, see the full consultation document at treasury.govt.nz/rbnz-act-review.

Chapter 2	Purposes of the Deposit Takers Act

2.A 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.B Do you agree with the proposed decision-making principles? If not, what changes would you propose to the principles? Are there other principles that should be considered?

The temptation is to have primary purposes, secondary purposes and decision-making principles, but I agree with the simplifying discipline of having just two lists: purposes and principles.

I agree with the three stability-oriented purposes set out here for the DTAct: promoting safety of DTs; promoting public confidence in the system; and mitigating systemic shocks. These underpin the primacy of stability and confidence and explicitly allow for the use of dynamic (macro-prudential) policies.

The list of principles is sensible but needs elaboration and an ordering to put "secondary objectives" at the top of the list. My list and ordering, without paying too much attention to wording, would be: To have regard to:

- Financial system efficiency and the costs of compliance
- Financial system competition and facilitating innovation
- Monetary policy objectives
- Other Govt policy objectives such as equity, climate change
- Regulatory practice of relevant international counterparts
- The impact of policy on financial system stability in Australia (flow on from S68A of the current Act)
- Transparency
- Collaboration with regulatory partners
- Proportionate to systemic importance
- Even-handed between like DTs

I would not include the "importance of long-term risks to financial stability" as a principle. That is covered by the purposes of the Act.

Chapter 3 Regulatory perimeter

Defining the overall regulatory perimeter

3.A Do you agree with the proposed approach to defining the overall regulatory perimeter? If not, what approach would you suggest?

3.B Do you support the proposed exclusion for wholesale-only funded lenders? If not, what approach would you suggest?

3.C Do you support a maximum size threshold for the wholesale exclusion? If so, what would be an appropriate measure of size?

3.D Do you agree with the proposed territorial scope of the legislation? If not, what approach would you suggest?

3.E Do you have any comments on the application of the Deposit Takers Act to associated persons?

3.F Do you agree with retaining the restriction on the use of the words 'bank', 'banker' and 'banking', but limiting it to persons providing 'financial services'? If not, what approach would you suggest?

3.G Do you agree that the use of the words 'deposit', 'deposit taker' and 'deposit-taking' should be restricted? What restrictions would you suggest?

3.H Do you support the proposed approach to foreign bank branches? If not, what approach would you suggest?

I agree with the proposed approach to the regulatory perimeter. Non-bank wholesale funded lenders should be excluded if they are below a size threshold on the basis that small non-bank institutions pose little risk to the financial system and wholesale investors should have the capacity to do proper due diligence.

I assume here that all banks will be subject to the Deposit Taker regulatory regime, even if they are wholesale funded. This would include branches of foreign banks that might be fully funded by offshore parents.

The size threshold for including non-bank lenders should be compared to the total assets of the lender. The threshold should be a percentage of total system Deposit Taker assets (not a dollar figure). I suggest 3 percent of total system assets, which might be around $18bn on current balance sheets.

I am not sure I agree with the proposed territorial scope which seems to require all included institutions to be borrowers in NZ. The definition should also include institutions that have a presence in NZ and that lend to NZ persons (such as the branches of foreign banks that are funded by their parents). While risk to investors may be mainly a function of the liabilities of DTIs, overall systemic risk will also be a function of the lending of DTIs.

Keep in mind that the DTI perimeter will be the default perimeter for various prudential policies, including macro-prudential policies focussed on DTI lending, as well as being the perimeter for Deposit Insurance.

RBNZ should continue to restrict the use of the word "bank" to licenced banks but with power to exempt foreign institutions who might be lending in NZ but who do not have a corporate presence in NZ or who are involved purely in capital market transaction activities.

It would be excessive to restrict the use of "deposit", however the use of "Deposit Taking Institution" and "NZ Deposit Taking Institution" should be restricted to licenced NZ DTIs.

I agree there should be a separate class of DTI to cover branches of foreign banks. These entities should not be deposit funded unless they are small (below systemic threshold), have a home regulator of strong repute and do not have a "sister" subsidiary in NZ or home-country depositor preference. They should be subject to DTI liquidity standards and any (macro) prudential restrictions on lending.

Regulation of finance companies that do not take insured deposits

3.I Do you agree that prudential regulation should be retained for finance companies funded via retail debt securities?

3.J Would you support the approach of creating a restricted licence category for finance companies funded via retail debt securities (option 1)? What do you think would be the benefits and costs of this approach?

3.K Under option 1, what restrictions should be placed on the services that a licensed finance company could offer without becoming a full licensed deposit taker?

3.L Should licensed financial market supervisors undertake the frontline supervision of finance companies under this model? If not, what approach would you suggest?

3.M Alternatively, would you support requiring finance companies to have full deposit taking licences to issue retail debt securities (option 2)? What do you think the benefits and costs of this approach would be?

Prudential regulation should most definitely be retained for finance companies funded via retail debt securities. We do not want to re-learn the lessons of 2006-2011. Regulation of Finance Cos can be by either RBNZ or FMA, but it must be done to a minimum standard.

I do not favour a restricted DT license under the RB regime where the entity is uninsured. That would be confusing to everyone and potentially undermine confidence in the DT regime. However, I am not attracted to option 2 as it would be inefficient and heavy handed to require all finance cos to be full participants in the insured DT regime.

I would favour an alternative to these two options. Finance Cos should be given the option of either a) becoming a licenced DT under RBNZ supervision with full deposit insurance and risk adjusted premiums; or b) becoming a licenced debt issuer under FMA supervision with no insurance of debentures. Under this regime the "finance co." label would become less important to investors than whether or not it is a "licenced Deposit Taker". The public would soon learn that all licenced DTs are insured and supervised by RBNZ, while all market issuers are uninsured and supervised (less intensively) by FMA. Finance cos have always been a mixed bag and there is no reason why they should be forced into one or other of the regulatory buckets.

Approach to small deposit takers

3.N Do you support the proposed approach to small deposit takers, under which the Reserve Bank would be expected to calibrate its regulatory approach in light of the proposed purposes, the decision-making principles, and the contents of the Remit? If not, what changes would you suggest?

3.O Alternatively, would you support creating a separate tier in legislation for small deposit takers? If so, how would you suggest drawing this distinction?

3.P Do you agree with retaining the restriction on the use of the words 'bank', 'banker' and 'banking', but limiting it to persons providing 'financial services'? If not, what approach would you suggest? (see answer to 3.F above)

3.Q Should current NBDTs have the same supervision, governance and disclosure exemptions from the FMC Act as banks? If not, what approach would you suggest?

3.R Should current NBDTs be subject to a disclosure regime that is similar to that for banks? If not, what approach would you suggest?

I agree the RBNZ needs to retain discretion to apply a proportionate approach to regulation and supervision of DTIs. The proportionality of the oversight regime should be related to the systemic risk presented by DTIs. Systemic banks and non-banks (either deposit or wholesale funded) should attract the most intensive level of regulation and supervision. Non-systemic banks and the medium to large non-bank DTIs would attract a medium level of oversight, and small DTIs would attract a lower degree of oversight. The legislation should recognise the need for proportionality to systemic risk but should not attempt to define these tiers too precisely. They do not have hard edges and may vary through time as the shape of the industry changes.

In my view, the Act should retain a separate licence for banks which should be more demanding to obtain than a DTI licence. To merge the two licencing regimes immediately would dilute the standing of a banking licence and potentially reduce the international standing of NZ banks. At some point down the track the bank and DTI licences could be merged, but it seems more likely they would be kept separate to offer a lower initial hurdle (the DTI licence) for new entrant firms. See further comments on use of the word "bank" in answer to Q 3F above.

Regarding the graduated levels of regulation/supervision, large systemic non-banks would face similarly demanding standards to systemic banks, so they would likely choose to become banks; however, it would be their choice. In the second tier of smaller banks and medium to large non-banks the standards applied (eg capital and liquidity requirements) would be comparable, but the actual default risk (and credit ratings) of the DTIs might be quite different. Such differences should be reflected in the range of deposit insurance risk premia charged to the DTIs. The somewhat lower standards set for the small DTIs would again be comparable across the tier for competitive neutrality purposes but the deposit insurance premia should still vary to reflect differences in default risk across the DTIs.

I agree that all DTIs, including current NBDTs, should have the same supervision, disclosure and governance exemptions from the FMC Act as banks currently have. This is consistent with the principle of having a consistent oversight regime across all DTIs and removing the current unwieldy mixed regime for NBDTs where RBNZ regulates but does not supervise.

Current NBDTs should be subject to a disclosure regime that is proportionate to their systemic significance but sufficient to give investors a reasonable ability to assess default risk. Consistent with my comments above, disclosure requirements should be aligned with the three tiers of regulatory oversight, systemic banks and non-banks being subject to the most demanding requirements.

Perimeter flexibility

3.S Do you support the proposed approach to perimeter monitoring? If not, what approach would you suggest?

3.T Do you support the proposed designation power? If not, what approach would you suggest?

3.U Do you support the proposed exemption power? If not, what changes or alternative approaches would you suggest?

3.V What should the criteria be for the Reserve Bank granting an exemption? What other limitations or safeguards should be placed on the power?

I support the proposed approach to perimeter monitoring. As noted in the consultation document, the Council of Financial Regulators should be the main clearing house for sharing the monitoring information collected by the Bank and other regulators.

Agree that the Bank needs a designation power: to ensure all systemic FIs are inside the regulatory net and to provide a deterrent to regulatory arbitrage.

Regarding exemptions from the DTI regime, I agree that such a power is necessary but should be limited by using secondary legislation, time limitations and other terms and conditions. I would add to the list an expectation that Deposit insurance risk premia would be adjusted to reflect the risk implications of exemptions. The criteria for exemptions should include the three currently included in the NBDT Act. A further criterion might be that the exemption should not be granted as a result of financial stress in the applying entity. The DT Act should be flexible enough for the Reserve Bank to exercise regulatory forbearance at its own discretion, however that should not be exercised through the exemption power.

Chapter 4 Standards and licensing

Scope of standards

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

I agree that the proposed scope of standards, as indicated in Table 4.1, is appropriate. I note that the list in Table 4.1 is more comprehensive than the list of relevant factors in S.78 of the current Act. In particular, the list needs to explicitly itemise Liquidity and Governance standards as separate items. The wording of the new list of prudential matters should be clear in their meaning but kept at a high level in order to retain flexibility in the evolution of standards through time.

Macro-prudential policy

4.B Do you agree with the proposed power for the Reserve Bank to set lending standards (such as LVRs and DTIs) in relation to mortgages? If not, what changes to the scope or additional safeguards would you suggest?

I agree that the list of risk areas to be addressed by prudential standards should include "lending standards" which would accommodate permanent micro-prudential measures and also variable macro-prudential measures such as LVRs and DTIs. Such standards should not be restricted to property lending. Wording might be along the lines of: "Lending standards to contain credit risk, including emerging systemic risks arising from increasing lending to particular sectors."

Flexibility of standards

4.C Do you agree that the Reserve Bank should be able to issue differing standards for different entity classes? If not, what approach would you suggest?

4.D Do you agree that the Reserve Bank should be able to make standards that enable it to exercise supervisory discretion on matters and within ranges specified in the standards? If not, what approach would you suggest?

4.E What procedural requirements and protections should apply to the Reserve Bank's use of supervisory adjustment?

4.F Do you support the proposed approach to allowing the Reserve Bank to set reporting standards and lending standards in relation to categories of non-deposit-taking lenders that have been prescribed via regulations? Why or why not?

As discussed earlier, the RB should certainly be able to apply differing standards to different classes of DTIs. The level of intensity of regulation (and supervision) of a class should be proportionate to the risk presented by that class to overall financial system stability. However, all DTIs should meet minimum safety standards to meet the "Deposit taker safety" and "Public confidence" objectives of the DTA.

Yes the RB should have discretion to impose supervisory adjustments to standards on an institution by institution basis. However, such adjustments need to be kept within sensible limits appropriate to the DT class. Supervisory adjustments need a clear risk-based rationale and should not become an ex-post enforcement instrument. They should require issuance of a public notice and give the DTI a chance to respond before imposition (say one week). Transparency is important to underpin market and customer discipline on DTIs.

I agree that RB should be able to set reporting standards for non-DTIs and to designate non-DTI lenders for the purpose of (macro-prudential) lending standards. However, there is a need to carefully consider how these powers should sit alongside the designation power discussed in Ch3 for systemic non-DT lenders. I am not sure both are necessary.

Procedural requirements for standards

4.G Do you agree that the proposed procedural requirements for standards are appropriate? If not, why not? Should any other requirements be considered?

I agree with the proposed procedural requirements around the RBs standard setting powers.

Licensing

4.H Do you support the proposed licensing test for deposit takers? If not, what approach would you suggest?

4.I Are the proposed procedural requirements for licensing appropriate? If not, why not? Should any other requirements be considered?

4.J What scope of appeal rights should be provided for in relation to licensing decisions and why?

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

I agree there should be a DT Licence issued by RBNZ based on the potential for a DTI to meet the standards for the relevant DTI class and other specific licence conditions. The other conditions would relate to the size, structure and risk profile of the applying entity.

I agree that RB licensing decisions, including Fit and proper assessments, should be appealable. This means that the additional licence conditions should be spelled out in secondary legislation as "DTI Licence conditions". F&P criteria for potential application decline (eg a principal of a financial institution that has failed) should be explicit.

I suggest that a minimum size and credit rating be required for a DTI licence – albeit at low hurdle levels. In terms of allowable structures, I would admit financial service providers who are in the business of borrowing and lending, including NB lenders even though they may not be issuing deposits.

As mentioned earlier, I recommend that banking licences be retained, requiring higher standards across several factors relative to the DTI licence.

On de-licensing:

- Agree with the general strengthening of the criteria and the need for a cease and desist power for entities that have been de-licensed
- If DTIs are also going to be subject to FMC licensing then a "fair conduct" licence or expectation thereof, should be a DTI licence condition.
- I question the inclusion of "a change in the controlling interest of the deposit taker that has left it materially weaker". If a DTI experiences material and persistent breaches of prudential standards and licence conditions then de-licensing should occur whether or not there has been a change of control.

Transparency requirements

4.L Do you agree with the proposed use of the register to record and apply standards and other requirements on deposit takers? If not, what approach would you suggest?

The idea of a single repository of all standards, supervisory overlays, licence conditions, enforcement actions and exemptions is a good one. Such a register will promote accountability through transparency and comparability.

Chapter 5 Liability and accountability

Civil and criminal liability

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

Yes I agree with the proposed approach to civil and criminal penalties.

Director accountability

5.B Do you agree with the specification of the new positive duties for directors of deposit takers? If not, why not?

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

5.D 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?

I agree the current attestation regime is unsatisfactory - having insufficient guidance for directors and excessive sanctions in the form of criminal penalties. The regime has resulted in cumbersome administrative internal processes that take up a disproportionate amount of board time. It is appropriate that the attestation regime be replaced with clearly specified positive duties, backed up by governance standards and an Accountability regime. However, the proposed new "positive duties for directors" set out in Table 5.2 are too weak. Directors would only be required to "take reasonable steps" to ensure their DTI is being run prudently. This is a low hurdle for directors in terms of their internal assurance role. I agree that guidance/expectations in the form of governance standards will help to put meat on the bones of this duty but I would like to see some stronger wording included directly in the new positive duties. Such as "ensure effective compliance with regulatory requirements" and "promote a governance culture within the firm". These are standard governance principles for boards and consistent with Companies Act requirements.

I agree that directors should not be indemnified or insured against civil penalties incurred through breach of their duties.

The Companies Act requires directors to act "in the best interests of the company". If "the company" is taken to include all stakeholders, including depositors and creditors as well as shareholders, then the proposed duties relating to prudent management, compliance and promoting a governance culture would all be consistent with the Companies Act. A problem only arises when boards (and senior execs) read "the company" as solely the shareholders.

Director penalties for disclosure breaches

5.E Do you agree that deemed liability should be retained for false and misleading disclosure? If not, what approach would you suggest?

I agree that deemed liability should be retained for knowingly misleading disclosures.

Penalty levels

5.F Do you agree with the proposed approach to maximum civil penalties on bodies corporate, including the use of maximum penalties based on the size of the institution or any benefit gained (or loss avoided)? If so, what specific metrics or amounts should be considered for these penalties?

5.G Should a lower tier of civil penalties be established for some contraventions, for example, those that do not adversely affect the deposit taker's prudential standing?

5.H What maximum level of individual civil penalty should be provided for and why?

5.I Should criminal offences relating to the obstruction of routine supervisory powers be subject to monetary penalties, but not imprisonment terms for an individual? If so, what level of maximum penalty would be appropriate and why?

5.J What monetary and imprisonment penalties should be considered for more serious criminal offences and why?

I agree with the general approach being proposed. Corporate penalties should be proportionate to: the seriousness of the breach; the benefits gained; and the size of the DTI. Comparable with other countries and regimes, a max fine of 10% of gross income – likely to be about 20% of profit – would be a strong deterrent.

The penalties for individuals should also be proportionate to seriousness and benefits gained, but not size of institution. I would reserve prison sentences for egregious breaches where directors/execs have deliberately misled supervisors and customers with the intent of personal gain.

Chapter 6 Supervision and enforcement powers

On-site powers

6.A Do you agree that the on-site power for the AML/CFT regime is an appropriate comparator for a similar power for the Reserve Bank's prudential functions?

6.B Should this power be a generic power in the new Institutional Act, or specified in the Deposit Takers Act?

6.C Do you think any additional safeguards are necessary for the on-site power?

6.D Do you think the FMA's on-site inspection power should be expanded in the same way that is proposed for the Reserve Bank?

6.E Should an expanded FMA on-site inspection power apply in all circumstances and to all FMA-regulated entities or only some (e.g. in high-risk circumstances or for dual prudential-conduct regulated entities)?

I agree that an on-site inspection power is appropriate to allow the RBNZ to develop a more effective verification capability. However, the power should have safeguards along the lines mentioned on page96 (give reasonable time; use authorised and trained persons; confidentiality protections) and also, in my view, a prior notice (of say one week). While there may be a case for no notice in criminal investigations where incriminating evidence may be destroyed, I do not believe that can be warranted for investigations aimed at verifying compliance with prudential regulations. A notice would also facilitate more efficient inspections by directing the DTI to have certain documents/files ready for inspection. As per the Chapter 5 discussion, any withholding of requested material would be an obstruction of supervisory powers and therefore subject to criminal penalties.

In my view the on-site inspection power should be in the DT Act, not the Institutional Act. The power needs to be set out in the context of the DT regulatory framework and objectives. It may be mirrored in the legislation for Insurance and FMI oversight, but the context of those frameworks may require variations to the power. Including a general on-site power in the Institutional Act would give a simpler legal structure but would be out of context and more rigid.

Re the FMAs inspection powers, I am not sure why this is being addressed here. I agree it makes sense to get broad consistency between the on-site inspection powers across the various financial-regulatory functions. However, they do not need to be identical and the discussion in the consultation paper does not equip the reader to give an informed view on the FMA power.

Other supervisory powers

6.F Do you have any comment on the appropriate legislative location of supervisory powers such as information gathering and sharing, on-site inspections, and other related powers? Do you see merit in consolidating similar powers from sectoral Acts into the Institutional Act?

As mentioned above, I consider the on-site and other related powers should be in the sectoral Acts to which they apply, not in the institutional Act. These powers need to be couched in the context of the sectoral regulatory regimes and their objectives, not simply announced as broad powers applying to any entity that happens to be supervised by RBNZ. Future amendments to the powers could be needed in response to specific sectoral issues and it should not be necessary to apply such amendments to every sectoral regime.

Breach reporting

6.G Should a breach-reporting requirement be directly provided for in legislation? Should this be provided for in the Deposit Takers Act, or located in the Institutional Act as a requirement for all entities regulated by the Reserve Bank?

I agree a breach reporting requirement should be included in the DT Act rather than using a “standing S93 notice”. It would cement the need for disclosure and allow RBNZ to decide on the materiality threshold.

Again, I would prefer to see this in the DTI and other sectoral Acts as appropriate. If all the supervisory powers and penalties etc are uploaded to the Institutional Act I suspect they will become set in stone and reduce the scope for modifying the various sectoral regimes as circumstances change.

Enforcement powers

6.H Do you agree that the Deposit Takers Act should provide for the Reserve Bank to accept a voluntary undertaking from a deposit taker that is enforceable in court?

6.I Should the Deposit Takers Act provide a statutory basis for the Reserve Bank to issue a formal notice to a deposit taker?

6.J Do you see any role for infringement notices in the Deposit Takers Act?

6.K Do you see a useful role for remedial notices and/or action plans in the Deposit Takers Act?

Yes the DT Act should provide for enforceable undertakings. Further, in line with the earlier discussion, there should be a requirement that breaches of undertakings be disclosed.

I support the inclusion of the range of enforcement powers summarised in Fig 6.1. Together they provide a graduated spectrum of powers that will enable tailored and proportionate responses to supervisory issues. It is a toolkit that will support an evolving supervisory regime across a range of financial sector circumstances.

Chapter 7 Resolution and crisis management

Conditions for placing a deposit taker into resolution

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

I agree with the general structure of the proposed triggers, however the non-viability test could perhaps be enhanced:

- Consider adding a phrase to the third bullet, along the lines of; " or failed to comply with a direction". This could well be the final factor pushing at DT into Stat Mgmt.
- Consider adding a further bullet to cover the case of reckless behaviour that threatens the stability or reputation of the financial system. This should not be a necessary condition (as under the present Act) but it should still be a sufficient condition. (See answer to 7.G below)

Liabilities that would be subject to statutory bail-in

7.B 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?

7.C Should statutory bail-in have retrospective application?

In my view the bail-in net should aim to include all unsecured wholesale funding instruments. Insured deposits should be excluded. Large deposits (held by individuals, corporates, local fund managers etc) should be included but **preferred** to wholesale market funding instruments.

I prefer the broader UK negative list to the Canadian positive list. Regulatory arbitrage will tend to erode a positive list approach over time. Eg. Wholesale instruments could cease to be marketable and transferable to get off the positive list. A negative list is more precise in this regard. The potential problem of having to bail-in large numbers of depositors can be minimised by putting depositor preference in place. Then the uninsured depositors would only need to be considered if the wholesale creditors were exhausted.

The bail-in powers should not be retrospective. That would invite legal challenge and be potentially damaging to NZ's reputation in the international markets – where the majors raise most of their market funding. In any case, the tenor of the banks market funding is generally 5 years or less and the likelihood of needing to use the powers in that timeframe is minimal.

The statutory management advisory committee

7.D Is there still a role for a ministerially-appointed advisory committee to a statutory manager? If so, should legislation be more specific about the purpose and the composition of that committee?

Under the proposed regime, the Stat Mgr will be appointed by RBNZ as the Resolution Authority. It therefore makes sense that any advisory cmte to the Stat Mgr also be appointed by RBNZ. If the RB deems it appropriate to appoint a Cmte, ie if the resolution is of sufficient size and complexity, it should appoint members to reflect the nature and objectives of the resolution. If the resolution involves use of public funds or guarantees then there should be one or more Treasury reps on the Cmte. If the DTI is an important participant in the markets then a markets specialist should be on the Cmte etc. The Cmte should be chaired by a senior RBNZ exec. The Act should not be prescriptive on the composition of a Cmte but be clear on the RBNZ as chair.

Resolving credit unions and building societies

7.E Should the Reserve Bank have the power to demutualise a building society or credit union that meets the criteria for being placed into resolution?

Yes, the RB should have the power to demutualise a bldg. society or credit union in resolution.

The application to deposit takers of CIMA statutory management

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

7.G Do you favour option 1, option 2, or some other approach (including the status quo)?

DTIs should be subject to only one Stat Mgmt and resolution regime, ie CIMA should be excluded as a resolution path. In a crisis it is important that decisions be made promptly on clear legislative grounds. Having two regimes would add unnecessary complexity to the decision-making process in a crisis.

I favour option 1 over option 2. In a crisis, the decision-making authorities should have a clear set of resolution criteria in front of them – located in one place: the DT Act. If a "bad conduct" criterion is needed as a further option for putting a DT into resolution then this should be added to the list of triggers in the DTAct. For example, under the **Non-viability test**, a bullet could be added along the lines:

- "The DTI has behaved in a reckless or fraudulent manner that presents significant risk to the interests of creditors or the stability or reputation of the financial system. "

This would cover cases where the DT was compliant with measurable prudential standards but conducting itself very poorly, to the extent that de-licencing or Stat Mgmt was being considered. The **Necessity test** would mean that exit strategies other than Stat Mgmt could still be applied.

The overlap between FMA and RBNZ oversight in the conduct/governance space has expanded considerably and accordingly there should be a clause in the Act (following the trigger clauses) that requires the RBNZ to consult FMA ahead of any resolution recommendation to the Minister.

Chapter 8	Depositor protection

Depositor preference

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

8.B If a preference for depositors is introduced, do you agree it should only cover insured deposits (not all deposits)?

In my view there is a clear case for Depositor Preference (DP) in order to: improve financial stability (make depositor runs less likely); make Deposit insurance less costly by raising the creditor ranking of the DIS; improve the political viability of bail-in resolutions; and also improve the operational viability of bail-in resolutions.

The arguments against DP relate to the cost and availability of unsecured wholesale funding. In the case of the major banks, with the imminent large increase in capital requirements – and hence reduced solvency risk for senior unsecured creditors - I would not expect investors to be too phased by the introduction of DP. These investors are now facing DP as a normal feature of most developed country bond markets, including in Australia. In the case of smaller banks and deposit takers, they have always had limited access to senior unsecured debt markets. Their non-deposit funding will continue to be relatively expensive, but no more so than before.

In my view the DP should apply to all non-tradeable deposit instruments, ie it should be broader than just insured deposits. This would substantially enhance the noted benefits related to bail-in resolutions. Uninsured deposits will be held by individuals (particularly retired persons), SMEs, corporates, charitable trusts and other local investment funds. The targets of bail-in resolutions are not these groups, rather they are the institutional investors and offshore fund managers who hold the tradeable debt instruments. Broadening the DP to all non-tradeable deposits would narrow the focus of a bail-in, making it more politically acceptable and also easier to implement. A broader approach to DP would also enhance the market discipline applied by institutional investors and reduce the likelihood of a run by uninsured depositors in a banking crisis.

Scope of coverage

8.C Do you agree with the proposed prescribed product approach for coverage under the new scheme? If not, what approach would you suggest?

8.D Do you agree that both retail and wholesale investors in insured deposit products should be covered up to the $50,000 coverage limit? If not, what approach would you suggest?

8.E Is the list of excluded deposit products appropriate? If not, what approach would you suggest?

I agree with the proposed prescribed product approach to coverage of the DIS. FMC disclosure requirements would exclude the prescribed products. The RB and the Insurer should maintain a list of insured products for each licenced DTI.

Agree that retail and wholesale investors should be covered up to the $50k per name. Protections will be needed to stop companies from using multiple names/nominees to maximise their insurance coverage. Also, as occurred with the Govt deposit guarantee during the GFC, retail fund managers will attempt to claim $50k coverage for each of their retail clients through the use of “bare trusts”. In my view this should be resisted. The asymmetric info argument does not hold when deposits are being managed by professional investors.

The proposed list of excluded deposit products makes sense. Apart from FX and related party deposits, I would exclude all tradable deposits (certificates of deposit) and all deposits held by other licenced DTIs (ie not just interbank deposits).

Mandate, powers and additional objectives

8.F Do you agree with the proposed narrow mandate for the deposit insurer?

8.G Do you agree that the deposit insurer should be able to provide funding for resolutions other than a liquidation?

8.H If yes, do you agree with the limit on the amount of funds that can be used? What are your views on the appropriate safeguards?

8.I What are your views on the appropriate decision authority for the coverage limit?

8.J If a deposit insurance fund is established, should changes to the target size and the levies be made by ministers via regulations or by the deposit insurer itself?

8.K Should there be a legislated requirement to review the deposit insurance scheme? If so, how often should it be reviewed (e.g., every five years)?

In my view the proposed mandate is too narrow. I agree that resolution and supervision are the domain of RBNZ, however the objectives of the DIS should be broader than ensuring prompt access to funds. I suggest 3 elements to the mandate:

1. An efficient charging regime that minimises the moral hazard impact of the DIS (supporting a user pays approach)
2. Ensure that the DIS is appropriately funded and that accumulated funds are well-managed
3. Ensure that insured depositors are promptly compensated in the case of a claim on the scheme.

Regarding the functions listed in Table 8.2, these look sensible, however item 5 on “funding” needs more elaboration and focus. The 3 real risks of “failure” of the scheme relate to the 3 mandate elements listed above. A poor pricing mechanism that promotes fund flows to riskier DTIs (ie moral hazard) is the greatest risk from the scheme over the long term. Hence the pricing issue needs to be given greater emphasis. Similarly, the level and management of funding in peace-time will have a major bearing on the cost of the DIS over the long term.

If the DIS is an independent entity, then it should be able to provide funding for resolutions other than liquidations. Safeguards along the lines of the IADI’s principles would be needed. In particular, the requirement of transparency and that any such funding must be less than would be incurred in a liquidation, net of costs and expected recoveries. However, as noted below, if the DIS is set up within the RBNZ it should not have this funding power as it would complicate resolution decisions and make it difficult for any DIS funding of a resolution without the RB appearing conflicted.

I do not agree that the Resolution authority should be given an objective to protect depositor funds. That is the role of the DIS and also the proposed depositor preference policy. The RA already has multiple objectives to juggle: 1) minimising damage to the financial system, 2) minimising the overall cost of the resolution (value destruction) and 3) minimising use of public funds. Its role is to focus on the system and overall impact of a resolution. From a resolution funding perspective, the RA should be a champion of the taxpayer, not of any creditor group.

On decision authorities, the legislation should include principles, not numbers.

- For the coverage amount, the legislation should give indicators, eg “to cover 80-90% of retail depositors by number”. The actual amount should be set through regulation by order in council.
- The fund size should have a guideline in the legislation (eg as a percent of total insured deposits) with the actual size managed by the DIS itself.
- The levies should have a guideline in legislation (eg “based on an objective assessment of default risk”). The actual levies should be set by the DIS itself. Levies should not be set by the Minister which would introduce political risk to the scheme.

I agree there should be a legislated requirement to subject the DIS to regular review – every 10 years.

Institutional arrangements

8.L Has the Review identified the appropriate criteria for assessing the best organisational form of the insurer?

8.M Do you agree that the insurer should be located within the Reserve Bank? If not, what approach would you suggest?

The Review identifies the relevant criteria for choosing the best organisational form of the DIS.
I agree with the pros and cons summarised in Table 8.3. The operational independence of the RBNZ together with the significant synergies between the DIS and the RB’s oversight/resolution functions make a good case to locate the DIS within the RB.
The main conflict I see relates to the potential use of DIS funds in resolutions. While a separate DIS structure can be established within the RB (like the old OIC), it is hard to see how this conflict can be resolved other than by restricting the use of DIS funds to paying out the losses of insured depositors. Ie DIS could not contribute to resolutions as a means of avoiding direct claims on the scheme.

Funding framework

8.N Do you agree that the insurer should build a deposit insurance fund ahead of a failure? If not, what approach would you suggest?

8.O What are your views on the appropriate size of any deposit insurance fund?

8.P Should the insurer charge higher levies to higher risk deposit takers? What are your views on how risk should be assessed?

8.Q What are your views on how the Government funding backstop should be designed?

I agree the DIS should be pre-funded through an accumulated insurance fund to underpin the substance/credibility of the scheme and its user pays principle. The fund will take years to establish, during which time the Govt guarantee will play a key role. The extent and cost of the Govt Guarantee will need to be considered carefully. There may be a need for an initial subsidy element to the G'tee fee to give an initial momentum to the accumulation fund.

The target size for the DI fund should be based on objective modelling and international comparators. I do not have a prior on where this analysis will come out.

It is fundamental to the DIS that insurance levies should be risk based. I agree that the risk adjustments will be in buckets, just as credit ratings are in buckets. Risk should be assessed for each DT based on expected loss on its insured deposits. The best methodologies should be adopted from rating agencies, banks and other Deposit Insurance schemes. The levies should also reflect expected loss on insured deposits over and above NZ Govt risk. There should be a degree of alignment over time between the DI levies and market-based credit spreads for like risks.

Given the need to build the fund over the early years, I suggest that the charge on the fund for the Govt backstop be based on the steady state configuration of the scheme. Any unfunded calls on the scheme ahead of steady-state being reached could be managed via Govt borrowing. The funding model should also consider private re-insurance as part of the mix if such a product is available in the international market.

Any other comments?

An important area where the paper is unclear relates to the role of banks and the future of banking licences. An overarching DT regime and Act makes good sense. However, there will continue to be significant differences between the various tiers of DTIs in terms of their size, complexity and importance for systemic risk. The proportionality principle does not imply that banks should attract closer regulatory attention per se. However, the bulk of systemic risk is currently contained in banks and there is considerable reputational value inherent in the existing bank licensing regime. In my view it makes sense to retain the bank licensing regime alongside the DT licensing regime and to retain the higher hurdle for a banking licence. The respective roles of the licences can be managed over time.

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