The Treasury

Reserve Bank Act Review Phase 2 Consultation 3 Submission Information Release

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Submission on the third round of public consultation on the Reserve Bank Act Review

ASB Bank Limited (**ASB**) welcomes the opportunity to provide feedback to the Treasury on the third round of public consultation on the Reserve Bank Act Review (the **Consultation**), concerning the prudential framework for deposit-takers and depositor protection.

Our key submissions on the Consultation are set out in the enclosures to this letter.

ASB has also contributed to the New Zealand Bankers' Association submission on the Consultation (the **NZBA submission**) and endorses the views and recommendations made therein except where expressly indicated otherwise in this submission.

ASB wishes to acknowledge the proactive and positive engagement from the review team over the course of this consultation. ASB looks forward to further engagement with Treasury on the Exposure Draft of the Bill. If the Treasury wishes to discuss any aspects of our submission, we would be happy to meet to do so.

We note that ASB's submission may be uploaded onto the Treasury's website and ASB does not seek confidentiality for any aspect of this submission, other than my direct contact details below.

Yours faithfully,

Sam Kelly
Head of Government Relations & Regulatory Affairs
ASB Bank Limited
[35]

ASB's overarching feedback on the Consultation

1. ASB is proudly committed to its purpose of accelerating the financial progress of all New Zealanders. A critical enabler of this purpose is a trusted regulatory framework that promotes financial stability and supports the economy. To that extent, ASB supports the policy intent of the proposed Deposit Takers Act and, subject to specific comments in this submission and in the NZBA submission, ASB broadly supports the proposals in the Consultation.

2. Our key feedback focusses on:

    - aspects of the in-principle decision to introduce depositor protection, particularly the need for the deposit insurance scheme to utilise transparent risk-based pricing from the outset; and
    - consideration of the proposed resolution and crisis management regime from an investor perspective.

Chapter 2: Purposes of the Deposit Takers Act

3. ASB supports the NZBA submission. In particular:

    - The Reserve Bank's financial stability objective should encompass efficiency i.e. how well the financial system performs its functions. The proposed decision-making principle relating to the benefits and costs of prudential decisions is not sufficient to address the regard the Reserve Bank should have to efficiency, even when amended as suggested below. A further Deposit Takers Act purpose should be added, to "promote the efficiency of the financial system".
    - We agree with the proposed decision-making principles overall, and suggest that the relevant decision-making principle should be amended as follows: *"promoting efficiency, including through the desirability of minimising unnecessary costs of regulatory actions, taking into account the benefits of the outcomes to be delivered."*

Chapter 3: The regulatory perimeter

4. ASB supports the NZBA submission. In particular:

    - We support the proposed approach to defining the overall regulatory perimeter.
    - We support the creation of a regime, similar to the Australian registered financial corporations (RFC) regime, to ensure that the Reserve Bank is able to respond to changes within the overall financial system, both within and outside the defined regulatory perimeter. An RFC-style regime would ensure the Reserve Bank has the information necessary to discharge its prudential function across the financial system.

Chapter 4: Standards and licensing

5. ASB supports the NZBA submission. In particular:

- We support the proposal for prudential policy to be made consistently through a single instrument (a Standard). This is preferable to the status quo, in which there are numerous elements (including Conditions of Registration and Orders-in-Council) and some requirements (e.g. in relation to internal risk management systems, controls and policies), which do not have specific statutory recognition.
- In relation to the proposed power for the Reserve Bank to set lending standards (such as LVRs and DTIs), we note the consultation refers to possible future restrictions on rural and commercial property lending. We consider that caution should be exercised in applying granular lending controls through this channel. We also agree that the application of lending standards should be competition-neutral.
- In terms of formulation of the Standards, we:
    - support the approach of setting the parameters for the Standards based on subject area, by reference to the current Banking Supervision Handbook and to the Basel Core Principles for Effective Banking Supervision;
    - ask that home jurisdiction prudential standards are considered when the Standards are formulated, to avoid conflicting home/host requirements;
    - agree that the Reserve Bank should be able to issue differing Standards for different entity classes;
    - agree that the Regulatory Impact Statement (RIS) should be prepared at an early stage in the process and that the RIS should not analyse prudential tools in isolation;
    - agree that the flexibility to cater for future developments should be provided via a regulation-making power; and
    - agree that the preparation of new Standards and the re-drafting of existing banking standards will be a "*very significant policy project.*" This will require substantial planning and also consideration of the transitional arrangements that will apply as the existing legislation is phased out.
- Given the new prudential regime proposed in the Consultation will introduce a number of new elements (including remediation orders, enforcement toolkit and crisis management tools, and listed fully at paragraph 87 of the NZBA submission), consideration must be given to ensuring these elements are harmonised in their design and can be implemented in a coordinated way. The various available tools and interventions must be subject to procedures, consequences and safeguards that are coherent and fair.

Chapter 5: Liability and accountability

6. ASB supports the NZBA submission. In particular:

- We support an approach to liability and accountability that aligns with the FMCA, particularly in relation to the distinction between civil and criminal liability, personal liability, and availability of 'due diligence' and other defences.

- We support the proposal to place a greater emphasis on civil, rather than criminal, liability in the Deposit Takers Act compared to the existing Reserve Bank Act.
- Criminal liability should be limited to knowing or reckless breaches of *key* provisions only. This will ensure that resources are adequately focused on those provisions. Civil liability is adequate to ensure compliance for more technical and procedural matters. Conflicting obligations on a deposit-taker that may otherwise give rise to a knowing breach should be taken into account when setting the scope of criminal liability (e.g. if the Reserve Bank seeks to direct a bank to maintain confidentiality, but this conflicts with the bank's obligations to its shareholders).
- It is important that director accountability changes under the Deposit Takers Act are coordinated with other executive accountability regimes including under the FMCA, the proposed laws regarding conduct of financial institutions, and expanded director obligations under the Credit Contracts and Consumer Finance Act 2003.
- The requirement to "*take reasonable steps to ensure that the deposit-taker is being run in a prudent manner*" is too broad and would leave considerable uncertainty as to compliance. The precise formulation of the positive duties should be closely considered, with input from governance specialists, specifically including a detailed review against formulations in other regimes, most notably the Australian Banking Executive Accountability Regime.
- The current director attestation regime, which requires six-monthly attestations, should be removed. The current director attestation regime can encourage a focus on 'point in time' compliance, which is not appropriate given the proposals in the Deposit Takers Act shift the director liability 'trigger' away from six-monthly attestations to an ongoing compliance requirement.
- We disagree with the proposed carve-out that prevents director indemnification of personal financial losses from unsuccessfully defending any proceedings relating to the new positive duties. 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. If a carve-out in relation to the new positive director duties is considered necessary, it should only extend to the duty to act with honesty and integrity.
- We support aligning the deemed director liability regime with the FMCA. In particular, this would mean deemed director liability for misleading disclosure, but with clear defences including a defence for taking reasonable steps to ensure that the disclosure was not misleading.

Chapter 6: Supervision and enforcement powers

7. ASB supports the NZBA submission. In particular:

- It is important that there are clear guidelines on what enforcement powers should be used when and protections to ensure that regulator responses are reasonable in the circumstances.
- There should be limits on entry for on-site inspections without notice and the use of gathered information and we disagree with the proposal to expand the FMA's on-site inspection power.

We are not aware of issues with the FMA's inspection powers under the FMCA and any proposal to change the FMA's powers should be subject to separate consultation.

- We support the inclusion of a breach reporting requirement in the legislation, with Standards setting out breach materiality thresholds. Liability for failure to comply with breach reporting requirements should be a civil matter only and limited to cases of actual knowledge or recklessness. Liability in such cases should generally arise under the actual breach rather than a failure to promptly report it.

Chapter 7: Resolution and crisis management

8. ASB supports the NZBA submission and in paragraphs 9-11 we set out our key observations. In particular:

    - There should be a single and cohesive crisis management framework. There will need to be a very clear hierarchy in terms of the tools available for the supervisor and when they will apply. If the regime simultaneously includes depositor preference, bail-in and Open Bank Resolution (OBR), investors and other stakeholders will not have certainty over what action the Reserve Bank will take. This will likely reduce investors' appetite to invest in deposit-takers. Further details are included at paragraphs 9-10 below.
    - In aligning the crisis management regime with international best practice, it must be ensured that existing and ongoing workstreams can, where possible, be efficiently 'repackaged' into the new framework (for example, OBR pre-positioning becoming a core part of resolution planning). It will also be essential to consider how the new crisis management framework is inter-connected with BS11 (Outsourcing Policy), separation plans, OBR and the Reserve Bank's Disaster Recovery and Business Continuity Policy.
    - We support the inclusion of an explicit obligation on the Reserve Bank to use its powers under the crisis management framework regime in a proportionate manner.
    - The triggers are not yet sufficiently clearly defined to give interested parties a clear understanding of when resolution action might occur.
    - The Reserve Bank must coordinate resolution actions with the relevant home regulator.
    - The liabilities that are subject to bail-in need to be clear and the approach should be aligned with international practice.
    - We do not consider depositors should be subject to bail in, in light of the practical difficulties with doing so and the increased complexity this would bring.
    - We do not consider that the Reserve Bank should have the power to place a deposit-taker into statutory management under the Corporations (Investigation and Management) Act 1989 (CIMA) on the recommendation of the FMA. This would undermine the in-principle decision that the Reserve Bank will be designated as the resolution authority for deposit-takers.

9. In considering the proposals from the perspective of investors in New Zealand's deposit-takers, simplicity of the crisis management regime is key. The market for wholesale debt issuance provides only small windows of opportunity to explain products and the regulatory environment

in which they are issued. An unnecessarily complex regulatory regime will reduce investors' appetite to invest in New Zealand's deposit-takers.

10. For the same reason, it is important that crisis management reforms in New Zealand are aligned with international norms as this will assist international investors in understanding the regime. For example, consistency with the Total Loss-Absorbing Capacity (TLAC) and Minimum Required Eligible Liabilities (MREL) regimes would be helpful. Familiarity with the regime's features will be an important factor for investors.

11. The NZBA submission notes that retrospective application of bail-in provisions would be inappropriate as investors in instruments subsequently designated as bail-inable would not have been able to price in the risk of bail-in when they invested. We support this view and furthermore consider that retrospective application of bail-in provisions:

    - has the potential to cause price volatility for existing debt; and
    - depending on the legal nature of the retrospective application, may require issuers to seek consent from investors. Issuers may even be required to repurchase notes on issue.

Chapter 8: Depositor protection

12. ASB supports the NZBA submission and in paragraphs 13-18 we set out our key observations. In particular:

    - We agree with the proposed approach of having a prescribed list of products that will be covered by the Scheme and note the importance of aligning the scope of entities issuing protected products with the regulatory perimeter of the Deposit Takers Act.
    - We agree with the proposed approach that both retail and wholesale investors should benefit from the protection offered by the Scheme, for the benefit of simplicity.
    - We oppose the introduction of depositor preference, at least without more detailed guidance on its legal implementation and impact on broader liquidation outcomes and insolvency principles. On balance, the complexities and other disadvantages of introducing a depositor preference are likely to outweigh the benefits.
    - We agree that the Scheme, in principle, should be able to provide funding for resolutions other than a liquidation, subject to proper safeguards and limitations. Such funding could be used if deposit accounts are transferred to other institutions.
    - We agree that the insurer should build a deposit insurance fund ahead of a failure over a reasonable period of time, subject to our comments at paragraph 18. The size of and time taken to build the fund should take into account the increased regulatory capital requirements coming into force.
    - We strongly support a risk-based approach to the setting of levies, as set out in paragraphs 14-17.
    - We agree with the implementation of a Government funded backstop, both for the phase while the fund is being built up and subsequently if required amounts exceed funds available at the Scheme. However, Government should not be entitled to make a profit out of any

contribution under the backstop, and funding should be offered at cost. The proposed fee for the use of the backstop would put another obligation on deposit-takers to cover a cost that they did not cause, in addition to likely increased levies.

13. ASB continues to support the introduction of depositor protection, subject to our comments herein and at paragraphs 14-18. As we have noted in previous submissions, the proposed $50,000 limit is low when compared to other comparable jurisdictions, and the 2008 New Zealand Crown Retail Deposit Guarantee Scheme. An insured limit of $50,000, while covering c90% of the industry's individual depositors by number, leaves c60% of deposit funds (by value) exposed across the industry. Notwithstanding Cabinet's in-principle decision, we would encourage reconsideration of the insured limit to a level that protects a larger proportion of deposit funds (by value). If the total level of deposit funds exposed to loss is too high, this risks the ability of depositor protection to achieve its objectives (to protect depositors from loss and contribute to financial stability).

14. It is essential that any deposit insurance scheme utilises transparent risk-based pricing from the outset of the regime, for example via a premium structure based on an entity's credit rating or non-performing loans as a percentage of gross loans and advances. The advantages of using credit ratings is that these represent an independent measure and typically reflect a sophisticated analysis of the risk of an entity.

15. As observed when the Crown Retail Deposit Guarantee Scheme was introduced, a non-risk based levy system causes market distortions, with depositors incentivised to seek the highest deposit rate without regard to the risk profile of the deposit-taker. As the Consultation itself notes, *"a single, flat premium rate…would be unfair to members who pose lower levels of risks to the scheme (they would effectively be subsidising higher risk members in funding the scheme).*" The Consultation itself also notes "*To the extent that finance companies decide to take insured deposits and are able to maintain relatively high returns from engaging in higher-risk lending, this would raise significant moral hazard issues. Investors would be incentivised to take advantage of these higher (risk free) returns, creating the potential for significant in-flows of funds to the sector."* A risk-based levy system would mitigate these risks.

16. We understand that a non-risk based levy structure is proposed to be put in place initially before moving to risk-based pricing. For the reasons noted above, we strongly oppose this approach. We also note that in the current very low interest rate environment, the market distortions referred to above would be exacerbated as depositors are more motivated to seek out higher yields. It is not in our view appropriate to introduce the scheme with a non-optimal levy structure with the intention to revise the structure subject to further consultation. Such an approach would be inefficient for both the Treasury review team and deposit-takers.

17. We note that the approach to risk-based pricing will be subject to further public consultation. We strongly advocate for this further consultation taking place before the introduction of deposit insurance and we look forward to future engagement on this topic.

18. Finally, we consider sufficient time must be given to build up the insured fund and, once the target fund size is reached, levies should cease to avoid the levies becoming a perpetual tax on deposit-takers.