The Treasury

Reserve Bank Act Review Phase 2 Consultation 3 Submission Information Release

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HEARTLAND BANK

30 October 2020

Phase 2 of the Reserve Bank Act Review
The Treasury
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Via email: rbnzactreview@treasury.govt.nz

Submission to the Treasury on the Third Consultation for Phase 2 of the Reserve Bank Act Review

1. Introduction

1.1. Heartland Bank Limited (**Heartland**) welcomes the opportunity to submit on the third consultation (**Consultation Paper**) for Phase 2 of the Reserve Bank Act Review (**Phase 2 Review**).

1.2. Heartland refers to its submissions on the first and second consultations of the Phase 2 Review dated 4 February 2019 and 30 August 2019, a number of which are restated and further expanded on in this submission.

1.3. Heartland supports the New Zealand Bankers' Association (**NZBA**) submission. However, there are some points in that submission that Heartland either diverges from or wishes to reiterate which are set out in more detail in our submission below.

1.4. We understand that the Co-operative Bank, SBS Bank and TSB Bank are also providing a combined supplementary submission on the Consultation Paper and note that the key themes outlined in this submission are anticipated to broadly align with their submission.

2. Chapter 8 of the Consultation Paper: Depositor Protection

2.1. Heartland supports regulation that protects the New Zealand public and provides confidence in the New Zealand financial system, and notes the Government's in-principle decisions to create a deposit insurance scheme to be funded by deposit takers, with a Government backstop, and with a $50,000 limit per depositor, per deposit taker.

Structure of the deposit insurance scheme

2.2. Heartland notes the Government's in-principle decision that the scheme be funded by levies on deposit takers, with a Government back-stop. As stated in our 30 August 2019 submission, where the costs of a depositor protection scheme are to be passed onto deposit takers (such as is proposed), we submit that using a 'fund' is a problematic model.

2.3. In 2019, the Reserve Bank of New Zealand (**RBNZ**) announced its final decision on the capital adequacy framework for banks. This new framework will require banks in New Zealand to increase the capital they hold over a 7-year transition period to protect against a 1-in-200 year event to make the bank system even safer. These changes are designed to reduce the chance of bank failure in New Zealand – and, in turn, to reduce the chance of depositors losing their deposits. A depositor protection scheme seeks to provide depositors with recourse in the event of such a risk eventuating. Heartland considers that some other financial product (such as insurance, the cost of which would take into account a lower chance of bank failure) could be

more appropriate and efficient. In any event, the use of a fund would appear to raise a number of complexities (which would not be the case with insurance).

2.4. The design, implementation and funding of a deposit insurance scheme is complex and we submit that there should be further specific consultation on these points before final policy decisions are made on the scheme, as the implementation of such a scheme will have wide-ranging impacts on the New Zealand economy and its participants, including deposit takers and their customers.

$50,000 limit on insured deposits should be increased

2.5. Should the Government proceed with implementing a formal deposit insurance scheme with a $50,000 limit, Heartland strongly supports the NZBA's submission that the banking industry would support a higher coverage limit than $50,000 given that this limit could disproportionately affect smaller local banks, including Heartland, for the reasons below.

2.6. From a recent review of Heartland's depositor base, a limit of $50,000 would only cover approximately 10% of its deposits by volume and the remainder would not be covered by the scheme. When this scheme is implemented customers may look to split deposits across guaranteed deposit takers and between their own entities (e.g. trust, individual, co-depositor) to maximise coverage.

This could potentially result in larger depositors exiting a deposit taker other than for deposit amounts up to the $50,000 limit. These larger depositors would need to be replaced by a greater number of smaller depositors, and there could be a timing mismatch, resulting in reduced retail depositor funding for the affected deposit taker. For example, if a depositor has $1m with a deposit taker and the coverage limit is $50,000, they may withdraw $950,000 from that deposit taker and invest it with others, which would require 19 new fully covered deposits to replace the funds. This could disrupt the retail deposit market and have adverse consequences, particularly for smaller deposit takers. The higher the coverage limit, the less impact there is likely to be from depositors splitting deposits.

Funding the deposit insurance scheme - ex ante vs ex post levies

2.7. If a deposit insurance scheme fund is ultimately the structure chosen, Heartland submits that the fund should be funded by ex post levies, not ex ante levies.

2.8. Given the changes to the capital adequacy framework for banks, the chances of the scheme needing to be relied upon are even remoter than they already are. If the fund were to be funded by ex ante levies, it would lead to a large fund being established over the next couple of decades, and needing to be administered, to protect against a 1-in-200-year event (once the new capital adequacy framework is implemented).

2.9. Heartland submits that, as stated in its 30 August 2019 submission, a levy on profits to seed the fund would make it more difficult for banks (particularly small local banks) to meet any future increased capital requirements (which, in the case of most small banks, will only be able to be met through retained earnings/profits). Institutions would also lose out on the benefit of those funds in the short term, which they would otherwise use to lend out to customers to help contribute to the economic recovery post-COVID, or for the purposes of complying with the new capital adequacy obligations which will be progressively introduced.

2.10. If ex ante levies were to be utilised, Heartland submits that they should be coupled with an element of ex post funding, reflecting the remote risk of the depositor protection scheme ever

needing to be invoked (for the reasons discussed above), and the need to align and integrate the scheme with the other elements of the crisis management framework

2.11. We understand from our discussions with the Phase 2 Review team and from the Consultation Paper itself that further consultation on this topic is intended, and we look forward to having the opportunity to participate in it.

Risk-based levies

2.12. The calculation of levies to fund a deposit insurance scheme will be complex, and Heartland submits this will require separate consultation with further analysis required on the possible financing structures. A conceptual decision should not be made without further analysis and only once the details of the deposit insurance scheme are further confirmed, given the complexity of the design of the scheme.

2.13. The design of any levies should also ensure that it does not stifle competition in New Zealand's financial system. Imposing risk-based levies will result in the deposit insurance scheme being more expensive for smaller institutions and those levies should not be based upon a deposit-taker's credit rating as that is an oversimplification of approach. As the global financial crisis highlighted, credit ratings and scale of an entity do not always prevent against failure (for example, the AIG bailout).

Depositor preference

2.14. Heartland supports NZBA's submissions that the complexities and other disadvantages of introducing a depositor preference are likely to substantially outweigh the benefits.

2.15. Although deposit preference schemes are not uncommon overseas, New Zealand has a unique financial market due to its smaller retail depositor pool, which results in institutions relying on wholesale funding to a greater extent than institutions overseas. This is particularly so in a low interest rate environment where a hunt for yield pushes customers to investments other than retail deposits. Further, sophisticated depositors are able to price risk themselves, and given the introduction of the new capital adequacy framework, that regime imposes a de facto preference on depositors as it reduces the chances that a bank will fail.

2.16. Finally, any depositor preference scheme implemented in conjunction with a depositor protection scheme would impose further costs upon deposit takers by increasing wholesale funding costs and potentially reducing demand for forms of unsecured funding, e.g. short term commercial papers and retail bonds. It is also likely to negatively impact Heartland directly as Heartland is restricted, by its banking conditions of registration, to allow no more than 10% of its assets to be owned by special purpose vehicles, such as securitisation vehicles. This requires Heartland to seek the vast majority of our funding from retail deposits and wholesale funding. In Heartland's view, the imposition of a depositor preference scheme would be yet another further financial and regulatory burden which would not be warranted in the circumstances.

3. Chapter 5: Liability and accountability

3.1. Heartland does not object to the introduction of positive duties on directors of deposit takers. Heartland supports NZBA's submission that the proposed positive duty to *"take reasonable steps to ensure that the deposit taker is being run in a prudent manner"* is too broad. Additional positive duties in other legislative regimes (e.g. directors' duties in the Insurance (Prudential Supervision) Act 2010 (**IPSA**)) are specific, rather than principles based, which Heartland submits is the appropriate way for such duties to be drafted.

3.2. What is meant by "prudent manner" will be different depending on the nature of the deposit taker, and such a duty would leave considerable uncertainty as to compliance, and would not therefore be an appropriate duty upon which to base a director liability regime. Given civil and criminal liability will be attributed to breaches of these director duties, it is crucial that there is very clear guidance provided (either by RBNZ or included in legislation) and/or jurisprudence in New Zealand in relation to the meaning of those duties. If this duty is retained, which Heartland submits would not be the right outcome, clear guidance should be provided in respect of the meaning of "reasonable steps" and "prudent manner", with evidence of a director's compliance with the provisions of the guidance to be treated as evidence of compliance with the duties.

3.3. Any positive duties which are introduced should be specific to New Zealand and have guidance and jurisprudence in New Zealand in respect of their meaning. It would not be appropriate to adopt duties from other jurisdictions without careful consideration of how they would apply in New Zealand.

3.4. Heartland supports NZBA's submission in respect of indemnification and insurance of directors and agrees and reiterates their submission that the proposed positive duties go beyond section 131 of the Companies Act.

4. Chapter 3: Regulatory perimeter – restricting use of the word 'bank' (and related words)

4.1. Heartland supports NZBA's submission on this point. The concept of deposits are different between banks and non-bank deposit takers, as different types of debt securities are offered by these institutions which require different levels of disclosure under the FMCA.

4.2. Banks under the proposed deposit takers regime would also be subject to different and more onerous prudential standards and oversight, and so should receive the benefit of being able to use the word 'bank' to communicate in a simple and clear manner to customers the nature of their business model. Customer outcomes should also be considered when determining which entities should get the benefit of the restricted words, as the word 'bank' communicates a certain level of scale and risk that New Zealand customers can easily understand.

4.3. Heartland notes that Australia has recently relaxed its restrictions on the use of the word 'bank', but notes that Australia has more non-bank lenders, and a particular neo-bank regime, which has not yet been developed in New Zealand.

5. Chapter 4: Licensing and standards

5.1. Heartland makes a general comment that any new licensing regime should seek to not only achieve its objective, but also leverage off existing regimes and minimise the administrative burden on institutions and their board of directors and senior management teams.

5.2. The new capital adequacy framework and the other prudential regulations and standards imposed on banks currently provides the primary source of protection for depositors in New Zealand. Heartland acknowledges that bolstered depositor protection imposed by a deposit insurance scheme is intended and that this new regime will apply to both bank and non-bank deposit takers and that they will all get the benefit of their deposits being insured under the scheme (up to the $50,000 limit). Further, non-bank deposit takers may also get the benefit of having a reduced chance of failure and perhaps even see increased demand for their products due to deposit splitting. Heartland recognises that the details of the proposed prudential standards are still to be finalised and that the Reserve Bank of New Zealand should be able to issue differing standards for different entity classes. However, where standards are to be

applied, it will be important to apply them across all deposit takers in a way that protects and promotes financial stability in New Zealand and preserves competitive neutrality.

6. Questions

6.1. If you would like to discuss any aspect of the submission further, please do not hesitate to contact me via the sender of this submission.

Yours faithfully

Bruce Irvine
Chairman of Heartland Bank