

The Treasury

Reserve Bank Act Review Phase 2 Consultation 3 Submission Information Release

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SAFEGUARDING THE FUTURE OF OUR FINANCIAL SYSTEM - SUBMISSION ON CONSULTATION 3, PHASE 2 OF THE RESERVE BANK ACT REVIEW

1. Introduction

- 1.1 Thank you for the opportunity to provide feedback on your consultation: *Safeguarding the future of our financial system – the prudential framework for deposit takers and depositor protection*. As “New Zealand owned” banks, we believe we hold an important role in the banking industry by adding diversity, competition and domestic capability to the sector, while providing a strong presence in the regions. The ownership structure of our entities’ mandates that our primary objective is to return value to our Members and Communities and to operate in a way that ensures long-term sustainability and financial stability. We commend the Phase 2 review work to date, and fully support the modernisation of the Reserve Bank of New Zealand’s (Reserve Bank) legislation to create an enduring and trusted prudential framework that supports a productive, sustainable and inclusive economy.
- 1.2 This submission has been written on behalf of the New Zealand customer and community-owned banks and is supplemental to the New Zealand Bankers’ Association (NZBA) submission, which we endorse. This submission focuses on matters of specific relevance to this group that enhance or clarify our position. As a result, we have not addressed all the areas or questions within the consultation, only those where we believe additional comment is appropriate.
- 1.3 We understand that Heartland Bank is also providing a supplementary submission and note that the key themes outlined here are anticipated to broadly align with their submission.

2. Depositor protection

Introduction

- 2.1 Our operating mandates ensure a strong focus on customer well-being, and we all have a strong commitment to good customer outcomes. To that end, we support the work to date to protect the New Zealand public and provide confidence in the New Zealand financial system.
- 2.2 We acknowledge the Government's decision to introduce a deposit insurance scheme, and the in-principle decisions on the scheme design which include a government backstop, and a \$50,000 insurance coverage limit per depositor.
- 2.3 We support the NZBA's comments and advocate for a higher insurance coverage limit than \$50,000, more aligned to international norms. We will provide some broader context that supports a higher limit, then explain why we believe a lower limit will disproportionately affect the smaller, New Zealand owned banks but also outline some concerns around the converse implications of having a limit that is too high. That will be followed by comments on other specific questions raised in the consultation.
- 2.4 Further, we reiterate our previous submission on the importance of ensuring the overall scheme design, and associated costs, ensure fairness and balanced outcomes for all stakeholders, including smaller deposit takers. Given the NZ financial system already has a number of existing protection measures, this is particularly important to avoid additional unnecessary costs or market distortion.

General comments

- 2.5 The \$50,000 limit is low when compared to other jurisdictions. This increases the risk of the scheme failing to adequately protect depositors from loss and harming public confidence and financial stability. The information provided in Figure 5D on page 100 of the Phase 2 Consultation 2 document shows that the only other countries whose deposit insurance limits would be as low as New Zealand's are South Korea, Chile, Iceland, and Turkey. All other countries in the study have deposit insurance limits of more than twice what is being proposed.
- 2.6 For example, we note that in the US, the FDIC determined during the GFC that deposit insurance coverage should be raised from USD100,000 (an amount that had been in place since 1980) to USD250,000, which increased public confidence (the UK and EU similarly raised insurance coverage limits). The then-Chair of the FDIC, Sheila Bair, noted that, despite 465 banks failing in the US between 2008-2012, depositors kept their funds in the banks because of the trust the public had in the deposit insurance guarantee and the FDIC's promise of making funds available to depositors throughout the crisis.
- 2.7 As the NZBA noted in its submission on Phase 2 Consultation 2, implementing a low limit increases the risk of the scheme failing to prevent bank runs, as there would still be a sufficient amount of deposits at risk and any doubts about the operation of a scheme can also counteract its effectiveness (as shown in the Northern Rock experience during the GFC, where a run occurred in part because the deposit guarantee was complex and poorly understood).
- 2.8 We believe the evidence supports that increased limits lead to increased public confidence and depositor wellbeing. We would support stronger measures to build support and confidence in the New Zealand financial system in case a deposit taker failed and believe that having a substantially higher insured amount up to \$250,000 would be more appropriate.

Lower insurance coverage levels will disproportionately affect small, New Zealand-owned banks

- 2.9 The in-principle decision indicates that the \$50,000 coverage limit would cover 90% of depositors. That may be accurate in aggregate but does not reflect the reality smaller, New Zealand-owned banks face.
- 2.10 Recent reviews of our funding books show that a \$50,000 limit would cover less than 90% of small New Zealand bank depositors, and closer to 20% of the value of total deposits. Further information regarding individual banks' depositor information is available and banks may be in further contact following this submission.
- 2.11 Implementing a deposit insurance scheme with a low insurance coverage level is likely to result in customers splitting their deposits across guaranteed deposit takers, and also across their own entities, to increase their insurance protection. At lower insurance coverage levels this could result in any customer deposits above the insured limit exiting a deposit taker. The loss of this funding would need to be replaced, most likely by a greater number of smaller depositors. Upon implementation of the scheme, and also during times of financial instability or economic stress, this could disrupt the retail funding market and inadvertently create funding pressures, particularly for those deposit takers that have lower levels of their retail deposit funding covered by the scheme due to the lower coverage levels. We believe that the higher the coverage limit, the less impact there is likely to be from splitting deposits.

However, higher insurance coverage levels may also disproportionately affect small, New Zealand-owned banks

- 2.12 We appreciate that higher insurance coverage levels prima facie imply increased costs for the scheme however we note that there are many factors that will eventually contribute to this, including decisions around the mechanisms for funding the scheme, the overall fund size, and the time to build up the fund. We also note that the impact of deposit splitting at a lower coverage level may, in fact, increase the overall cost of the scheme more than just setting a higher coverage level. In addition, there are other broader factors that should also be considered as they will operate to mitigate risks of the scheme, such as the increasing capital requirements for banks and other regulatory and prudential changes that operate to further strengthen bank resilience. We understand that this consultation does not fully address these issues in detail, and as such further consultation will be necessary to address the final details of the scheme design, including assumptions and modelling around the fund levels and the associated levies. We welcome further engagement on this, particularly in respect of the setting of levies that must be fairly costed so these do not create market distortions or have other unintended consequences especially the potential cost burden these may impose on smaller deposit takers whom do not have the relative economies of scale to just absorb additional costs into their businesses.
- 2.13 As outlined in the consultation document, we are also cognisant that an insurance limit that is set too high may create moral hazards by encouraging the flow of insured funds into higher risk entities from other safer deposit takers.
- 2.14 Overall, we note that the setting of the insured limit will be a fine balance, and caution needs to be taken to ensure the scheme can meet its objective of protecting depositors from loss and contributing to financial stability including ensuring a fair and balanced outcome for all stakeholders.

Risk-based levies

- 2.15 We note that the ultimate levy calculation to fund the deposit insurance scheme will be complex and the final funding makeup, the various assumptions and modelling used, as well as all the other broader factors that will need to be considered when determining the rate of funding and an entity's levy are still being determined and, as such, will need further consultation.
- 2.16 In principle, we support a risk-based (or differential) approach to the setting of levies, though we do not support a single-variable risk-based approach, such as using credit rating alone. Any risk-based approach should consider multiple factors.
- 2.17 Factors that should be considered for any risk-based (or differential) approach to the setting of levies include stand-alone credit ratings, as these remove factors such as implicit parent or government guarantees. In addition, an entity's overall systemic risk and the effect of an institution's failure on market stability should also be considered along with individual business models and funding and liquidity profiles. It will be important to consider multiple factors to ensure the levy design does not have the effect of reducing competition in the New Zealand banking sector by making it more expensive for smaller deposit taking institutions.

Depositor preference

- 2.18 We support the NZBA's submission that the complexities and other disadvantages of introducing a depositor preference are likely to substantially outweigh the benefits. We do not support any associated depositor preference regime, as this has the potential to fundamentally challenge and, or significantly alter funding profiles for some deposit taking entities.

Excluded deposit products

- 2.19 Finally, we support NZBA's submission on the proposal to exclude connected person deposits from coverage. Given that Banking Standard 8 requires that commercial terms may not be any more favourable than those offered to other customers for like products, it could be difficult to justify this exclusion.

3. The regulatory perimeter

- 3.1 As smaller domestic banks, we support a mandate that will empower the Reserve Bank to promote fairness across the regulatory spectrum and ensure a level playing field within the NZ financial services industry.
- 3.2 In line with the NZBA industry submission, we support the proposed approach to defining the overall regulatory perimeter and that there should be flexibility to discourage regulatory arbitrage and moral hazard. We also support the proposed wholesale exclusion using a size threshold.
- 3.3 We support the proposed restrictions on the term's "bank" and "deposit taker" and note the importance of alignment and consistency with the depositor protection scheme to support public confidence and understanding. We also support restricting the word "bank" to entities within the regulatory perimeter that are of a certain size or characteristics, including the level of prudential standards and regulatory oversight. We note that there is already a reasonable public understanding that the word 'bank' reflects a certain level of scale and risk so any changes to the current distinction will need careful consideration to ensure the public are able to clearly distinguish between the various entities that will ultimately be included within the regulatory perimeter.

- 3.4 We agree that smaller deposit takers should be subject to simplified supervision and regulation but note that, in conjunction with this, it will be important to have clear distinctions between the various 'levels' of supervision and regulation. We propose that this could be undertaken by having separate tiers of deposit takers outlined within the legislation using existing and reasonably well known concepts such as systemically important registered banks (D-SIBs), smaller registered banks (non-D-SIBs), and then other small deposit takers. In order to avoid any arbitrary cliff edge, regulated entities could be provided a period of time over which they can transition between different categories so as not to impede growth. The incorporation of clear and distinguishable tiers within the DTA legislation will also support the Reserve Bank to apply a flexible and proportionate regulatory approach.

4. Supervision and enforcement

- 4.1 We acknowledge the in-principle decisions made to provide a wider range of formal enforcement powers and submit that it will be important that the supervision approach be flexible to accommodate the risk, scale and legal structure of the regulated entity.
- 4.2 In particular, we consider the supervisory and enforcement approach by the Reserve Bank must continue to be both proportionate considering our market share, and flexible to consider our unique ownership structures and the relatively simple and sound operating models that benefit our Members and Communities. Flexibility recognises the avoidance of unnecessary regulatory burden and costs for small deposit takers. It also notes that small domestic owned banks are active contributors to a sustainable and productive economy, aligned to the Reserve Bank's supervisory objectives.

5. Liability and accountability

- 5.1 We support the comprehensive approach outlined in the NZBA industry submission to liability and accountability including the overarching themes. We reiterate the view supporting consistency and alignment in this area, particularly with both the FMCA and the other director accountability regimes, with clear and specific guidance to ensure the regulatory response is both proportionate and reasonable.
- 5.2 In addition, we agree to the indemnification and insurance proposals provided by NZBA, noting that banks can face greater governance risks to encourage capable and diverse individuals in a potentially narrowing directorship pool. We also submit that any positive duties that are introduced should be specific to New Zealand and have guidance and jurisprudence in New Zealand in respect of their meaning.

Once again thank you for the opportunity to provide feedback on this consultation. We would be happy to discuss these submissions, participate in further specific consultation, or provide additional information as required. We also welcome continuing engagement with the Phase 2 review team as they develop the policy framework and legislation.

Yours sincerely

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