

# The Treasury

## Reserve Bank Act Review - Deposit Takers Bill Information Release

April 2021

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Chair,

Cabinet Economic Development Committee

## **Reserve Bank Act Review – Prudential Regulation of Deposit Takers and Deposit Insurance: Depositor Protection and Deposit Insurance (Paper 3 of 4)**

### **Proposal**

- 1 This paper seeks agreement on depositor protection arrangements for inclusion in the proposed Deposit Takers Act (DTA). It is one of four papers on Phase 2 of the Review of the Reserve Bank Act (the Review).

### **Executive Summary**

- 2 In this paper, I am recommending that Cabinet agree to a set of foundational proposals that pave the way to establish a deposit insurance scheme (DIS) for New Zealand.
- 3 My first proposal is that Cabinet agree and confirm its previous in-principle decisions [DEV-19-MIN-0161 and DEV-19-MIN-3046 refers] to establish a DIS, that DIS membership would be compulsory for all licensed deposit-taking institutions (banks, credit unions, building societies, and finance companies eligible to be licensed deposit takers), would be fully funded by levies on member institutions, and would be supported by a government backstop that will enhance the credibility of the DIS's ability to protect depositors.
- 4 My second proposal is that Cabinet agree to increase the coverage limit for deposit insurance from the previous in-principle decision of \$50,000, to \$100,000 (per depositor, per institution). A \$100,000 limit would mitigate risks to stability and liquidity highlighted by small deposit takers in recent consultation, respond to broader concerns raised by stakeholders over two successive rounds of public consultation that a \$50,000 limit was out of step with international norms, increase public confidence in the safety of deposits, and strengthen the commitment of future governments to use resolution tools (knowing that the vast majority of depositors would be fully protected in resolution).
- 5 In addition, I am asking Cabinet to agree to a number of recommendations associated with the design of New Zealand's DIS:
  - 5.1 *Statutory objective* – I am proposing that Cabinet agree to the statutory objective of the deposit insurance scheme to be along the lines of “protecting depositors to the extent that they are covered by the deposit insurance scheme and thereby contributing to financial stability”. This

proposal differs from Cabinet’s previous in-principle decision [DEV-19-MIN-3046] that the objective would be “protecting depositors from loss and in doing so contribute to financial stability”. The objective has been amended to reflect the policy intent that only insured depositors (and not uninsured depositors) are protected by the DIS and that ‘protecting depositors’ also includes ensuring that they receive prompt access to their funds;

- 5.2 *Governance and mandate of the deposit insurer* – I am recommending the role of the deposit insurer be fairly narrow and tied to promptly reimbursing depositors, collecting and managing levies, monitoring risks to the DIS and raising public awareness. I am also recommending that the DIS is located within the Reserve Bank;
- 5.3 *Funding framework* – these are a set of recommendations to ensure funding is available to promptly reimburse depositors in the event of failure and are designed to support public confidence, be cost effective, and provide a predictable and well-understood framework for both deposit takers and the wider public. The centrepiece for this set of recommendations would be the ‘funding strategy’ for the DIS, which the Minister of Finance would be required to publish at least every five years. This document would set out guidance for levies and how the DIS will have adequate funding over time;
- 5.4 *Boundary for eligible products and depositors* – a well-designed scheme needs to clearly set out the rules for defining the level and scope of coverage, so depositors understand which products are (and are not) covered by the DIS. I am recommending that the limit and scope of coverage be set out in primary legislation and that the scheme covers transactional, savings and term deposits. Excluded from this definition are certain retail debt securities such as bonds, debentures and capital notes.

## **Background**

- 6 Deposit insurance is a key feature of almost every financial system safety net in other developed countries. In the absence of a formal scheme, there is greater potential hardship for depositors in the event a deposit taker fails, and a further undermining of financial stability if depositors lose confidence in their deposit taker and decide to rapidly shift their funding (i.e. perpetuate a ‘bank run’).
- 7 Deposit insurance schemes seek to promptly reimburse protected depositors in a failed deposit-taking institution(s), rather than leaving depositors to rely on an insolvency process, which can involve significant delays and uncertainty in the recovery of funds.
- 8 Cabinet has previously agreed in principle [DEV-19-MIN-3046 refers], subject to further policy development, that:

- 8.1 the DIS's objective should be to "protect depositors from loss, and in doing so, contribute to financial stability";
  - 8.2 the maximum amount of coverage for a single depositor at a single institution will be \$50,000;
  - 8.3 membership in the scheme should be compulsory for all licensed deposit-taking institutions;
  - 8.4 the scheme will be fully funded by levies on member institutions;
  - 8.5 the government will provide a funding backstop to enhance the credibility of the scheme, with any funds provided ultimately recouped from member institutions.
- 9 Following these decisions, the Review further consulted on proposals for the DTA. This consultation led to a total of 45 formal submissions, alongside a programme of stakeholder engagement. The consultation, and further analysis by the Review and an Independent Expert Advisory Panel<sup>1</sup>, have informed the additional recommendations in this paper.

### **Deposit insurance coverage limit**

- 10 Cabinet has made an in-principle decision to set the maximum amount of coverage for a single depositor at a single institution at \$50,000 [DEV-19-MIN-3046 refers]. I recommend that Cabinet now agrees to increase the limit to \$100,000, which would fully cover more than 93 percent of depositors in New Zealand. Over the latest two rounds of public consultation in 2019 and 2020, the Review received numerous submissions from stakeholders raising concerns that the proposed \$50,000 limit is too low.
- 11 During the 2020 consultation, a number of small banks, credit unions and building societies, and finance companies (collectively 'small deposit takers') submitted that the introduction of deposit insurance with a \$50,000 limit poses a threat to their stability and liquidity. Small deposit takers suggested that depositors with balances above the \$50,000 limit are likely to seek to mitigate their exposure to loss, resulting in a reallocation of deposits which may disproportionately benefit the major banks. The New Zealand Bankers Association (NZBA) also supported a higher coverage limit.
- 12 The recent feedback is consistent with the feedback received during the 2019 consultation, where the majority of stakeholders suggested that a limit more in line with international norms would improve the ability of deposit insurance to contribute to financial stability. The majority of OECD countries have a coverage limit of approximately NZD \$150,000, while Australia has a significantly higher limit of AUD \$250,000.
- 13 I believe that a \$100,000 limit would mitigate the risks to stability and liquidity highlighted by small deposit takers, respond to the broader concerns raised

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<sup>1</sup> The Independent Expert Advisory Panel is chaired by Suzanne Snively and provides independent advice to me on the recommendations put forward by the Reserve Bank and the Treasury.

by stakeholders, increase public confidence in the safety of deposits and strengthen the commitment of future Governments to use resolution tools. I expect that the increased incentives for risk-taking and the greater contingent liability of the Crown as backstop for the DIS can be mitigated through more intensive supervision of deposit takers and the use of risk-based levies for the scheme.

- 14 I recommend that the coverage limit for the DIS be set in legislation, consistent with guidance from Legislative Design and Advisory Committee, and recognising that any future change to the scope of coverage would have significant impacts on depositors and therefore decisions should be made by Parliament.

### **Depositor preference**

- 15 The Review consulted on whether the introduction of deposit insurance should be supported by an 'insured depositor preference', which would move insured depositors ahead of uninsured depositors and other general unsecured creditors (such as bond holders) in the queue to be repaid if their deposit taker failed. In practice, insured depositor preference acts as a preference (i.e. gives priority) for the DIS, as insured depositors would be reimbursed by the DIS and the DIS would 'stand in the shoes of' insured depositors in a liquidation, giving the DIS a better chance of recovering the cost of reimbursing depositors.
- 16 Implementing insured depositor preference would simplify resolutions that enable insured depositors prompt access to their funds and improve the DIS's recoveries after a deposit insurance payout. However, this would not be without cost. Giving some creditors (e.g. the DIS) a better chance at recovering their money would come at the cost of other creditors having a worse chance at recovering their money. Officials have also advised me that despite the benefits of simplifying resolutions, resolutions can still be facilitated to protect insured depositors without insured depositor preference.
- 17 While public consultation focused on insured depositor preference, I have also considered the merits of introducing a general preference for depositors. This form of preference would effectively improve the safety of uninsured deposits at major banks, by concentrating losses on wholesale creditors such as bond holders. The likelihood of uninsured depositors facing losses in the future will, however, be mitigated by other reforms. The Reserve Bank is introducing substantially higher capital requirements in coming years and will be able to require deposit takers to preposition additional liabilities that could be bailed-in (face losses) ahead of depositors in the event of failure (see the attached paper on crisis management and resolution). Preferring all depositors would also likely result in a larger ongoing increase in wholesale funding costs for deposit takers than under a preference for the DIS, and would place smaller deposit takers at a competitive disadvantage.
- 18 Banks do not support the introduction of a depositor preference, noting that it would have flow on impacts on their funding costs and would potentially fundamentally challenge, or significantly alter, the funding profiles of some

deposit-taking entities. Submitters from the non-bank deposit taking sector noted that, under current legal arrangements, their depositors already have priority over other creditors and that their customers should be left no worse off as a result of decisions on preference.

- 19 I recommend that the status quo is maintained – that depositor preference is not introduced. Although there would be benefits of a preference for the DIS these would ultimately come at the cost of making other creditors worse off. In addition, without insured depositor preference, the costs of introducing deposit insurance would be more likely to fall on those who benefit from the DIS. Deposit takers benefit from more stable funding as a result of the DIS, and would pay for the losses of the DIS through levies over time. Some form of these costs would potentially be passed on to depositors, who benefit from being promptly reimbursed in the event of failure, although the ultimate cost to depositors would depend on the individual pricing decisions of DIS members.

### **Governance and mandate**

- 20 Cabinet previously agreed in-principle that the objective of the DIS be “protecting depositors from loss, and in doing so, contribute to financial stability”. I now propose that Cabinet agree that the objective of the DIS be along the lines of “protecting depositors to the extent they are covered by the deposit insurance scheme and thereby contributing to financial stability”. This proposed wording clarifies that the DIS’s obligation extends only to insured depositors (and not uninsured depositors), and recognises that protecting depositors extends beyond just ensuring they do not face losses on their insured deposits – that is, it also entails providing them prompt access to their deposits.
- 21 I am also recommending that the role of the deposit insurer would be further defined through a statutory purpose along the lines of “to promptly reimburse eligible depositors in a liquidation”, and statutory duties along the lines of to:
- 21.1 release funds outside of a liquidation and payout, subject to safeguards that will be set out in legislation;
  - 21.2 promote public awareness of the DIS;
  - 21.3 monitor the risks of the DIS;
  - 21.4 collect levies; and
  - 21.5 administer, operate and invest the deposit insurance fund.
- 22 These objectives, purposes and duties will provide guidance on the expected role of the deposit insurer, and provide a clear mandate for use of the powers created by the DTA when undertaking this role.
- 23 I propose that the role of the deposit insurer will be narrow to avoid costly duplication of the Reserve Bank’s supervision and resolution roles. Notably, the function of the DIS to promptly reimburse depositors only applies when an entity is placed into liquidation. If other resolution tools are used, the

resolution authority (the Reserve Bank) would be required to protect depositors to the extent they are covered by the DIS, with the intent that depositors have prompt access to their insured deposits (up to the \$100,000 limit). Reflecting this critical role in achieving the objectives of deposit insurance, I am recommending that the DTA should make the resolution authority responsible for protecting insured depositors in non-liquidation resolutions (see the attached paper on crisis management and resolution).

- 24 I recommend that the Reserve Bank can direct the DIS to release funds for resolutions (other than liquidation) for the purpose of protecting insured depositors, provided that the overall contribution of the DIS is expected to be no more than it would have otherwise incurred in liquidation and payout of insured depositors, net of expected recoveries.<sup>2</sup> This proposal would help ensure that regardless of the resolution tool used, depositors will always be protected and have prompt access to their insured deposits. This proposal recognises that non-liquidation resolutions may result in better outcomes for insured depositors, the DIS, and other creditors, and therefore facilitates such options.
- 25 I expect that further decisions around 'safeguards' for use of the DIS's funds in resolutions (other than liquidation) will be made by Ministers under delegation from Cabinet. These further decisions may include tighter restrictions around the contributions the DIS can make to resolutions, procedural and reporting requirements, and any other safeguards to align with guidance from international standard setting body, the International Association of Deposit Insurers.
- 26 I recommend that the DIS be the responsibility of the Reserve Bank Board<sup>3</sup> (rather than a stand-alone entity or part of any other government department or agency) given the relatively narrow focus of the deposit insurer and the synergies with Reserve Bank's wider safety net functions (regulation, supervision, providing liquidity facilities, resolution authority). The Reserve Bank Board will be responsible for the DIS achieving its objective and purpose, and the successful execution of the duties described in paragraphs 20 and 21.
- 27 I recommend that the DTA contain a mechanism for the Reserve Bank to establish a subsidiary for the purpose of carrying out the Reserve Bank's deposit insurance duties that could:

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<sup>2</sup> In a liquidation it is likely that the DIS will need to promptly payout all insured depositors at the failed deposit taker. If for example there were \$1 billion in insured deposits at the failed deposit taker, the DIS would need to pay out \$1 billion initially. However, it is expected that over the course of liquidation the DIS would recover some of those funds as the assets of the failed deposit taker are sold, but this can take some time. If for example the DIS recovers \$800 million over time, then the long-run cost would be \$200 million. This proposal would allow the DIS to contribute upfront the initial \$1 billion provided it expected to recover the remaining \$800 million during the course of the resolution.

<sup>3</sup> A new governance Board is to be established through the Reserve Bank of New Zealand Bill, currently before the House.

- 27.1 hold funds of the DIS that would be used for payout;
  - 27.2 make recoveries from the assets of a failed deposit taker (along with the associated legal right); and
  - 27.3 undertake any other duties delegated to it by the Board (for example, making the actual payment to depositors).
- 28 The establishment of the subsidiary would allow for a clear delineation between the balance sheets of the DIS and the Reserve Bank, and mitigate the risk that the Reserve Bank itself is drawn into disputes or litigation associated with the operational functions of the DIS.

### **Funding framework**

- 29 I am proposing a range of measures relating to a funding framework, which has been designed to support public confidence, be cost effective, and to provide a predictable and well understood framework for deposit takers and the wider public.
- 30 I recommend that Cabinet confirm its in-principle decisions that the DIS be fully funded by levies on member deposit takers with a Crown backstop [DEV-19-MIN-3046 refers]. In addition, I propose that levies will be set by Order in Council on recommendation of the Minister of Finance.
- 31 The provision of a backstop means that the Crown would commit to provide funds to support prompt reimbursement of depositors if the Deposit Insurance Fund (see below) is insufficient to meet the reimbursement requirements. Any Crown provision of funds would be repaid by the DIS, with interest, through DIS levies on deposit takers and recoveries made from the assets of the failed deposit taker, ensuring that any losses faced by the DIS, over time, would not be borne by the taxpayer.
- 32 I recommend that a Deposit Insurance Fund (DIF) managed by the DIS is established in legislation and would be comprised mainly of levies collected from DIS members. It would also include income from investments of the DIF and any recoveries from the assets of failed deposit-taker(s). This approach would give the public confidence that levies are being used consistently with the purpose of the scheme and would demonstrate clearly to the public that the costs of the DIS are fully funded by deposit takers. The DIF can also be used to support public confidence in the ability of the scheme to reimburse depositors, by providing a ready source of funds that can be drawn on without recourse to the Crown backstop.
- 33 To support the transparency of the DIS, I propose that the Minister of Finance publish a funding strategy for the DIS every five years. The requirement is based on a similar statutory requirement that exists with respect to the Accident Compensation Corporation.
- 34 I consider the funding strategy is a key component to promote public confidence in the DIS. The funding strategy should disclose financial



information from a whole-of-Crown perspective, including the projected costs of the DIS and how the DIS will have sufficient funding to meet its objectives. The funding strategy should be required to set out risks to the DIS, guidance for levy setting, the approach to management of the DIF, and how the Crown's role as backstop to the DIS will be managed. I propose the DIS must act consistently with the funding strategy when carrying out its duty to administer and manage the investments of the Deposit Insurance Fund.

- 35 Under my proposal, the funding strategy would provide significant flexibility to adapt a funding model that is sustainable over time despite financial system changes. I propose that this flexibility be balanced with transparency and consultation requirements including that the Minister of Finance consult with the public and the Reserve Bank in developing the funding strategy and that the said strategy be published, including any advice received on it.
- 36 To support the transparency and consistency of the overall funding framework I recommend that the legislation provide a set of broad considerations that the Minister of Finance must "have regard to" when setting the funding strategy and levies. The intent is to allow the Minister of the day discretion to allocate levies across deposit takers and over time, based on how they weight these criteria. To this end, I propose the Ministerial considerations include:
- 36.1 the DIS should be funded by industry over time;
  - 36.2 the financial position of the Crown;
  - 36.3 that the levies reflect the amount of claims made or likely to be made by a licensed deposit taker or class of licensed deposit taker;
  - 36.4 the stability of licensed deposit takers or a class of licensed deposit takers;
  - 36.5 the desirability of consistency and predictability in levies.
- 37 The intent of these considerations is that they are not exhaustive and allow the Minister of Finance to take into account other matters besides those mentioned above, provided they are clearly explained in the funding strategy. I propose the Minister must also have regard to the funding strategy and the published advice of the DIS when setting levies.
- 38 In the unlikely event that a larger deposit institution(s) fails, there may be a large call on the Crown backstop. In these circumstances, raising the required funds within the time needed to reimburse depositors promptly, may be more challenging and costly than a planned, managed, and incremental increase in the government's borrowing programme. As such, I expect that liquidity arrangements between the Crown and the Reserve Bank will be prepositioned to support the temporary liquidity needs of the Crown. I expect that the terms and conditions for provision of liquidity will be prepositioned at the time the funding strategy is developed.

- 39 I expect that the funding strategy would be developed in the lead up to implementation of the DIS. The setting of the funding strategy would have financial implications for the Crown and there would be options for how these financial implications are managed. Internationally, some governments and DISs have set target funds (a desired amount of funding to be accumulated in a deposit insurance fund to be used as the first port of call for a deposit insurance payout). Some governments have also provided an initial repayable capital contribution to support the establishment of a DIS. I recommend that the Minister of Finance report back to Cabinet on the funding strategy, prior to the setting of the first funding strategy.

### **Scope of coverage**

- 40 Clear and well understood rules defining the level and scope of coverage are critical for ensuring that depositors know which products are (and are not) covered by the DIS so that they can arrange their financial affairs accordingly.
- 41 I recommend that the scope of products covered by the DIS be set in legislation, consistent with guidance from Legislative Design and Advisory Committee, and recognising that any future change to the scope of coverage would have significant impacts on depositors.

### *Scope of products covered by the DIS*

- 42 I recommend that the DIS covers transactional, savings and term deposits currently offered by registered banks, and the equivalent products offered by non-bank deposit takers. These products are widely held by everyday New Zealanders and are more likely than other products to destabilise the financial system if they are subject to a 'run' by their depositors.
- 43 These products also represent a boundary for deposits that is both familiar to depositors and that deposit takers can readily measure. Transactional accounts provide critical services to the economy, while savings and term deposits are widely held products used by New Zealanders as a savings vehicle. Making these products eligible for deposit insurance is consistent with the wider financial system regulatory framework, such as the Financial Markets Conduct Act 2013, where many of these products are exempt from product disclosure requirements due to their low risk and low complexity.
- 44 Under my proposal, a clear and consistent boundary would be defined between these insured products and other retail debt securities, such as bonds, debentures and capital notes, which I propose not to be eligible. Excluding these other types of debt securities from the DIS would still allow for the continued existence of higher risk and return debt products that can be offered to retail investors.
- 45 I propose that there will be restrictions around how financial service providers use the word "deposit" when marketing uninsured products, to support a clear and well understood boundary. I have asked officials to work with the Ministry of Business, Innovation and Employment and the Financial Markets Authority on the consequential amendments that would need to be made to the

Financial Markets Conduct disclosure regime prior to implementation of the DIS to disclose the boundary and risks of insured and uninsured products.

- 46 Given the dynamic landscape of the financial system, I propose that the Minister of Finance be able to bring products within the scope of the DIS via regulation provided that they are substantially the same as other products covered by the DIS. This proposal would support the durability of the legislative boundary over time.

#### *Scope of depositors covered by the DIS*

- 47 I recommend that the following eligibility rules would be set through primary legislation:
- 47.1 amounts held in joint accounts at a single institution are split equally across account holders and count towards eligible deposits, up to the coverage limit for each depositor at that institution. This applies the principle of per depositor, per institution coverage to this widely held product;
- 47.2 I propose that financial institutions, related parties of DIS members, large non-financial corporates and government bodies would be ineligible DIS coverage, in order to avoid the DIS weakening the incentive for these more sophisticated groups to monitor the risk-taking of their deposit taker. I also propose that foreign currency deposits are excluded.
- 48 I recommend that detailed eligibility rules are established via regulations set by Order in Council. Such rules would include the treatment of trusts, sole proprietors, unincorporated and incorporated societies, partnerships and custodians.

#### **Other matters**

- 49 I am also proposing several technical recommendations to support the functioning of the DIS. I propose that:
- 49.1 the deposit insurer have the right to 'stand in the shoes' of insured depositors (the right of subrogation) once the deposit insurer has reimbursed them. This will be based on similar provisions contained in the Crown Retail Deposit Guarantee Scheme Act 2009. This ensures that the deposit insurer can rely on the rights of insured depositors which have been reimbursed and enforce those rights itself, for example making recoveries on the assets of a failed deposit taker;
- 49.2 the DTA provide when eligible depositors become entitled to a payout from the deposit insurance scheme, and that the latest point at which depositors will become entitled will be when a deposit taker is placed into liquidation. I expect to make further decisions on timing of entitlements under delegation (see the attached Overview paper) as

more detailed policy aspects of crisis management and deposit insurance are developed;

- 49.3 the Insurance (Prudential Supervision Act) 2010 will not regulate (or impose licensing requirements on) the deposit insurance scheme, the Crown, the Treasury, the Reserve Bank as deposit insurer or any Reserve Bank subsidiary established for the purposes of operating/administering the scheme.

## Next Steps

- 50 Should Cabinet agree to the proposals in this paper and accompanying papers, I expect that the DIS provisions of the Bill would commence prior to the full commencement of the Deposit Takers Bill, with a target timeframe of 2023. The implementation of the Deposit Takers Act will be a multi-year process and there will be substantial work to develop the new prudential framework. Officials have advised that the full commencement of the Deposit Takers Act should not occur until around 2026/27.
- 51 Commencing the deposit insurance provisions ahead of the full commencement of the Deposit Takers Bill should be a matter of priority to ensure depositor protection arrangements are in place should a deposit taker come under stress in the near-term.
- 52 However, there are risks to early implementation of the DIS, before the Reserve Bank has fully developed a new prudential regime that takes into account the existence of deposit insurance and developed the operational infrastructure for the DIS. These risks include that a deposit taker may rapidly grow its insured deposit book through offering high returns and subsequently make high-risk loans that could result in its failure. In addition, the ability for DIS to identify eligible depositors and promptly reimburse depositors in the event of failure may be limited initially.
- 53 Officials have advised me that the above risks, to an extent, can be managed through existing prudential requirements, the possibility for further controls on risk-taking during the transition period as a condition of being able to offer insured deposits, and planning for the necessary operational infrastructure ahead of 2023. I have asked officials for advice on options for limiting the likelihood of higher risk-taking during the transitional period and to inform me of any significant operational risks that may arise in implementing deposit insurance by 2023.
- 54 There are a number of detailed issues that still need to be identified and progressed before legislation can be introduced. These include second order issues such as:
- 54.1 transitional arrangements to enable the DIS to be in place prior to the full commencement of the DTA;
- 54.2 how the funding strategy will work in practice and the exact scope;

- 54.3 powers necessary to make payout and related provisions;
- 54.4 process requirements for setting levies;
- 54.5 process requirements for setting the deposit insurer's operational budget and related budgetary oversight mechanisms;
- 54.6 further detail on triggers for activating the scheme;
- 54.7 further detail on safeguards for use of the deposit insurer's funding in resolution, and associated process requirements;
- 54.8 transparency and reporting requirements for the DIS and the Deposit Insurance Fund;
- 54.9 detailed definitions of depositor and deposit exclusions;
- 54.10 whether to provide scope to extend higher coverage to certain parties that have temporarily high balances (e.g. a person who has recently sold a house or a person who has recently received a life insurance payout).

## **Financial Implications**

- 55 Implementing a formal DIS with a Crown backstop will have financial implications. While the DIS will be fully funded by industry levies over time, there will be ongoing revenue implications for the Crown. The quantum of the levies on an annual basis is uncertain at this time, given that the Minister of Finance will determine the strategy for levies through the funding strategy, which will be issued around the time the DIS commences.
- 56 In relation to expenses, as it becomes likely that a deposit taker will fail and therefore call on the DIS, the DIS will need to reflect the likely cost of that failure on its balance sheet (i.e. the total exposure less expected recoveries). Should the DIS's assets be insufficient to cover the cost of a payout, then the Crown will be required provide funds through the backstop. Should Cabinet agree to the recommendation that the DIS be fully funded by industry over time, then the DIS (and the Crown) would recover the costs of any failure over time through industry levies.
- 57 However, the larger the call on the Crown, the more likely it will be that the time to recover any funds is prolonged (e.g. if a major bank failed). It is likely, given the DIS's design, that the fiscal risk that the Crown will suffer losses from the Scheme (operating balance impact) is likely to be remote, but the fiscal risk that there will be a liquidity impact on the Crown if claims were made (debt risk) will be somewhat higher.
- 58 In addition, the decisions in this Cabinet paper will have direct financial implications for the Reserve Bank as the deposit insurer. This would include, for example, operating expenses to support the Reserve Bank to execute the duties of the DIS. There would also be operating expenses and capital expenditure related to establishing and maintaining pay-out infrastructure.

- 59 The costs incurred by the Reserve Bank in carrying out its deposit insurance function are expected to be met through levies on industry. The process for setting the DIS's operational budget will be decided under delegation. As such, the costs are sufficiently uncertain at this time, as is the process for recovering these costs from industry, which will be determined around the time the funding strategy is set.

### **Legislative Implications**

- 60 The recommendations in this package of Cabinet papers will be given effect by the Deposit Takers and Depositor Protection Bill, which has a category 4 priority on the 2021 Legislation Programme (to be referred to select committee in 2021).
- 61 The Deposit Takers and Depositor Protection Act will bind the Crown.

### **Regulatory Impact Analysis**

- 62 See Cabinet Paper 1: Overview for the Quality Assurance Panel's (comprising representatives from the Reserve Bank of New Zealand, the Treasury and the Regulatory Impact Analysis Team at the Treasury) assessment of the attached Regulatory Impact Statement against the Quality Assurance criteria. The Panel considers that the Regulatory Impact Statement for the reforms in this Cabinet paper **meets** the Quality Assurance criteria.

### **Human Rights**

- 63 My officials will be working with the Ministry of Justice to ensure that any concerns relating to the New Zealand Bill of Rights Act are addressed.

### **Consultation**

- 64 The following agencies were consulted on the contents of this package of Cabinet papers: the Ministry of Business, Innovation and Employment; the Financial Markets Authority; Parliamentary Counsel Office; Inland Revenue; and the Ministry of Justice. The Department of the Prime Minister and Cabinet has also been informed.
- 65 Three rounds of public consultation have taken place as part of Phase 2 of the Review. The first round closed in January 2019 and received 67 submissions. A second round of consultation closed in August 2019 and received 45 submissions. The third consultation closed in October 2020 (following a six-month extension to the original deadline for submissions due to COVID-19). This consultation received 45 written submissions on the detailed design aspects of a new prudential regime for deposit takers and the introduction of deposit insurance.

### *Views of the Independent Expert Advisory Panel*

- 66 The joint Treasury-Reserve Bank Review team has been supported throughout Phase 2 by an Independent Expert Advisory Panel (the Panel) chaired by Suzanne Snively. The Panel's views are provided in Paper 1.

## **Communications**

- 67 I recommend that Cabinet decisions, the package of Cabinet papers and related material will be publicly released on the Treasury and Reserve Bank websites shortly after decisions are made.
- 68 In addition, I plan to announce some of the key decisions shortly after the Cabinet meeting, and the timeframe for the implementation of deposit insurance.

## **Recommendations**

- 69 The Minister of Finance recommends that the Committee:
- 1 note Cabinet has previously agreed in-principle [DEV-19-MIN-0161] to establish a depositor insurance scheme with a coverage limit in the range of \$30,000 - \$50,000;
  - 2 note Cabinet has previously agreed in-principle [DEV-19-MIN-0346], subject to further policy development, that:
    - 2.1 the deposit insurance scheme's objective should be to "protect depositors from loss, and in so doing, contribute to financial stability";
    - 2.2 the maximum amount of coverage for a single depositor at a single institution will be \$50,000;
    - 2.3 membership of the scheme should be compulsory for all licensed deposit-taking institutions;
    - 2.4 the scheme will be fully funded by levies on member institutions;
    - 2.5 the government will provide a funding backstop to enhance the credibility of the scheme, with any funds provided ultimately recouped from member institutions;
  - 3 note that recommendations to confirm or modify these decisions are below;
  - 4 agree to confirm Cabinet's previous in-principle decision to establish a deposit insurance scheme;

## *Governance and decision-making*

- 5 agree that the statutory objective of the deposit insurance scheme will be along the lines of "protecting depositors to the extent that they are covered by the deposit insurance scheme, and thereby contributing to financial stability";

- 6 agree that there will be a statutory purpose for the deposit insurance scheme along the lines of “to promptly reimburse eligible depositors in a liquidation”;
- 7 agree that the deposit insurer will be responsible for carrying out the statutory purpose, and will have statutory duties along the following lines:
  - 7.1 to release funds outside of a liquidation and payout subject to safeguards that will be set out in legislation;
  - 7.2 to promote public awareness;
  - 7.3 to monitor risks to the deposit insurance scheme;
  - 7.4 to collect levies; and
  - 7.5 to administer, operate and invest the deposit insurance fund;
- 8 agree that the Reserve Bank will be the deposit insurer;
- 9 agree that the Deposit Takers Act will allow the Reserve Bank to establish a subsidiary under its ownership and control for the purpose of operating and/or administering the deposit insurance scheme;
- 10 agree that the permitted role of any subsidiary in the deposit insurance scheme is likely to include:
  - 10.1 managing any funds to be used for the purpose of paying out eligible depositors;
  - 10.2 holding and enforcing rights of subrogation acquired as a result of deposit insurance pay outs;
  - 10.3 undertaking other duties relating to the deposit insurance scheme delegated to it by the Reserve Bank, such as making payment to eligible depositors;

### *Funding*

- 11 agree to confirm Cabinet’s in-principle decision that the deposit insurance scheme will be fully funded by levies on member institutions (i.e. licensed deposit takers);
- 12 agree that the Deposit Takers Act will require the Minister of Finance to publish a Statement of Funding Approach (funding strategy) for the deposit insurance scheme;
- 13 agree that the funding strategy will include information along the following lines:
  - 13.1 risks to the deposit insurance scheme;



- 13.2 guidance for levy setting;
  - 13.3 guidance for the management of the deposit insurance fund;
  - 13.4 liquidity sources for the deposit insurance scheme; and
  - 13.5 how the Minister intends to manage the Crown's exposure under the scheme;
- 14 agree that the funding strategy must be published at least every five years and, in setting the funding strategy, the Minister of Finance must consult the public and have regard to the advice of the Reserve Bank and the Treasury;
  - 15 agree that levies for the deposit insurance scheme will be set by regulations made by Order in Council on the advice of the Minister of Finance and, in giving that advice the Minister must follow the funding strategy and have regard to published advice of the Reserve Bank;
  - 16 agree that in setting the funding strategy and levies for the deposit insurance scheme, the Minister of Finance will be required to take into account certain considerations;
  - 17 agree that the considerations in 16 will include matters along the following lines:
    - 17.1 the deposit insurance scheme should be funded by industry over time;
    - 17.2 the financial position of the Crown;
    - 17.3 that the levies reflect the amount of claims made or likely to be made by a licensed deposit taker or a class of licensed deposit taker;
    - 17.4 the stability of licensed deposit takers or a class of licensed deposit takers; and
    - 17.5 the desirability of consistency and predictability in levies;
  - 18 agree that the Deposit Takers Act will establish a deposit insurance fund that will capture levies collected from licensed deposit takers;
  - 19 agree that the Reserve Bank will administer, operate and invest the Deposit Insurance Fund consistently with the funding strategy;
  - 20 agree that if the balance of the deposit insurance fund is not sufficient to meet deposit insurance scheme payment obligations, the Crown will provide the required funding to the deposit insurer to satisfy those deposit insurance scheme payment obligations;
  - 21 agree that shortfalls in funding can be recovered through future levies;

- 22 note that the Reserve Bank has agreed to provide liquidity to the Crown to support a rapid payout of deposit insurance to eligible depositors, in certain circumstances, and that this role will be prepositioned ahead of the implementation of the deposit insurance scheme;
- 23 note that the policy intention of 22 is that any risk arising from liquidity provided by the Reserve Bank to the Crown under the arrangements noted directly above, will be borne by the Crown;
- 24 agree the funds of the deposit insurance scheme may be released by the Reserve Bank for the purpose of protecting insured depositors in resolution (outside of a liquidation and payout), subject to safeguards that will be set out in legislation;
- 25 agree that safeguards will provide that the overall contribution of the deposit insurance scheme is expected to be no more than it would otherwise have expected to incur in a liquidation and payout of insured depositors, net of expected recoveries;
- 26 agree that there will be other safeguards for the release of funds of the deposit insurance scheme (outside liquidation and payout), with decisions to be made under delegated authority;

#### *Scope of coverage*

- 27 note the Reserve Bank and the Treasury provided advice to the Minister of Finance in December on the coverage limit in response to stakeholder feedback and that the Minister agreed to recommend to Cabinet that this be increased from \$50,000 to \$100,000 per eligible depositor, per licensed deposit taker;
- 28 agree that the deposit insurance coverage limit for the deposit insurance scheme be set at \$100,000 per eligible depositor, per licensed deposit taker;
- 29 agree that membership of the scheme will be compulsory for all licensed deposit takers;
- 30 agree that changes to the deposit insurance coverage limit will require parliamentary approval;
- 31 agree that the eligible products covered by the scheme will be transactional, savings and term deposits currently offered by registered banks and the equivalent products offered by non-bank deposit takers;
- 32 agree that the Deposit Takers Act provide for regulations to be made by Order in Council on the advice of the Minister of Finance to add eligible products for deposit insurance that are of the same or substantially similar economic substance as those specified in the Deposit Takers Act;
- 33 agree that deposits held by financial institutions, related parties of scheme members, large non-financial corporates, government bodies and foreign

- currency deposits be excluded from coverage by the scheme and that this exclusion will be set out in the Deposit Takers Act;
- 34 agree that a person's share of jointly held eligible products should count towards that person's individual claim on the deposit insurance scheme (up to the \$100,000 limit for each individual depositor) and that this should be in the Deposit Takers Act;
- 35 agree that regulations to deal with how eligibility applies to other types of ownership structures (e.g. trusts and partnerships) may be made by Order in Council on the advice of the Minister of Finance;
- 36 agree that there will be restrictions applying to all financial service providers around the use of the word "deposit" and substantially similar terms to ensure confident and informed participation of business, investors and consumers when dealing with products offered by deposit takers;
- 37 agree that consequential amendments to the Financial Markets Conduct Act 2013 and Regulations, including disclosure requirements, be made (under delegated authority or subsequently) where required as a result of the deposit insurance proposals, and that these will be developed ahead of the implementation of the deposit insurance scheme;
- 38 agree that Deposit Takers Act will provide when eligible depositors become entitled to a payout from the deposit insurance scheme and the policy intent is that the latest this will occur is the time a licensed deposit taker is placed into liquidation;
- 39 agree that the Deposit Takers Act provide that the deposit insurer will have a right of subrogation to the extent of any payout to an eligible depositor, and these provisions will be based on similar provisions contained in the Crown Retail Deposit Guarantee Scheme Act 2009;
- 40 agree that the Insurance (Prudential Supervision Act) 2010 will not regulate (or impose licensing requirements on) the deposit insurance scheme, the Crown, the Treasury, the Reserve Bank as deposit insurer or any Reserve Bank subsidiary established for the purposes of operating/administering the scheme;

#### *Next steps*

- 41 invite the Minister of Finance to report back to Cabinet on the first funding strategy to be published under the Deposit Takers Act, prior to the funding strategy being published.

Authorised for lodgement

Hon Grant Robertson

Minister of Finance