The Treasury

Additional Documents Related to Phase 2 of the Reserve Bank Act Review - December 2019 to April 2021 - Proactive Release

June 2021

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Key to sections of the Act under which information has been withheld:

[7] 6(e)(ii) - to prevent serious damage to the economy of New Zealand by disclosing prematurely decisions to change or continue government economic or financial policies relating to the regulation of banking or credit

[27] 9(2)(ba)(ii) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely otherwise to damage the public interest

[29] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment

[36] 9(2)(h) - to maintain legal professional privilege

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RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

TE TAI ŌHANGA
THE TREASURY

Report: RBNZ Act Review - Draft Cabinet Papers: Deposit Takers Act

Date:	18 March 2021	**Report No:**	T2021/645
		File Number:	MC-1-7-3-1-13

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Provide** feedback on the draft suite of Cabinet papers **Note** the changes made to the draft Cabinet recommendations provided to you 25 February [T2021/313] **Indicate** whether you wish to discuss this report further with officials	By 22 March 2021

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Chris Hunt	Advisor, Reserve Bank Act Review – Phase 2	[39]	✓
Tamiko Bayliss	Review Director, Reserve Bank Act Review – Phase 2	[35]	

Minister's Office actions

Return the signed report to Treasury.

Enclosure: Yes – draft Cabinet papers on policy decisions relating to the Reserve Bank Review Deposit Takers Act, and a draft Regulatory Impact Assessment.

Report: RBNZ Act Review – Draft Cabinet Papers: Deposit Takers Act

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Recommended Action

We recommend that you:

a **note** that a draft set of Cabinet recommendations on a new prudential framework for deposit takers and the introduction of deposit insurance was provided to you on the 25 February for your initial feedback [T2021/313].

b **note** that this set of draft recommendations has been subsequently structured into four separate draft Cabinet papers (attached), for your consideration and feedback.

c **note** the enclosed working draft of the Regulatory Impact Assessment, which will summarise the Reserve Bank's advice (as advising agency / proposed administrator of the Deposit Takers Act) on the impact of the regulatory proposals.

d **note** the changes made to some of the draft Cabinet recommendations based on your recent decisions in the following areas:

  i. a statutory provision that the Reserve Bank inform you of key policy changes;

  ii. the scope of appeal rights for parties affected by Reserve Bank decisions;

  iii. aspects of the deposit insurance framework including depositor preference.

e **note** we are still awaiting your decision on the permitted scope of regulations pertaining to 'macro-prudential' lending standards, and on the process for setting this regulation.

f **note** that you previously agreed to a limited set of exclusions from the deposit insurance scheme and sought further advice on additional exclusions.

g **agree** that large non-financial corporates and government should be excluded from deposit insurance coverage.

Agree/disagree

h **note** the additional exclusions would increase alignment with the principle that only retail depositors (and entities with similar characteristics) should be eligible but would increase the cost of implementing the scheme.

i **agree** to the following further changes to the draft recommendations based on additional policy work from the Review team:

i. the Reserve Bank will administer, operate and invest the Deposit Insurance Fund consistent with the funding strategy.

Agree/disagree

ii. the Reserve Bank will be able to release funds of the deposit insurance scheme (and the deposit insurance scheme will have a corresponding duty) for use in non-liquidation resolutions, subject to safeguards set out in legislation.

Agree/disagree

iii. there will be a safeguard requiring 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.

Agree/disagree

iv. amend the objective of the deposit insurance scheme to “protecting depositors to the extent they are covered by the deposit insurance scheme and thereby contribute to financial stability”.

Agree/disagree

v. restrictions around the use of the word ‘deposit’ (and substantially similar terms) will apply to all financial service providers.

Agree/disagree

vi. more flexibility provided for further work on when eligible depositors will become entitled to reimbursement from the deposit insurance scheme.

Agree/disagree

vii. the deposit insurance scheme will not be considered an ‘insurer’ for the purposes of the Insurance (Prudential Supervision) Act 2010.

Agree/disagree

viii. an additional resolution authority objective to protect depositors to the extent they are covered by the deposit insurance scheme.

Agree/disagree

ix. whether insured deposits should be subject to bail-in will be finalised under delegated authority after further advice related to the implications of the decision not to introduce depositor preference, noting that they will in any case be protected by the insurance scheme.

Agree/disagree

x. the DTA will include powers and technical provisions for the resolution of licensed deposit takers based on the statutory management provisions in the Reserve Bank Act 1989 as reviewed, adapted and appropriately modified under delegated authority.

Agree/disagree

xi. the DTA will include a moratorium on creditor enforcement actions based on section 122 of the Reserve Bank Act 1989 with further decisions on the nature of the moratorium (such as duration and process) to be made under delegated authority.

Agree/disagree

xii. the DTA will clarify the legal status of payment instructions on a licensed deposit taker's entry into resolution, with further technical decisions on how to achieve this to be made under delegated authority.

Agree/disagree

j **note** that we seek feedback on the draft Cabinet papers by 22 March so that we can provide revised draft Cabinet papers and a Regulatory Impact Assessment for ministerial and agency consultation, and a final Cabinet paper and regulatory impact assessment on 7 April for a DEV meeting on 14 April.

Tamiko Bayliss
Review Director, Reserve Bank Act Review – Phase 2

Hon Grant Robertson
Minister of Finance

Report: RBNZ Act Review – Draft Cabinet Papers: Deposit Takers Act

Purpose of Report

1. This report provides you with draft versions of a set of Cabinet papers on the foundational aspects of a new prudential regime for deposit takers and the introduction of deposit insurance, and a working draft of the supporting Regulatory Impact Assessment. Cabinet decisions will inform the drafting of a new Deposit Takers Bill which we anticipate will be introduced into the House late this year.
2. This report identifies relevant changes to the draft set of Cabinet recommendations provided to you on 25 February, based on your decisions on several split recommendations in that advice, and arising from other subsequent policy decisions.
3. In addition, this report describes the implementation pathway for the Deposit Takers Act, with a focus on the timeframes for implementation of the deposit insurance scheme.

Background

4. On 25 February, you were provided with a set of draft Cabinet recommendations on a new Deposit Takers Act (DTA) [TR2021/313]. This joint Treasury-Reserve Bank advice contained close to 200 recommendations on a new prudential framework for deposit takers and the introduction of deposit insurance, and is part of the broader Phase 2 Review of the Reserve Bank of New Zealand Act 1989.
5. This advice contained two split recommendations on:
   - a the merits of a statutory provision requiring the Reserve Bank to *inform* you as Minister of Finance of key policy changes;
   - b the appeal rights afforded to parties impacted by prudential decisions of the Reserve Bank.
6. You indicated your comfort with the suite of recommendations and agreed:
   - a with the Treasury preferred approach that there should be a statutory inform provision in the DTA;
   - b with the Reserve Bank preferred approach that decisions by the Reserve Bank that are tied to conditions of licence should be limited to appeals on questions of law, and that decisions in relation to enforcement will be limited to judicial review only.

7. The joint report also indicated that officials would provide you with additional advice on:

   a depositor preference and other design elements of the deposit insurance scheme (DIS);

   b the permitted scope of a proposed regulation-making power in relation to ‘macro-prudential’ lending standards.

8. A follow-up joint report on the DIS was sent to you 4 March [T2021/460]. The section below outlines your subsequent decisions and further amendments to the deposit insurance recommendations proposed by the Review.

9. A follow-up joint report on the permitted scope of regulations, with respect to lending standards, was sent to you 11 March [T2021/518]. We are awaiting your decisions in this area and will make amendments to the Cabinet advice once this is received.

Format of the Cabinet advice

10. Given the large number of proposals associated with the new prudential framework for deposit takers and deposit insurance, we have organised your recommendations to Cabinet into four separate papers:

    a **Paper 1: Overview** – this paper provides a high-level summary of the scope of recommendations in the three accompanying decision papers and outlines your role as Minister of Finance in the new prudential framework. This paper has a small number of recommendations that sit across all three decision papers, including general delegations for follow-up decisions.

    b **Paper 2: The framework for the regulation and supervision of deposit insurance** – this paper provides a set of recommendations around the regulation and supervision of deposit takers. This set of recommendations focusses on:

       i the purposes for the DTA and decision making principles;

       ii the regulatory perimeter for the single licensed ‘deposit taker’ regime;

       iii the prudential framework for setting prudential standards and licensing;

       iv enhancements to the accountability framework for directors of deposit takers;

       v the suite of supervisory and enforcement tools available to the Reserve Bank; and,

       vi the appeal rights afforded to affected parties impacted by prudential decisions of the Reserve Bank.

    c **Paper 3: Deposit insurance** – this paper details your recommendations around whether to introduce a preference for depositors, and the design elements of a formal scheme to protect depositors from loss, including the coverage limit, governance, funding arrangements and the insured product boundary.

d **Paper 4: Crisis management and resolution** – this paper provides your recommendations to strengthen New Zealand's crisis management framework. The recommendations here will provide a clear mandate for the Reserve Bank as New Zealand's resolution authority, and equip it with a suite of powers to manage a deposit taker in distress.

11. The proposed format of this Cabinet advice reflects the complexity and magnitude of the Phase 2 Review process, and the once in 30 years' opportunity to redesign the prudential framework and financial safety net. Splitting the recommendations into three substantive decision papers will also enable your colleagues to focus on those areas of most interest to them, whether that be deposit insurance, crisis management, or other parts of the new framework.

Changes to draft Cabinet recommendations

12. The following section identifies the changes we have made to the draft set of Cabinet recommendations we initially provided you on 25 February. We focus on changes that reflect policy development and key decisions taken, rather than minor amendments to the wording of the recommendations.

Paper 2: The framework for the regulation and supervision of deposit takers

13. The key changes to the recommendations in this paper are:

a a recommendation to reflect your decision to have a statutory requirement for the Reserve Bank to inform you of key policy changes;

b recommendations to reflect your decisions on the scope of appeal rights with respect to conditions of licence (limited to appeals on the matter of law), and the Reserve Bank's enforcement decisions (limited to the inherent right of judicial review).

14. Note there is a placeholder in this Cabinet paper for your decision on the scope of regulations with respect to lending standards and the process for setting this regulation.

Paper 3: Deposit insurance

15. Following your decisions on funding arrangements and depositor preference [T2021/460 refers] officials have included the following recommendations in the Cabinet paper on deposit insurance:

a a recommendation that the Deposit Insurance Fund (DIF) will be managed by the deposit insurer;

b a recommendation that funds of the deposit insurance scheme can be drawn on for the purpose of protecting insured depositors in resolutions (outside of liquidation);

c a recommendation that there are no changes to the creditor hierarchy relative to the status quo (i.e. no form of 'depositor preference').

16. Officials have included a recommendation that the Reserve Bank (as deposit insurer) must act consistently with the funding strategy set by the Minister of Finance when carrying out its duty to invest and manage the DIF. This recommendation supports the role of the funding strategy, which will cover how, from a whole-of-Crown perspective, the deposit insurance scheme will have adequate funding over time to support the objectives of the deposit insurer.

17. Officials have added to the recommendation in 14(b) above to clarify that the Reserve Bank will control the release of the funds of the deposit insurance scheme in non-liquidation resolutions, subject to safeguards set out in legislation. This change ensures that the Reserve Bank is able to fulfil its objective to protect depositors covered by the scheme during non-liquidation resolutions (see below).

18. Officials have also included a recommendation that the expected overall contribution to non-liquidation resolutions in 14(b) above be limited to no more than what the deposit insurer would have expected to face in a liquidation net of expected recoveries. This ensures that the deposit insurance scheme's liability is limited and that levies are being used for a proper purpose. In addition, this restriction is broadly in line with guidance from the International Association of Deposit Insurers.

19. Officials have amended the recommendation that the restrictions on the use of the word 'deposit' such that the restriction applies to all financial service providers rather than just licensed deposit takers. This has been amended to fit with the policy intent of creating a clear and distinct boundary between insured and uninsured products across the financial system.

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". Officials propose that this be revised to "protecting depositors to the extent they are covered by the deposit insurance scheme and thereby contributing to financial stability". This would clarify that the DIS's obligation extends only to insured depositors (and not uninsured depositors) and recognise that protecting depositors entails providing them prompt access to their deposits. Officials also propose to elevate the duty to "promptly reimburse depositors in a liquidation" to a purpose of the deposit insurer.

21. Officials have also included three technical recommendations to support the drafting of the Deposit Takers Bill:

a recommendation that the deposit insurance scheme will not be considered an 'insurer' for the purposes of the Insurance (Prudential Supervision) Act 2010;

b providing more flexibility for further work on when eligible depositors will become entitled to reimbursement from the deposit insurance scheme. The general intent is that the latest point at which depositors will become eligible will be when a licensed deposit taker is placed into liquidation, and officials will provide you with further advice on details relating to the timing of entitlements as they develop policy on reimbursement processes.

Paper 4: Crisis management and resolution

22. The decision not to introduce depositor preference [T2021/460 refers] means the treatment of insured depositors in a statutory bail-in requires further consideration. Insured depositors should get prompt access to their deposits in a bank resolution irrespective of how that resolution is conducted, but there are multiple ways this can be achieved. We will provide further advice on whether insured deposits should be subject to bail-in and recommend decisions to be taken under delegated authority.

23. The other key changes to the recommendations in this paper are:

    a Resolution authority to have an additional resolution objective along the lines of protecting depositors to the extent they are covered by the deposit insurance scheme. This objective was included in the original second public consultation. Following further work on the linkages between objectives and the selection of resolution strategies, we believe it would be desirable that the Reserve Bank is required to consider what might be best for insured depositors when faced with a choice between liquidation or, for example, a transfer of insured deposit accounts to another entity;

    b Parliamentary Counsel Office (PCO) has suggested that we use slightly broader language in describing the conditions around the Reserve Bank's power to issue directions by adding 'or desirable' to the existing 'necessary' qualification, so that the conditions would be where something is 'necessary or desirable';

    c We have included a recommendation that significant powers currently available to a statutory manager be carried over to the Reserve Bank. This is in line with Cabinet's December 2019 in-principle decision that, where practicable, existing statutory management powers be available directly to the Reserve Bank. Various existing technical supporting provisions require further review. We propose that decisions on those provisions be made under delegated authority;

    d We have included a recommendation that DTA will include a moratorium based on section 122 of the Reserve Bank Act 1989, with further decisions on the nature of the moratorium (such as duration and process) to be made under delegated authority;

    e There are a number of additional technical matters that will need to be decided under delegated authority. One is a long-standing issue around the legal status of payment instructions on a deposit taker's entry into resolution. We have included a recommendation on this matter to be clear that the DTA will need to address it.

Further advice on the scope of depositors eligible for deposit insurance

24. You indicated that you would like officials to provide you with further advice on potential exclusions from the deposit insurance scheme [T2021/460 refers]. You have agreed that depositors excluded from the DIS will be related parties of DIS members, financial institutions and foreign currency deposits.

25. As a general principle, the coverage of the deposit insurance scheme should be limited to retail depositors (or entities with similar characteristics), as these depositors are not well-placed to monitor the risk-taking of their deposit taker and could experience hardship in the event of failure. However, this needs to be balanced against the potential for exclusions to add to the complexity of quickly determining coverage, and more generally to increase the costs of implementing such an exclusion.

26. The Review consulted on proposals that are consistent with your existing decision for a limited set of exclusions. Based on international practice, officials recommend two further exclusions, that were not the subject of consultation, to better align with the intent to cover retail depositors, and feedback from several individual submissions:

    a large non-financial corporates[1];

    b government bodies.

27. These depositors are sufficiently large as to be able to monitor risk taking and adjust their affairs accordingly. The financial stability impact of including or excluding such depositors is likely to be minimal given that the first $100,000 of their deposits would be small relative to their total deposit holdings at a deposit taker.

28. The recommended exclusions for large non-financial corporates would require increased costs for deposit takers to implement the deposit insurance scheme, as comprehensive information on the level of turnover and/or assets of the corporate will be needed to implement the exclusion. The recommendation is inconsistent with feedback provided by the New Zealand Bankers Association that the complexities involved in distinguishing between retail and wholesale depositors would outweigh any benefit of excluding wholesale depositors. However, we have not recommended exclusions of some wholesale depositors, such as high net worth individuals, due to the significant impact on implementation costs.

29. We will provide you further advice on the exact definition of ‘financial institution’, ‘large non-financial corporate’, ‘government body’ and ‘related party’. We anticipate that decisions on these definitions will be taken under a ministerial delegation from Cabinet. We note that defining ‘large non-financial corporate’ will likely require setting a maximum revenue or asset threshold, above which a corporate would be considered ‘large’.

[1] We note that financial corporates such as insurance companies and non-deposit taking lender would already be excluded based on your decision to exclude financial institutions.

Implementation pathway for the DTA and deposit insurance

30. Under our proposed timeline we anticipate drafting of a Deposit Takers Bill to commence shortly after the Cabinet decisions are taken in late April, with the Bill introduced into Parliament late this year. This implies passage of the DTA in late 2022, or early 2023.

31. You have previously expressed an interest in understanding how the Phase 2 Review will deliver on Cabinet's in-principle decision to introduce deposit insurance and how this may relate to other parts of the new prudential framework.

32. Enactment of the DTA will not deliver the new framework immediately. Implementation of the DTA will be a multi-year process, potentially taking until 2026-27 to fully embed. There will be substantial work to develop the new prudential requirements for deposit takers, including standards applying to the current non-bank deposit takers and the translation of existing conditions of requirements for banks into the new legislative instrument (i.e. into standards). Licensing of deposit takers under the new standards will also be an extensive process.

33. There are options to implement a deposit insurance scheme (DIS) prior to the full implementation of the DTA. Based on the current legislative timeframe, the earliest point at which deposit insurance could be in place is around the second half of 2023 after enactment of the DTA.

34. Commencing the DIS prior to the full DTA would improve outcomes for depositors and the financial system in the event that a deposit taker fails, while also managing any implicit guarantee that may have been strengthened following the Government's in-principle decision to introduce deposit insurance in 2019.

35. However, introducing deposit insurance ahead of the full enactment of the DTA does increase the following risks:

    a Moral hazard – a deposit taker may rapidly grow its insured deposit book through offering high returns, take excessive lending risk, and eventually fail;

    b Operational risks – the ability for the deposit insurer to identify eligible depositors and deposits, and payout promptly may be limited on implementation.

36. You agreed that finance companies will be eligible for deposit insurance subject to the Reserve Bank managing moral hazard of finance companies by imposing 'sufficiently robust regulatory requirements and risk-based pricing for deposit insurance' as part of the new steady state regime [T2020/3517 refers].

37. We note that under the proposed approach the Reserve Bank will have limited capacity to run a licensing process prior to implementation of deposit insurance, would be reliant on existing or transitional supervisory and enforcement powers for banks and non-bank deposit takers, and will not have yet developed a framework for risk-based levies on implementation.

38. There will also be increased moral hazard risk prior to the implementation of the DIS following the announcement of more detailed elements of the DIS, including the scope of the regulatory perimeter. Officials will work with your office on communications to help address some of this risk.

39. Moral hazard risk during the transitional period should be viewed in light of the small size of the finance company sector and existing NBDT prudential requirements. The Reserve Bank could further mitigate the risk by imposing additional requirements (e.g. higher capital requirements) that limit potential for risk-taking as a condition of providing deposit insurance to riskier deposit takers. The Review will advise you on whether certain supervisory and enforcement powers should be available during the transition period to support this approach (as part of the second tranche of advice on the DTA) and the Reserve Bank will advise you on conditions that will be placed on entities eligible for deposit insurance (prior to implementation).

40. The Reserve Bank will seek to mitigate operational risks through their work programme on implementation of the DIS and will engage with you on this prior to 2023. The initial payout approach is likely to be slower, with design possibly focussed on smaller deposit takers that are more likely to fail. Based on international experience, implementation of the steady state payout approach may take some years after the scheme initially comes into force, reflecting the time required to develop and consult on the systems required to support rapid payout.

Regulatory Impact Assessment

41. The enclosed draft Regulatory Impact Assessment (RIA) will summarise the Reserve Bank’s best advice on the Impact Analysis relating to the regulatory proposals. The Reserve Bank’s responsibility for this RIA is a function of its administration of the DTA. In addition, the RIA will note the Treasury’s views for the few instances where there has not been alignment in agencies’ advice to you.

42. The RIA is currently being reviewed by an independent quality assurance panel comprising representatives from the Treasury and the Reserve Bank. In addition, the RIA is being updated to reflect your recent and anticipated policy decisions, such as on depositor preference and the scope of regulations with respect to lending standards. The RIA will be updated to reflect panel feedback and your final policy decisions, and a further draft will be provided to you ahead of the Ministerial and agency consultation.

Next Steps

43. We ask that you provide feedback by 22 March in order that the Cabinet papers are sent out for ministerial and agency feedback.

44. We anticipate lodgement of the Cabinet papers on 8 April to meet the DEV meeting scheduled for the 14 April.

45. The key dates are as follows:

Date	Description
By 22 March	Feedback from you on the Cabinet papers
22 March – 1 April	Ministerial and agency consultation
5-7 April	Incorporate comments from ministerial feedback
By 7 April	Final version of Cabinet papers to you
8 April	Lodgement of Cabinet papers
14 April	DEV
19 April	Cabinet

Please refer to the final version of documents relating to the Review of the Reserve Bank of New Zealand Act, which can be found at:
https://www.treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act/proactive-releases