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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[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

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RESERVE BANK OF NEW ZEALAND
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Reference: T2021/783 MC-1-7-3-1-13

Date: 31 March 2021

To: Minister of Finance (Hon Grant Robertson)

Deadline: 06 April 2021

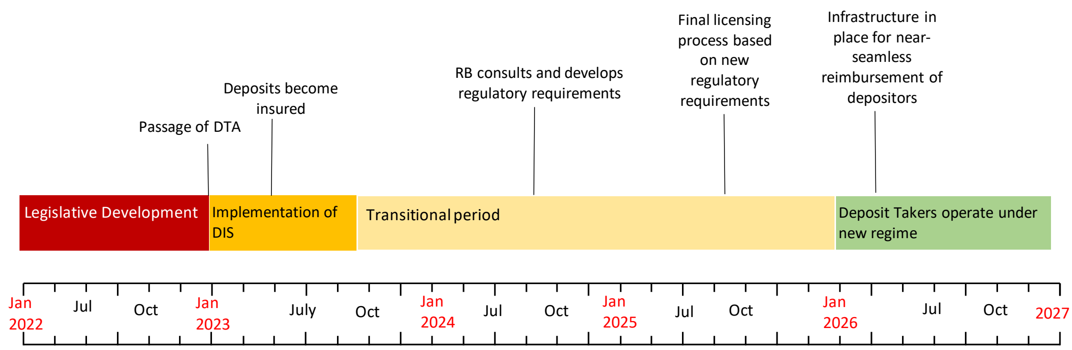
Implementation approach for deposit insurance

Purpose of this note

The Review signalled in recent advice [T2021/645] that there would be a substantial work programme required to fully implement the new prudential framework after the Deposit Takers Act (DTA) is passed next year. You have sought further detail on the timetable for implementation, particularly for the deposit insurance scheme (DIS).

The proposed timetable, which remains indicative at this early stage, is shown below. Officials propose that the DIS is targeted for implementation in mid-to-late 2023, ahead of the rest of the DTA. There would be a transitional period – potentially extending until 2026 – to provide time for the Reserve Bank to develop regulatory requirements and license deposit takers for the new regime.

Figure 1 Timetable for implementation of the DTA



This note also provides further analysis of whether the DIS should be excluded from the scope of bail-in, and suggests that you make a decision on this matter alongside further work on the resolution framework.

Work programme to implement the Deposit Takers Act

The DTA is likely to be enacted in late-2022 at the very earliest. Following passage, there will be a substantial work programme led by the Reserve Bank to implement the new prudential framework for deposit takers. This will involve developing and consulting on new regulatory requirements and licensing of deposit takers.

Developing and consulting on regulatory requirements for deposit takers

The Reserve Bank will develop and consult on the secondary legislation that will contain the regulatory requirements for deposit takers. These standards and regulations will implement new functions (e.g. deposit insurance) and merge the regulatory requirements for banks and non-bank deposit takers under the single deposit taker regime. The Reserve Bank will have flexibility to tailor requirements to different classes of entity.

Developing and consulting on standards is likely to take around 2 years, based on the experience from other substantial regulatory reforms in the financial sector. There is the potential for the Reserve Bank to start preparing requirements ahead of the passage of the DTA to accelerate implementation. However, there is limited scope to reduce the overall timeframe for development of standards. This is because of the substantive amount of policy work involved and the need to engage with the new Reserve Bank Governance Board and then deposit takers.

The intention is that existing requirements applying to banks would be largely transposed into the new framework, with further review of these standards extending the timeframes outlined above. New regulatory requirements may have more significant implications for non-bank deposit takers (NBDTs), given the shift to a unified deposit takers regime for prudential regulation and supervision and the introduction of deposit insurance.

Licensing of deposit takers

Deposit takers will need sufficient time to ensure that they are in compliance with new regulatory requirements before the new prudential regime comes into place. Based on previous licensing processes implemented in New Zealand, this would likely take at least one year after standards are finalised.[1]

The required timeframe will depend in part on whether some deposit takers need to significantly change their business model, balance sheets, or compliance resourcing as a condition of receiving a deposit taking licence under the new regime. You agreed that

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[1] Upon the implementation of Insurance (Prudential Supervision) Act 2010, insurers were provided with a three year transition period – as part of this transitional period insurers were required to hold a provisional or full license after 18 months, and a full licence by the end of the three year period – this approach allowed certain aspects of the full licensing framework to apply to insurers at an earlier point than would otherwise have been the case.

all banks and NBDTs will be eligible for deposit insurance subject to the Reserve Bank managing moral hazard by imposing ‘sufficiently robust regulatory requirements and risk-based pricing for deposit insurance’ [T2020/3517 refers]. Some firms may not wish to meet those elevated regulatory requirements and instead elect to cease taking retail deposits, and the legislation and timeframe will have to allow for this possibility.

Transitional period for deposit insurance

It is possible for certain aspects of the DTA, such as deposit insurance, to come into force prior to developing the new regulatory framework and licensing deposit takers under the new regime. Bringing forward implementation of the DIS would better manage the impact on the financial system in the event that a deposit taker fails in the interim. The Review has previously noted [T2021/645 refers] that a transitional period that brings forward implementation of the DIS increases the following risks:

- **Moral hazard:** Deposit takers may try to take advantage of the fact that some depositors will ‘rate chase’ by shifting deposits to riskier deposit takers that offer the highest return, as occurred with South Canterbury Finance (which eventually failed) following the introduction of the temporary Crown Deposit Guarantee scheme during the GFC.

- **Operational:** Implementation during the transition period provides limited time for the Reserve Bank to undertake preparatory work to enable identification and prompt compensation of eligible depositors.

Agencies are comfortable that the DIS can be implemented by mid-to-late 2023 (based on the current parliamentary schedule) and that the above risks can be managed. Moral hazard risk during the transitional period is lowered by the small size of the finance company sector, existing NBDT prudential requirements (which did not exist at the time South Canterbury Finance failed), and the possibility that further controls on risk-taking will be introduced as a condition of being able to offer insured deposits (or that levies will be used to limit incentives for risk-taking).

The mid-to-late 2023 timeframe would be sufficient for the Reserve Bank to put in place the necessary infrastructure needed for the DIS to carry out its objective of protecting depositors covered by the DIS and thereby contributing to financial stability. [27] We expect that DIS would have the following high-level elements at the time of implementation:

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- **Legislative framework:** The legislation would introduce an obligation on the Reserve Bank to pursue the objective of the DIS, an ability for the Reserve Bank to create a subsidiary to carry out the duties of the DIS, powers to charge levies to members and make recoveries in the event of failure, and clear limits on the level of coverage and scope of products covered.[3]

- **Institutional boundary:** As the final requirements under the new regime would not be complete, existing banks and NBDTs would need to demonstrate compliance with existing requirements prior to being able to offer insured deposits. Deposit insurance could come into force with the passage of the Act or with a delay to provide time to assess compliance and potentially to put in place additional limits on risk-taking.

- **Framework to manage risk-taking:** The NBDT sector poses the highest risk of firm failure during the transitional period because of the weaker regulatory requirements currently in place compared to the banking sector. The sector will be subject to full licensing requirements once the DTA is enacted and the transitional period provides time to prepare for these licensing requirements. The Reserve Bank will be able to draw on the existing NBDT framework during the transition, which includes prudential requirements and trustee supervision.

- **Operational infrastructure:** The initial DIS will require development of detailed rules for defining eligible deposits and depositors, an initial reimbursement process, and an agreed Crown strategy for funding the DIS.[4] The payout process will take into account that banks will not be accepting cheques beyond May 2021, which could make it more difficult to reimburse depositors that do not have, or have difficulty opening, an account at a surviving deposit taker.

You will receive further advice prior to the exposure draft for the DTA (targeted for Q3 this year) on any transitional provisions for the legislation. This advice will consider whether the Reserve Bank should have additional supervisory and enforcement powers during the transition, whether it is desirable to have a transitional licensing process prior to commencement of the DIS, and whether aspects of the resolution framework should come into force alongside the DIS.

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[3] A transitional issue is the treatment of debentures at finance companies. Debentures are currently the most common offerings from finance companies and would not be eligible for coverage. Debenture holders could be advised that their first ranking security over the assets of the finance company would be phased out and replaced by the issuance of term deposits protected by the DIS up to the maximum coverage limit. These instruments may also need to be adjusted so that they are no longer ‘transferable’ in order to be eligible for deposit insurance coverage.

[4] The initial reimbursement process would be targeted towards paying out the deposit takers that are most likely to fail, and would be improved in the years after implementation through the introduction of infrastructure that will enable deposit takers to rapidly identify eligible depositors based on a single customer view. The funding strategy for the scheme is expected to be published prior to implementation, and will set out risks to the DIS, guidance for levy setting, the approach to management of the deposit insurance fund, and how the Crown’s role as backstop to the DIS will be managed. Although it is expected to take some years after implementation before the long-run framework for risk-based pricing is introduced, a simpler interim approach could be used during the transition.

Annex 1 provides a more detailed timetable of the proposed implementation approach for deposit insurance and the Deposit Takers Act.

Further advice on the scope of bail-in

You asked for more information concerning the following comment in T2021/645:

> *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.*

Officials see this as a largely technical matter than can be progressed post-April alongside the design of the no creditor worse off safeguard. We have provided a more detailed explanation of the issue below.

Officials consider that the following objectives should be met in a bail-in that impacts on deposits as part of a resolution:

1. Insured deposits should receive rapid access to their funds, consistent with the objective of the resolution authority to protect depositors covered by the deposit insurance scheme.
2. The costs of protecting insured depositors in resolutions should be borne by the deposit insurance scheme – as a rule of thumb, the scheme should be liable for the costs it would have otherwise faced in a liquidation.
3. The framework should generally aim to avoid triggering payments arising from 'No Creditor Worse Off' (NCWO) safeguards. This safeguard (to be designed under delegated authority) is likely to impose an obligation on the Crown to compensate other creditors if resolution action makes them worse off than they would have been in a liquidation. The safeguard is intended to give creditors confidence that they will not be treated unfairly, but is not intended to be triggered in the normal course of resolution. The use of the bail-in tool could trigger NCWO compensation payments if insured deposits are exempt from being 'bailed-in'.

There are multiple ways in which these three objectives could be achieved:

1. One solution could involve insured depositors being 'technically' subject to bail-in, so long as there is a clear mechanism for the DIS to compensate them for any insured funds that are bailed-in (and acquire any associated securities they are eligible for as a result – e.g. shares in the restructured bank).

2. An alternative solution would be for insured deposits to be exempted from bail-in. In this case, assuming we don't want to trigger NCWO payments, care will have to be taken to ensure the DIS funds are able to be used to support the

resolution, in order to make sure that other creditors have not wound up with less value than they would have received in a liquidation.

These two options achieve the same substantive outcomes in slightly different ways.

We note the need to provide clarity to depositors. In particular, if insured deposits were subject to bail-in then this would need to be communicated very clearly so it does not give people the impression they could end up losing funds as a result.

Officials will advise you on the preferred option post-April. In the meantime, officials will work with your Office to provide guidance for public communications that notes that the final decision on whether insured deposits are eligible for bail in will be determined post-April, while emphasising that regardless of their eligibility it would not affect their outcome (prompt access to insured balances). This is to allow the final decision to be taken alongside detailed decisions about the NCWO framework and the safeguards on the use of deposit insurance funds in non-liquidation resolutions. Overall, this will provide greater confidence that all of these policy pieces work together well and achieve the objectives described above.

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Annex 1: indicative timeline for DTA and DIS implementation

	2022	2023	2024	2025	2026
Deposit insurance	RBNZ prepares operational infrastructure for the DIS. Minister publishes funding strategy for the DIS.	DIS sections of DTA comes into force in mid- to late 2023. Institutional boundary developed with associated requirements.	Standards for DIS that implement single customer view requirements are completed.	Deposit takers implement single customer view systems. DIS consults on steady-state risk-based levy framework.	Prompt reimbursement capabilities become operational.
Deposit Takers Act	DTA passes through Parliament.	RBNZ developing and consulting on final standards for prudential regulation of deposit takers.	RBNZ developing and consulting on final standards for prudential regulation of deposit takers.	Deposit takers apply for licences and RBNZ assesses deposit takers compliance with standards.	Transitional period ends.