

The Treasury

Statement of Funding Approach Consultation Submissions Information Release

December 2023

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Submission to the Reserve Bank of New Zealand and The Treasury on:

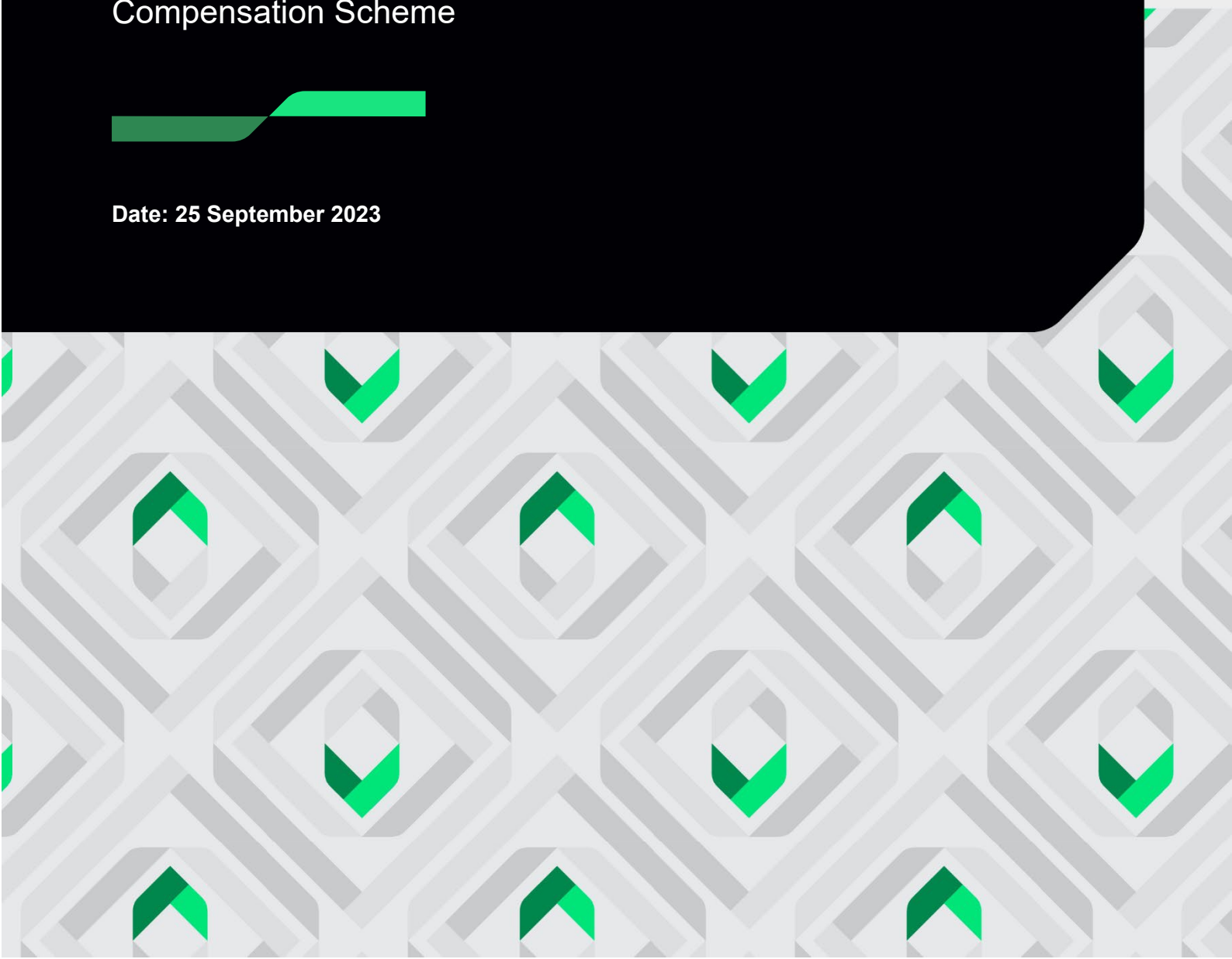
Levy framework for the Depositor Compensation Scheme

Proportionality framework for developing standards under the
Deposit Takers Act

Statement of Funding Approach – funding strategy for the Depositor
Compensation Scheme



Date: 25 September 2023



Kiwibank submission to the Reserve Bank of New Zealand (RBNZ) and The Treasury on the levy framework, proportionality framework and Statement of Funding Approach

Executive summary

1. Kiwibank welcomes the opportunity to provide feedback on RBNZ's consultations on:
 - a) the levy framework for the Depositor Compensation Scheme (**DCS**)
 - b) the proportionality framework for developing standards under the Deposit Takers Act (**DTA**), and
 - c) The Treasury's consultation on the statement of funding approach for the DCS.
2. Kiwibank's submission also addresses other issues relating to the implementation of the DCS and topics raised at the recent RBNZ workshops. In particular, we highlight our feedback on the DCS pay-out model options and our submission that the outcomes of the Liquidity Policy Review should be aligned with the single customer view (**SCV**) reporting requirements.
3. Kiwibank has also contributed to NZBA's submission. Kiwibank's submission focuses on those issues where our viewpoint may differ from others in the industry. However, we reiterate the concerns raised in NZBA's submission regarding the timeline for implementation of the DCS. There is still significant uncertainty around key features of the DCS (including the detail of the Regulations, what products will be in-scope and the extent to which they will be protected, how the DCS and Open Bank Resolution will co-exist, and how a pay-out event will be managed) which could threaten the success of the October 2024 go-live. While we acknowledge that the implementation date for the DCS has been extended once (from early- to late-2024), deposit takers have not benefited from this extension as they are limited in the extent to which they can advance their implementation programmes while key features of the regime are still under development.
4. A key priority for Kiwibank is to ensure that the DTA promotes a level playing field for deposit takers through the proportionate application of prudential requirements and equitable apportionment of costs associated with the DCS. The outcomes of these consultations may have a bearing on competition in the deposit taking sector and we wish to highlight our concern that the proposed DCS levy and proportionality frameworks, which both use capital as a determinative factor (or 'strength' as a proxy for capital), may unfairly advantage the domestic systemically important banks (the **D-SIBs**)¹. Kiwibank's views on the undue benefit accorded to D-SIBs from internal ratings-based capital modelling is well documented. Most recently, it was discussed in the joint domestic bank submission to the Commerce Commission in response to its preliminary issues paper on the market study into personal banking services. In summary, Kiwibank submits that it is inconsistent with s 4(b) of the DTA² to bake-in that capital advantage through the DCS levy and proportionality framework. To that end, Kiwibank has also contributed to a joint submission on these consultations with the domestic banks which highlights the areas we consider the outcomes could undermine competition in the deposit taking sector, particularly vis-à-vis D-SIBs and non-D-SIBs.

¹ As defined by the Reserve Bank of New Zealand: [Requirements for domestic systemically important banks – Reserve Bank of New Zealand – Te Pūtea Matua \(rbnz.govt.nz\)](https://www.rbnz.govt.nz/requirements-for-domestic-systemically-important-banks).

² Section 4(b) of the DTA provides:

4 Principles to be taken into account under this Act

In achieving the purposes of this Act, the Bank must take into account the following principles that are relevant to the performance or exercise of the functions, powers, and duties conferred or imposed on the Bank:

- ...
- (b) the need to maintain competition within the deposit-taking sector:

5. Finally, we note that some of the information provided in this response is confidential and commercially sensitive and should be redacted for publication accordingly.

Feedback on the levy framework for the DCS

Proxy for protected deposited amounts

6. RBNZ's preferred approach to calculating a proxy for deposited amounts is to apply an adjustment to Bank Balance Sheet (**BBS**) data. RBNZ explains that this option is preferred because it uses data which is already available from all deposit takers, and avoids the compliance cost of undertaking a one-off survey. Kiwibank broadly supports the use of adjusted BBS data for the proxy. However, we reiterate NZBA's submission that more information is needed regarding the rationale for, and calculations supporting, the choice of adjustment factor. RBNZ could consider requesting aggregated balances at account level for the first \$100k balance in the BBS to support a more accurate calculation. We would welcome the opportunity to discuss this with RBNZ further.
7. Our responses to the specific questions in the consultation paper and topics that came up in the recent RBNZ workshops are as follows:

Question 4: Do you think the proxy should be reviewed one or two year(s) after the DCS is in place?

8. We consider that this is unlikely to be practical. After the proxy is in place, RBNZ should focus its full attention on finalising the SCV requirements so that banks are able to progress their implementation work programmes.

Would you support a wash-up mechanism to address the risk of an over- or under-estimation of protected deposits?

9. In principle, we do not support this suggestion as it would add significant complexity to the regime. The purpose of the proxy is to introduce a simple measure of building a fund for protected deposits while the SCV is under development. A proxy is, by definition, an estimate and will inevitably over- or under-estimate protected deposits. The introduction of a wash-up mechanism would undermine the simplicity of the proxy when banks should be focusing their resources on the implementation of the SCV. Again, we would welcome the opportunity to discuss further how RBNZ has landed on the proposed adjustment factor so that we can be assured that it provides the best estimate of protected deposits. The outcome of that may influence our view of whether the proxy should be reviewed and whether a wash-up mechanism is needed.

DCS levy approach

10. Kiwibank supports the adoption of a risk-based approach using composite risk indicators to set the DCS levy.
11. A risk-based model will incentivise deposit takers to ensure that they have appropriate policies and processes in place to effectively manage risk.
12. We acknowledge that a risk-based model could have a significant impact on those deposit takers that fall into a different bucket to their key competitors. However, we consider that is necessary to mitigate the very real risk of moral hazard that the DCS could otherwise create.
13. Our responses to the specific questions in the consultation paper are as follows:

Question 5(a): Do you agree with the design of the four risk buckets? Do you agree a four-times difference in the levy rate across buckets is appropriate given the objectives of the levy? Would a higher multiplier more accurately reflect risk? If so, what should the multiplier be?

14. Kiwibank supports the design of the four risk buckets. It is clear from Figure 1 that the four buckets reflect natural breakpoints in the distribution of deposit takers under the composite risk indicators approach.
15. At the recent RBNZ workshops, the group discussed whether Bucket 1 should be further broken down given that it is the largest bucket. We would strongly oppose that suggestion as it would impact deposit takers that compete in the same market with no corresponding benefit to depositors. The banking sector is extremely low risk as a result of RBNZ's new capital requirements, so it is logical that most banks sit comfortably in Bucket 1.

Question 5(b): Do you agree with the selection of the quantitative risk indicators and the boundaries for each matrix?

16. We agree that the four indicators chosen are appropriate metrics to assess the risk to depositors. However, we have concerns regarding the definition of several of those indicators which are outlined below.
17. In terms of weighting, our view is that the liquidity indicator should be given a higher rating. That is because low levels of liquidity present a direct risk to the DCS in that:
 - a) It places a bank's ability to repay depositors in the ordinary course of business at risk, increasing the chance it will have to call on the DCS.
 - b) It places the DCS at a greater risk of loss as more of the deposit taker's assets will need to be realised to reimburse the DCS, and such a process is likely to be time consuming and expensive.
18. We also consider that it would be appropriate to give liquidity a higher weighting taking into account New Zealand's experience during the GFC during which time liquidity issues were the most significant threat to financial stability.
19. Correspondingly, we consider that a lower weighting should apply to the business model and management metric as that represents an indirect risk to the DCS that will crystallise through other risk attributes, particularly:
 - a) Return on assets via capital adequacy ratios, and
 - b) Top 5 credit exposures via non-performing loan percentages.

Capital adequacy as a risk indicator

20. The risk indicator framework does not differentiate between banks that calculate their capital ratios using the standardised vs internal ratings based (**IRB**) methodologies.
21. The IRB methodology allows the D-SIBs to calculate a lower risk weighted asset outcome than a standardised bank for key exposures, namely residential mortgages and lending to small and medium enterprises. As a result, for the same amount of capital against the same exposure, the D-SIBs report a higher capital ratio. This risk indicator would treat IRB banks as 'safer' than standardised banks when the underlying risk exposure and the amount of loss absorbing capital held is the same.
22. In setting capital requirements, the RBNZ has chosen to utilise the D-SIB buffer to equalise the amount of capital IRB and standardised banks hold against key exposures by requiring the IRB banks to report a higher capital ratio when using IRB risk weights. The original Basel intent was for the D-SIB buffer to require large banks to hold more capital than smaller banks to provide additional protection from the impacts of a large bank failure.

23. To take reported IRB capital ratios at face value and treat them as equivalent to standardised ones appears inconsistent with s 4(b) of the DTA which requires the RBNZ to take into account the desirability of maintaining competition within the deposit-taking sector. In particular, it fails to account for regulatory advantages that the IRB banks enjoy in the calculation of their capital ratios.
24. To enable an apples-with-apples comparison, the capital adequacy risk indicator should be based on the standardised capital ratio for all banks. The implementation of dual reporting makes this feasible.

Top 5 credit exposures as a risk indicator (a subcategory of the business model and management indicator)

25. Based on the provided workings for Kiwibank's risk indicator score, the 'Top 5 credit exposures' referenced in the framework appear to be non-bank credit exposures only. The scope is further narrowed by the OIC which excludes sovereign, multilateral organisations, and connected persons exposures from this category. Additionally, the measures utilise IFRS 7 disclosure amounts (ie they are non-risk weighted and exclude the effects of credit risk mitigation). If this is the intent, then the consultation paper should make this clear. However, we have the following concerns with this approach:
- a) Referencing non-bank exposures results in the capture of common liquidity book securities such as the Local Government Funding Agency and Housing NZ. We would like to understand why the framework should effectively penalise large holdings of these securities while ignoring large liquid asset holdings of bank securities, which have lower credit ratings and represent a systemic concentration of risk.
 - b) Given the nature and extent of the use of parent bank branches by locally incorporated banks, the exclusion of connected persons exposures is at odds with a measure of risk associated with a bank's 'business model'.
 - c) The IFRS 7 basis of measurement excludes the benefits of well-established credit risk mitigation arrangements, namely netting and collateral arrangements. This particularly impacts QCCP exposures (for example, [25] is a non-bank exposure) – due to the naturally large amount of offsetting derivatives and the full collateralisation of the net exposure. By way of illustration, [25]

	BPR 131 /	
\$m	132	IFRS 7
[25]		

- d) Under the OIC basis, Kiwibank reports the credit exposure as the value of in-the-money swaps as well as initial margin posted. This omits the large amount of out-of-the-money swaps and variation margin received against the net asset position. Kiwibank's true exposure to [25] is better characterised as the initial margin posted.

26. We suggest that the above issues be addressed by including all exposures (bank, non-bank, sovereign and connected person), recognising the effects of credit risk mitigation, and risk weighting them using the standardised approach. This avoids the exclusion of key exposures, allows recognition of management of credit risk, and applies risk weights on a uniform basis.

Question 6: Which levy method of calculating or ascertaining the amount of levies do you think is most fit-for-purpose?

27. Subject to the feedback outlined above, Kiwibank strongly supports a risk-based approach which is based on composite risk indicators. As explained, we consider that this will drive self-discipline among deposit takers by incentivising appropriate risk management.
28. Kiwibank does not support a risk-based levy determined by a bank's credit rating:
- a) This approach would not be likely to directly influence deposit takers' approach to managing risk which could lead to moral hazard.
 - b) Credit rating methodologies cannot be used as a proxy for assessing the risk of a bank calling on the DCS. A credit rating measures the risk of loss to creditors – the levy charged to a bank ought to reflect the probability of an entity requiring the use of the DCS, rather than the losses that creditors bear after the fact of a failure. A key consideration underlying a credit rating is the likelihood of Crown support – in other words, the likelihood that the government will bail-out creditors in the event of a failure. The DCS is designed to avoid the need for the Crown to bail depositors out.

Feedback on the proportionality framework for developing standards under the DTA

29. Kiwibank supports the proportionate application of prudential standards to different groups of deposit takers. The development of the framework recognises that the 'one-size-fits-all' approach to prudential regulation has a disproportionate impact on smaller banks and inhibits competition. We broadly support the proposed framework, subject to our comments below.
30. First, deposit takers that are registered banks should be grouped according to whether they are D-SIBs or not. Introducing a new method of categorisation which delivers the same outcome as the D-SIB/non-D-SIB classification introduces unnecessary complexity to the regulatory regime. Using the D-SIB/non-D-SIB classification (which is consistent over time) also mitigates the risk of deposit takers straddling two groups or transitioning between groups, which creates uncertainty and inefficiency. We note that the D-SIB classification was developed to 'provide analytical clarity for the identification of banks that may be subject to the proposed D-SIB capital buffer'. However, that classification should be deployed in the proportionality framework, and indeed any proportionate regulation where the rules reflect the fact that the failure of some market participants would have a larger impact on the financial system (the same policy justification as set out in the consultation paper: *A framework for identifying domestic systemically important banks*).
31. Secondly, if 'strength' is used as a dimension for tailoring requirements, consistent with our submission on the DCS levy framework, it must be based on the standardised approach to calculating capital requirements. Otherwise, non-D-SIBs (which are not permitted to use IRB modelling) may be unfairly penalised. Allowing the use of IRB capital ratios in the methodology creates a material competitive advantage as the D-SIBs report a higher capital ratio than other banks as their risk weighted assets are typically less for a given exposure. That would be inconsistent with s 4(b) of the DTA. Please also refer to our submission at paragraphs 20-24 above.

Feedback on the Statement of Funding Approach for the DCS

32. Kiwibank supports Option A and reiterates its submission to the Finance and Expenditure Committee that the target fund should be a low, slow build. Aotearoa's banking sector is strong as a result of RBNZ's significant capital requirements. Additionally, we consider that a more aggressive approach to building the fund could send an unintended message to the market that the deposit taking sector is not sound, which could influence depositor behaviour.

Feedback on other matters

33. Alignment of the outcomes of the Liquidity Policy Review with SCV data requirements: Kiwibank strongly supports the alignment of the outcomes of the Liquidity Policy Review (**LPR**) with SCV data requirements. We note that this is already being considered – in the second consultation paper on the LPR, RBNZ indicated that it would consider the impact of the DCS and insured deposits on cash outflows in relation to any potential changes to the mismatch ratio. More recently, when informing banks of a delay to the next LPR consultation, RBNZ noted that it intends to align the remaining stages of the LPR with the development of the DTA's core standards. Alignment of the data requirements for the SCV and changes to the liquidity policy will ensure a smoother implementation of both and should be progressed urgently.
34. Pay-out mechanism: Pay-out of DCS compensation must be as simple and smooth as possible for deposit takers and customers. We encourage RBNZ to prioritise urgent engagement with the industry (through bilateral meetings and/or further workshops with relevant subject matter experts) about the pay-out options presented by RBNZ at the recent workshops. Engagement is vital to clarify certain matters, to explore the pros and cons for each option, and to identify solutions to issues identified. Our feedback on the proposals follows:
- a) RBNZ must further clarify the interaction between the DCS and Open Bank Resolution (**OBR**, particularly before the SCV is implemented), including whether the pay-out options are likely to be relevant only for smaller/non-OBR deposit takers (which could impact how many customers may need to be supported by the pay-out model and how much impact, in turn, that may have on a deposit taker appointed to support pay-out for the purposes of Option 1).
 - b) RBNZ has indicated that Option 1 may be its preference. We request clarity from RBNZ as to the proposed process for 'appointing' deposit takers that will facilitate pay-outs to customers. Those appointed deposit takers will need to start planning for that, which would be a significant exercise. A number of issues with Option 1 need to be resolved if this is to be considered. Expanding on this:
 - i) In Kiwibank's view, given that a nominated deposit taker could be tasked with onboarding potentially thousands of new customers in order to make compensation payments, existing customer due diligence requirements (**CDD**) would make pay-out slow and difficult. RBNZ would need to consider putting in place (in advance) a CDD class exemption for appointed deposit takers, delayed verification, or a class exemption to enable the appointed deposit taker to rely on the failed deposit taker's CDD. RBNZ could also explore whether, here, appointed deposit takers could open limited/restricted accounts for the purposes of paying compensation only.
 - ii) Setting up as an appointed deposit taker would be significant because of technology requirements and also the need to increase front-line and call centre capacity at short notice.
 - iii) The potential impact on the appointed deposit taker's staff and pressure on its infrastructure should be considered and mitigated against as much as possible.
 - iv) The availability and supply of cash at short notice should be explored by RBNZ in conjunction with NCR (as some customers may prefer compensation be paid in cash).

- c) As to the other pay-out options, Kiwibank would be grateful for more information from RBNZ about these. Our preliminary thinking is that there could be benefits for customers and deposit takers with Option 2. In particular, it would remove the difficulties with CDD requirements created by Option 1 and is therefore more likely to result in prompt payment. We would appreciate more information about Option 2 including why RBNZ does not prefer this option. In respect of Option 3, again, more information about this would be appreciated, for example regarding how RBNZ would manage CDD (and whether it would be outsourced). At this stage, we are minded to agree with RBNZ that Options 4 and 5 do not appear to be viable.
35. Protected deposits: we request urgent clarity from RBNZ on the detail of which deposits will be protected so that planning for implementation can advance. Deposit takers will need to be able to identify and describe such products to their customers and s 193 of the DTA will require deposit takers to publish a list of classes of protected deposits. This will require deposit takers to have analysed products in advance of implementation. In response to two particular points raised at the recent workshops:
- a) Revolving products (credit balances on revolving home loans, revolving credit facilities and credit cards): Kiwibank has no objection to inclusion of these as protected deposits.
 - b) Temporary high balances: we consider that it would take time to work out how to bring these into scope as protected deposits and that this is unlikely to be achievable by the current go-live date of October 2024. If RBNZ decides that such balances should be brought into scope sooner rather than later this is another reason why it would be sensible to lengthen the timeline for DCS implementation generally – to provide time for the development of any regulations on this and then time to implement.
36. Relevant arrangements and look through: Kiwibank supports the comments made in NZBA's submission on this. Clarity on this aspect of the DCS is required so that deposit takers can identify affected accounts in their systems and advance planning for implementation.