The Treasury

Statement of Funding Approach Consultation Submissions Information Release

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Deposit Takers Act - Depositor Compensation Scheme:

BNZ response to The Treasury consultation questions on the Statement of Funding Approach for the Depositor Compensation Scheme.

25 September 2023

Introduction

1.1 BNZ welcomes the opportunity to provide a response to The Treasury - Te Tai Ōhanga on the Statement of Funding Approach (SoFA) for the Depositor Compensation Scheme (DCS).

1.2 We acknowledge the considerable work that has gone into developing the Deposit Takers Act (the Act) under Phase 2 of the Reserve Bank Act review. We also acknowledge and appreciate the active engagement and consultation by both the Reserve Bank of New Zealand – Te Pūtea Matua (the Reserve Bank) and The Treasury – Te Tai Ōhanga (The Treasury). BNZ welcomed the opportunity to engage with The Treasury in the recent workshops on the SoFA.

1.3 Set out below we provide responses to the consultation questions from The Treasury on the SoFA. We suggest that this response is read together with BNZ's response to the Reserve Bank on the DCS Levy Framework consultation.

1.4 Should The Treasury team have questions in relation to this response please contact Paul Hay, Paul_Hay@bnz.co.nz.

Paul Hay

GM, Regulatory Affairs, Bank of New Zealand

BNZ Response to The Treasury questions on the SoFA

Section 3	Objectives and Principles that guide the funding strategy in the SoFA.
Question 1	Are there other principles that you think we should consider?
BNZ Response	• BNZ supports the objectives and principles that guide the funding strategy in the SoFA. • The Consultation notes that the DCS funding strategy should consider the likelihood of failure (fifth item in Table 1) and provides for consideration to be given to other aspects of the 'safety net' such as capital requirements. BNZ supports this approach and in particular notes that the progressive uplift in capital requirements over the next 5 years will considerably enhance the resilience of the financial system by design and that capital uplift and its impact on system resilience should be given specific consideration in the determination of the target size of the DCS fund.

Section 4	Conceptual approaches to the funding strategy.
Question 2	Do you agree with adopting a target fund approach to communicate the future path of levies? Why or why not?
BNZ Response	• BNZ supports Treasury's preferred approach to adopt a target fund approach to communicate the future path of levies as it will give deposit takers certainty about their levy obligations. • The target fund approach built up through ex-ante levies payable by deposit takers aligns with the accountability, predictability, equity and efficiency principles set out in the Consultation.

Section 5	The role of post-failure recoveries in the funding strategy. Preferred approach of factoring in recoveries from a failed deposit taker when setting the funding strategy.
Question 3	Do you agree that the target fund size should take into account likely recoveries from failed deposit takers? Why, or why not?
BNZ Response	• BNZ supports the approach of setting a target fund size based on the expected shortfall after the use of resolution tools and accounting for recoveries. • The Consultation considers the funding obligations of the DCS in the event of deposit taker liquidation and factoring in recoveries from failed deposit takers in setting the funding strategy and establishing a target fund size. • We note however, that not all deposit taker failures will result in liquidation. This is particularly pertinent in the case of deposit takers that are subject to the Reserve Bank – Open Bank Resolution (OBR) policy. OBR is the primary resolution tool that the Reserve Bank has at its disposal for resolution of larger banks/deposit takers. Deposit takers that are subject to OBR present an alternative resolution path and this scenario should also be considered in setting the target fund size. Where OBR is used as a resolution tool, the DCS may have an initial payout equivalent to the "frozen" amount of the protected deposits (to ensure that depositors receive access to the full protected deposit amount when the bank reopens the next day). The DCS may then receive repayments of some of that initial payout where frozen funds are released as the financial position of the bank is better understood. • If the net funding shortfall after resolution (including recoveries) were not factored into establishing a target fund size the levies charged are likely, over time, to exceed the long-term costs to the DCS associated with deposit taker failures. • An approach that considers the net expected shortfall after the use of resolution tools (OBR or liquidation) would be consistent with the accountability, equity and efficiency principles. • BNZ submits further that the Consultation has limited information on the approach that

	would be taken to rebuild the fund after a failure. We note that rebuilding the fund by increasing the levy obligations on surviving deposit takers could potentially be contrary to the predictability and equity principles set out in the Consultation. The alternative, of maintaining levy obligations at the same rate that were in place prior to the failure event and extending the timeframe to restore the target DCS fund size would create additional liquidity risks on the Crown and amplify the risk to the Crown to backstop the DCS. BNZ suggests that the SoFA will need to find a balance between these two aspects.

Section 6	**Methodology for assessing the funding obligation of the DCS in severe but plausible failure scenarios. Preference for using a discretionary method for estimating the DCS's funding obligations.**
Question 4	Do you agree with using the discretionary method? If not, why not? What method would you recommend and why?
BNZ Response	• BNZ supports the Treasury's preference to use a discretionary approach to assessing the funding obligations of the DCS noting that the approach remains subject to the specified requirements in the Act (Part 6, subpart 7, clause 247) that the SoFA should include: ○ Information on the likelihood of a payout event/s; ○ estimated costs of the DCS including estimates of the cost of entitlements; ○ information about the assumptions and evidence used to prepare estimates; ○ set out requirements for the investment of the fund; ○ set out the Minister's proposed approach to managing the financial position of the Crown in relation to the scheme; and ○ target fund size and estimated timeframe. • BNZ submits that these requirements/principles will provide appropriate guide rails within which the discretionary method can be used to estimate the likely costs to the DCS from 'severe-but-plausible' scenarios of deposit taker failures. • This will provide a pragmatic approach to establishing the likely funding obligations of the DCS in the context of the low frequency and lack of recent deposit taker failures in New Zealand.
Question 5	Do you think we should commission independent modelling to estimate the DCS's expected losses?
BNZ Response	• BNZ does not consider that independent modelling would result in a better outcome on the basis that the low frequency and lack of recent deposit taker failures in the New Zealand would not provide an independent modeler sufficient empirical data to enable statistically relevant modelling to be performed.

Section 7	Using 'severe-but-plausible' failure scenarios to estimate costs to the DCS.
Question 6	Do you agree with our 'severe-but-plausible' failure scenarios? Are there other scenarios we should consider or modelling assumptions that are more appropriate?
BNZ Response	• BNZ agrees both with the approach to considering 'severe but plausible' failure scenarios and the proposed scenarios. • BNZ also agrees with the factors considered in assessing these scenarios, specifically the changes currently underway aimed at strengthening the resilience of deposit takers.
Question 7	Do you agree with the assumed losses given default for the different classes of deposit taker? If not, why not? What would be an alternative approach?
BNZ Response	• BNZ agrees both with the approach and assumed potential losses from deposit taker failure based on recent overseas experience and previous experience in the finance company sector in New Zealand. • Further, we agree with the expected outcomes wherein residual losses following liquidation or resolution are markedly more severe in the higher risk non-bank deposit taking sector. We note the importance of recognising the variability in outcomes and that these factors are considered in the differentiation of levy contributions based on relative risk to the system.

Section 8	Options for a target fund size.
Question 8	What is your preferred target fund size? Why?
BNZ Response	• BNZ supports the approach of setting a target fund size based on the liquidation of a medium sized deposit taker/bank, widespread liquidations of non-bank deposit takers or resolution of one of the five largest banks. • BNZ agrees with the appropriateness of a target fund size as proposed, ranging from \$0.6 billion to \$1.4 billion, or 0.5% to 1.1% of protected deposits. For practical and planning purposes, BNZ proposes the adoption of an initial target at the mid-point of this range, i.e. \$1 billion or 0.8% of protected deposits. We further propose that this target is reviewed regularly in light of considerations, such as the size of the protected deposit base, inflation impacts, idiosyncratic risks exhibited by deposit takers and systemic risks.

Section 9	Timeframe to reach target fund size
Question 9	Do you prefer a 10-, 15-, or 20-year timeframe to build up the DCS fund? Why?
BNZ Response	• BNZ submits that consideration of the following factors should inform the setting of the timeframe to build the DCS fund: ○ stability in the in the New Zealand financial services landscape; ○ recent history, characterized by low incidence of failure; and ○ the signals to the market that the build timeframe would indicate, including the unintended consequence of raising concerns around market instability that a shorter timeframe may suggest. • In consideration of these factors BNZ supports a period to build the DCS fund of 20 years.
Question 10	Do you prefer an alternative timeframe? Why?
BNZ Response	• No, see above.

Section 10	Options analysis for target fund size and timeframe.
Question 11	Which of the three options do you prefer and why?
BNZ Response	• Further to our responses to questions 8 and 9 above BNZ supports option B – although BNZ has a preference for a longer timeframe to build the DCS fund, extending to 20 years (rather than the 15 years proposed in option B). • BNZ believes that this would result in a target fund size of sufficient magnitude to provide an appropriate level of system resilience and protection to depositors under a range of scenarios and built up over a period of time that signals confidence in the stability of the financial system and at the same time requiring a material contribution by participating deposit takers.

Section 11	Changes to the Statement of Funding Approach
Question 12	Do you agree with how we have described the process for updating the SoFA? Have we missed any key triggers for a review?
BNZ Response	• BNZ broadly supports the proposed approach for updating the SoFA though we propose the addition of a trigger for reassessment of the funding strategy to be invoked upon any resolution action adopted by the Reserve Bank aimed at preventing the failure of a deposit taker – this is broader than the current proposal to reassess on the "failure" of a deposit taker. • Additionally, BNZ proposes that the emergence of a significant external/macro-economic shock that is considered likely to precipitate deposit taker failure should also be included as a trigger for reassessment of the funding strategy and that this is not left until the five-year review of the SoFA.

Section 12	Outline of next steps.
Question 13	Do you have any other comments on matters covered in this discussion document?
BNZ Response	• BNZ notes that a second consultation on the SoFA is proposed early in 2024 and we look forward to engaging with Treasury on the additional aspects of the SoFA. • In addition to the investment strategy and operating costs, BNZ requests that the second consultation covers clarity on the levy approach once the target fund size is reached including determinations for factors such as growth in the deposit base, (any) inflation adjustments for the level of deposit protection, potential future incorporation of temporary high balances and foreign currency denominated deposits and management costs of the DCS fund. • Tax treatment of the DCS fund also needs to be clarified and we reference the discussion held at the recent DCS industry workshop where Reserve Bank representatives indicated that engagement was underway with Internal Revenue regarding taxation treatment of the DCS. In BNZ's view, taxation of the scheme would be inconsistent with the purpose of the DCS and would be out of step with deposit protection/insurance schemes operating in other jurisdictions internationally. BNZ also considers that DCS levy contributions should specifically exempt from GST on the basis that they are a financial service. • BNZ recommends that the SoFA should provide clarity on the approach to be taken once the DCS fund has reached the target size and ongoing earnings result in the fund size growing beyond the target. In that event BNZ expects that the collection of levies would cease and the potential for levy refunds to deposit takers should be considered. BNZ further proposes that The Treasury and the Reserve Bank should collaborate and agree on the principles of DCS fund management once the target size is achieved. • BNZ also understands that The Treasury and the RBNZ are looking at the need for clear public communication regarding the DCS, including the roles of both The Treasury and the Reserve Bank, the size of the DCS fund, the timeframe for the DCS fund to be built and the

	Crown "backstop". BNZ supports this work on communications as we expect that depositors will look to deposit takers for clarity regarding the operation of the DCS. It will be useful for deposit takers to have a consistent and central place supported by the Treasury and the Reserve Bank to direct depositors to explain how the DCS fund will work to instill public confidence in the scheme. • Given the tight timeframe between the SoFA and DCS levy framework and standards being finalised by The Treasury and RBNZ and the DCS becoming effective in October 2024, we request that additional consultation on the SoFA is completed as soon as is practical to provide certainty.