The Treasury

Reserve Bank Act Review - Deposit Takers Bill Information Release

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Coversheet: A New Prudential Framework for the regulation and supervision of deposit takers and the introduction of deposit insurance

Advising agencies	Reserve Bank of New Zealand
Decision sought	Key policy decisions on a new prudential regulation framework for the regulation and supervision of deposit takers and the introduction of deposit insurance
Proposing Ministers	Hon Grant Robertson, Minister of Finance

Contents

Summary: Problem and Proposed Approach

Problem Definition

What problem or opportunity does this proposal seek to address? Why is Government intervention required?

The Reserve Bank of New Zealand Act 1989 has been in place for over 30 years. In that time, there have been many changes to the economy and the financial sector. The volume of transactions has increased and financial institutions have grown both in terms of their size and the range of financial services that they offer. Likewise, the global financial system is both larger and more interconnected than it was in 1989. Consumers' pattern of use of financial services and financial products has also changed significantly over this period.

Internationally, financial regulation has increased in scope and detail in response to these changes. The role and mandate of prudential regulators have increased both in New Zealand and abroad. The role of the Reserve Bank expanded over the late 2000s to include oversight over insurance companies and non-bank deposit takers. The scope, focus, and intensity of regulation and supervision have also evolved over the last 30 years, enabled by the flexibility provided by the current statutory framework. Change to the statutory framework has occurred through a series of separate, targeted amendments rather than through a comprehensive review.

In 2016, the International Monetary Fund (IMF) undertook a comprehensive and in-depth analysis of New Zealand's financial sector as part of the Financial Sector Assessment Programme (FSAP), which was published in 2017. The goal of FSAP assessments is twofold: to gauge the stability and soundness of the financial sector (i.e. a conjunctural analysis) and to assess the quality of the regulatory framework. An FSAP includes an assessment of the country's degree of compliance with the Basel Core Principles for Effective Banking Supervision (BCP), as well as comparable international standards for the prudential regulation of the insurance sector and standards for conduct regulation (relevant to the Ministry of Business, Innovation and Employment (MBIE) and the Financial Markets Authority (FMA)).

The 2016/17 FSAP recommended that, while a significant amount of progress had been made since the last FSAP in 2004, there should be: an increase in the Reserve Bank's resources for supervision and regulation, enhancements to the crisis management framework, steps to strengthen cooperation with Australian authorities, and clarifications of responsibilities to reinforce the role and autonomy of the Reserve Bank as prudential regulator and supervisor.

The trans-Tasman dimension, and cooperation with Australian authorities, is particularly important given that Australian banking groups own around 85 percent of New Zealand's banking system assets. In addition, around 60 percent of New Zealand's insurance market is Australian-owned. The Australian prudential regulator – the Australian Prudential Regulation Authority (APRA) – is therefore the 'home' regulator for a large part of the New Zealand financial system.

In addition, the IMF's 2016 FSAP recommended that New Zealand strengthen the financial safety net by introducing deposit insurance.

Government intervention is required to address the recommended changes because they stem from existing settings in the Reserve Bank of New Zealand Act 1989 and the Non-bank Deposit Takers Act 2013.

Also, legislation is required to elaborate on how the Reserve Bank will fulfil its new financial stability objective, and its prudential function in respect of the deposit-taking sector under the Reserve Bank of New Zealand Bill (RBNZ Bill), currently before Parliament. The purpose of the RBNZ Bill is to promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy. A focus on well-being as a policy goal or objective is being increasingly reflected in legislation, such as in recent amendments to the Public Finance Act. The Reserve Bank will contribute, including through the Deposit Takers Act, to building and protecting stocks of financial and physical capital.

Summary of Preferred Option or Conclusion (if no preferred option)

How will the agency's preferred approach work to bring about the desired change? Why is this the preferred option? Why is it feasible? Is the preferred approach likely to be reflected in the Cabinet paper?

The proposal is to merge New Zealand's two existing regimes for regulating banks and NBDTs into a single deposit-taking regime, establish deposit insurance, strengthen the regulatory and supervisory framework, and enhance the crisis management framework.

The Deposit Takers Act (DTA) will help to protect society from the damage to the financial system and wider economy that could be caused by a run on a bank or banks, excessive risk taking by this sector, and the failure of individual deposit takers. By doing so, the DTA will promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy.

Both the Reserve Bank Bill and the DTA recognise the significant Australian ownership of the New Zealand financial system and the deposit taking sector in particular, and the importance of the home-host relationship between the Reserve Bank and Australian authorities. The Reserve Bank Bill contains a new generic function around cooperation which includes a requirement to cooperate with overseas bodies that perform similar functions to the Reserve Bank. The DTA will carry over the current explicit reciprocal obligation tied to trans-Tasman cooperation from the Reserve Bank Act, and there will be other parts of the new legislative framework that recognise the importance of regulatory cooperation between the Reserve Bank and its international counterparts.

The Reserve Bank's package of recommendations

Previous Cabinet in-principle decisions

Cabinet is being asked to confirm its previous in-principle decisions, which include:

- regulating and supervising banks and non-bank deposit takers under a single prudential regime;
- using 'standards' as the primary legislative mechanism for imposing prudential requirements;

- enhancing the accountability and liability of directors of deposit takers;
- giving the Reserve Bank an on-site inspection power and a more graduated enforcement and penalty framework with a broader range of potential sanctions;
- establishing a deposit insurance scheme, and;
- designating the Reserve Bank as the resolution authority with a broader range of powers.

Additional and consequential recommendations, following on from the decisions set out above, are as follows:

The framework for the regulation and supervision of deposit takers

- define the legislative purposes of the DTA and the decision-making principles that will help guide the exercise of powers under the Act;
- define which financial institutions will be regulated and supervised as 'deposit takers' and the flexibility afforded to the Reserve Bank to manage entities that sit close to the boundary of the prudential perimeter (i.e. exemption and designation powers);
- empower the Reserve Bank to set prudential requirements on deposit takers via standards within a permitted scope, with a high degree of flexibility to tailor requirements given the diversity of the sector;
- empower the Reserve Bank to license and de-license deposit takers, subject to criteria specified in the DTA, and in consultation with the Financial Markets Authority (FMA) which will be licensing the same set of financial institutions from a market conduct perspective;
- empower the Reserve Bank to set 'fit and proper' requirements on directors and senior managers in line with those requirements in the Insurance (Prudential Supervision) Act 2010;
- provide greater assurance that directors of deposit takers are prudently managing risks to their institution, via the imposition of an on-going duty to ensure that there are adequate systems, processes and policies in place so that the entity complies with its prudential obligations;
- provide for an on-site inspection power and a more graduated enforcement and penalty framework with a broader range of potential sanctions;
- calibrate the scope of the Reserve Bank's regulatory and supervisory powers for 'associated persons' of deposit takers as appropriate – i.e. entities that have a relationship with the deposit taker and whose activities may pose a risk to the soundness of the deposit taker and/or the stability of the financial system; and
- provide for a well calibrated framework for appeal rights in the prudential framework – i.e. the ability of affected parties to challenge decisions of the Reserve Bank, in a way that strikes the right balance between protecting the rights of affected parties while enabling the Reserve Bank to pursue its statutory mandate effectively and efficiently.

Crisis management and resolution

- the design of some key elements of the new resolution and crisis management framework, including the introduction of statutory bail-in[1], the Minister's role in the framework at specific decision points, the triggers for resolution and the liabilities eligible for bail-in

Deposit insurance

- the Deposit Insurance Scheme (DIS) would be compulsory for all licensed deposit-taking institutions, would be fully funded by levies on member institutions, and would be supported by a government funded backstop that will enhance the credibility of the DIS.
- a reframing of the objective of the deposit insurance scheme along the lines of "protecting depositors to the extent they are covered by the deposit insurance scheme and thereby contributing to financial stability".
- the governance and mandate of the deposit insurer
- the funding framework
- the boundary for eligible products and depositors.

Alignment between the Reserve Bank and the Treasury

Both the Reserve Bank and the Treasury strongly support the proposed reforms and see the package of proposals as a significant step forward to protect society from the damage to New Zealand's financial system and wider economy that could be caused by excessive risk taking by the deposit taking sector, and the failures of individual deposit takers. Taken together the recommendations will strengthen New Zealand's financial system safety net.

The agencies have, however, made different judgements in the following areas:

Section 4.4.G Macro-prudential policy

- This issue relates to the scope of lending standards, which refers to three aspects of macro-prudential policy (the types of lending, the types of borrower and the type of instrument). These aspects of macro-prudential policy need to be either delegated to the Reserve Bank through empowering provisions in the DTA or prescribed through regulation and implemented through an Order in Council on the recommendation of the Minister of Finance.
- The Reserve Bank prefers Option 2: Types of lending that lending standards may apply to will be prescribed by regulation, leaving the types of borrowers and the types of macro-prudential instruments used to be set by the standards. Empowering the Reserve Bank to set lending standards that define the macro-prudential tools is important in terms of the operational independence of macro-prudential policy. It also aligns with the Reserve Bank's role as technical expert. This option is reflected in the Cabinet paper.

1 'Bail-in' is a resolution tool where unsecured liabilities are written down or converted into equity. This power would provide a new option for imposing costs of a deposit taker failure on investors and creditors rather than taxpayers.

- The Treasury prefers Option 1: Types of lending and the types of borrowers that lending standards may apply to and the types of macro-prudential instruments that may be included in lending standards will be prescribed by regulation.

Section 4.4.H The role of the Minister of Finance in changing the scope of lending standards

- Lending restrictions used for macro-prudential policy may generate 'distributional' consequences, and may have implications for other areas of government policy. It is therefore important to clarify the role of the Minister as it relates to the Reserve Bank's use of such tools. There are trade-offs between the degree of Ministerial involvement in prudential policy and the Reserve Bank's degree of operational independence.
- The Reserve Bank prefers Option 1: A requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards only in accordance with a recommendation of the Reserve Bank.
- The Treasury prefers Option 2: A requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards after consultation with the Reserve Bank. This option is reflected in the Cabinet paper.

Section 4.7.U Incurring expenditure without appropriation in a financial crisis

- Parliament can be asked to pass specific spending authority through an Appropriation Act or additional Imprest Supply. However, a government cannot always rely on the availability of Parliament to do so in the time required. Resolution of a financial entity must be able to be executed in a timely manner and, at least initially, often out of the public eye; speed is usually of the essence if damage to the wider financial system and economy is to be avoided.
- The Review proposes a new section in the Public Finance Act similar to existing section 25 but focussed on and tailored to the requirements of a financial crisis (whether in banking or insurance, such as the post-Canterbury earthquake AMI Insurance crisis in 2011).
- The Reserve Bank is neutral on this recommendation, which is proposed by the Treasury. The subject matter is outside the scope of the Reserve Bank's mandate or expertise.
- The Treasury supports the proposed approach.

Section 4.8.W Deposit insurance and the insurance limit

- A common and long-standing approach used overseas is to establish a deposit insurance scheme that protects eligible depositors up to a pre-set maximum or 'coverage limit' if their deposit taker failed.
- The Reserve Bank prefers the introduction of deposit insurance with a $50,000 limit to address the issues in relation to enhancing New Zealand's financial safety net. A well designed DIS can protect depositors from risks beyond their control, mitigate the potential hardship that depositors would face from loss of access to, and loss on, their transactional accounts. This in turn can raise public confidence, reduce the likelihood and severity of bank runs and disorderly bank failures, and contribute to financial stability.

- The Reserve Bank considers that this option would sufficiently protect depositors from loss by mitigating any hardship depositors would face through lack of access to and loss faced on amounts up to $50,000. The Reserve Bank places substantial weight on the moral hazard risks that arise from protecting depositors from loss at higher coverage limits, and the greater reliance on costly and imperfect mitigation tools that this creates. At higher coverage limits under Options 3b ($100,000) and 3c ($250,000) there would be material moral hazard risks for little marginal benefit in terms of additional depositors fully covered.
- The Treasury prefers the introduction of deposit insurance with a $100,000 limit. The Treasury sees that there is significant uncertainty about the appropriate coverage limit. This option is reflected in the Cabinet paper.
- A $100,000 limit would cover a substantial number of depositors who are otherwise not necessarily well placed to monitor their deposit taker, such as first-home buyers and retirees. The Treasury notes that there is substantial variation in the number of deposit takers fully covered at each institution under the coverage limit options. At a $100,000 limit the vast majority of depositors would be fully covered at the vast majority of deposit takers, while leaving a significant amount of the value of deposits unprotected. A $100,000 limit would support future Governments willingness use resolution tools that impose losses on depositors, knowing that the vast majority of depositors are fully covered.
- A $100,000 limit would support confidence in the financial system, without materially blunting incentive of more sophisticated depositors to monitor risks. While the Treasury sees moral hazard as a key consideration for depositor protection, the increase in risk-taking and the Crown's contingent liability would need to be managed using the enhanced monitoring, supervisory, and regulatory powers being provided to the Reserve Bank under the Deposit Takers Act and through levies differentiated according to the level of risk. It is also unclear whether depositors up to $100,000 are currently engaging in risk monitoring

Section 4.8.X Depositor preference

- Bank deposits – including those deposits covered by the DIS – under the current creditor hierarchy[2] rank *pari passu* (have equal rank) with other senior unsecured creditors. That means that depositors and other unsecured creditors absorb losses equally in proportion to their claim. A depositor preference would rank preferred depositors ahead of the other unsecured creditors, thereby increasing the amount of recoveries received by these creditors from the assets of the failed deposit taker.
- The Reserve Bank, on balance, favours Option 2: Insured Depositor Preference (preference for the deposit insurance scheme) over the status quo. Option 2 would provide material benefits to the operational effectiveness of resolution tools. Furthermore, the costs identified with a preference for the deposit insurance scheme, and any associated impacts on competition will be partially mitigated by the increased capital requirements recently announced as part of the Reserve Bank's Capital

2 The creditor hierarchy dictates how losses are allocated amongst creditors, including depositors. A typical creditors' hierarchy would consist of the following, in order of priority: secured creditors; administration and liquidation expenses; other preferred creditors (wages, taxes); general unsecured creditors (e.g. deposits); unsecured subordinated debts; and shareholders' equity.

Review, and the forthcoming enhancements to early intervention and resolution powers.

- The Treasury, on balance, favours Option 1: enhanced status quo (deposit insurance with the status quo creditor hierarchy). The Treasury's view is that the preference decision is a difficult on-balance judgement weighing up implications for market structure, ease of resolution options, and the burden of costs in a resolution. On balance, the Treasury favours no preference due to the adverse effects on smaller deposit takers of the other options.

Section 4.9.BB Appeal rights

- The DTA will, where appropriate, provide for a right of appeal if the rights or interests of a particular person are affected by an administrative decision.
- The Treasury agrees with the Reserve Bank's proposed system of appeal rights for the Reserve Bank's administrative decision-making powers, other than in relation to:
    - appeals from decisions affecting the rights and interests attaching to deposit taking licences: the Treasury considers that these decisions should be subject to full ('merits') appeal
    - appeals from decisions on enforcement or direction: the Treasury considers that these decisions should be subject to appeal on questions of law.
- The different conclusions by the Treasury and the Reserve Bank reflect a difference in judgement on the right balance to be struck between protecting the interests of affected parties versus enabling the Reserve Bank to pursue its statutory mandate efficiently and effectively. In general, a limitation reflects the need for certainty, including potential risks to financial stability, and the expertise of the decision maker.

The proposed approach to the DTA seeks to build on the governance changes being progressed through the Institutional Act, providing the Reserve Bank with clearly defined independent powers and responsibilities, subject to appropriate procedural requirements.

The operational independence of the Reserve Bank as prudential regulator is critical to providing credible commitment to the long-term objective of financial stability. This operational independence needs to be balanced by mechanisms that allow elected decision-makers and the wider public to hold the Reserve Bank to account and transparency requirements that promote quality decision making and reinforce the Reserve Bank's legitimacy. These considerations were criteria that informed the proposed design of the RBNZ Bill and the Deposit Takers Act (see section B below).

The proposed role of the Minister in the regime recognises that prudential regulation can have significant distributional and fiscal implications. While the balance and complementarity between independence and accountability is an important consideration for the legislation as a whole, it is a particularly important consideration for the purposes of the legislation and decision-making principles for the Reserve Bank (see section 4.2), and the Reserve Bank's proposed standard-setting and licensing powers (see section 4.4).

No significant incompatibilities with the Government's 'Expectations for the design of regulatory systems' have been identified.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

This package of proposals will help protect society from the damage to New Zealand's financial system and wider economy that could be caused by excessive risk taking by the deposit taking sector, and the failures of individual deposit takers. Taken together, the recommendations will strengthen New Zealand's financial system safety net.

The reforms are expected to strengthen New Zealand's financial system safety net with respect to the deposit taking sector, with attendant benefits for regulated entities, depositors and the taxpayer.

There will be benefits in terms of the Reserve Bank's role as prudential regulator and supervisor. At a high level, the recommendations provide the Reserve Bank with the operational independence necessary for a credible commitment to financial stability. More specifically, the recommendations provide the Reserve Bank with a modernised framework and an enhanced set of tools in order for it to:

- protect and promote the stability of New Zealand's financial system (the Reserve Bank's financial stability objective, as would be established through the RBNZ Bill), and thereby promote the prosperity and well-being of New Zealanders and contribute to a productive economy (the purpose of the RBNZ Bill;
- fulfil the proposed purposes of the DTA:
    - the promotion of the safety and soundness of deposit takers;
    - the promotion of public confidence in the financial system;
    - the mitigation of the risks that arise to and from the financial system,
- fulfil the following objectives in performing the resolution function:
    1. enable all deposit takers to be resolved in an orderly manner;
    2. avoid significant damage to the financial system in the event of the failure of a deposit taker, including by maintaining the continuity of systemically important financial functions and preventing contagion;
    3. to the extent not inconsistent with objective 2 above:
        i. minimise the cost of resolution and avoid unnecessary destruction of value and interference with property rights
        ii. protect public funds, including by minimising the need to apply public funds to resolve the failure of a deposit taker.
- Fulfil the objective the deposit insurance scheme, which would be to protect depositors and thereby contribute to financial stability.

As discussed below in the *Impact of proposals on well-being* section, financial and physical capital is a critical component of well-being. As we saw in the global financial crisis and in global shocks (such as COVID-19), well-being is impacted when physical and financial capital stocks are depleted. The global economic shock related to COVID-19 saw financial capital depleted around the world as incomes and employment fell and resulted in governments and central banks engaging in unprecedented monetary and fiscal stimulus to support their economies.

The package of reforms are expected to provide wider benefits by way of improved public confidence in the regulation of deposit takers, reducing the likelihood and severity of bank runs and disorderly bank failures, and contributing to financial stability. The increased trust and confidence in the financial system would provide benefits across a range of well-being domains (e.g. income and consumption, jobs and earnings). The proposals may help investors to understand the risks associated with their investments and to price those risks accordingly.

Finally, there would be benefits from alignment with international best practice as international investors would have clarity and certainty about the risk they face in the event of a resolution. This could have efficiency benefits in terms of better coordination of policies and improved or lower cost access of New Zealand banks to international markets. It could also (see the next point) reduce any costs associated with perceived inconsistencies of international regulatory approach.

The DTA will establish a new regulatory perimeter and create a single regulatory regime for all deposit takers. This will create a more consistent regime for the sector and align prudential regulation and supervision with the deposit protection arrangements.
The DTA's purposes and decision-making principles will clarify how the Reserve Bank is to pursue the financial stability objective in respect of the deposit-taking sector (and in certain cases, associated persons of deposit takers). Clear objectives will also provide the means for the Minister of Finance, the Treasury (as the Reserve Bank's monitor), and the public to hold the Reserve Bank to account.

The DTA will:

- provide for a flexible regulatory perimeter, allowing the Reserve Bank, and in some cases the Minister, to respond to changes in the financial system and evolving risks to financial stability (see sections 4.1 and 4.3)
- modernise the Reserve Bank's approach to imposing prudential requirements on regulated entities through disallowable instruments to be known as Standards, while providing the Reserve Bank with a high degree of flexibility in applying the prudential regime to individual deposit takers and classes of deposit takers, in a proportionate manner (see section 4.4)
- strengthen accountability requirements for directors of deposit takers (see section 4.5)
- enable a more intensive supervision model by providing the Reserve Bank powers to obtain the information necessary to assess whether firms are opeating prudently and according to the standards and other conditions imposed by the Reserve Bank (see section 4.6)
- provide the Reserve Bank with a more flexible and graduated enforcement toolkit that allows it to proportionately and effectively promote compliance (see section 4.6).
- enhance the crisis management framework (see section 4.7)
- establish deposit insurance (see section 4.8).

Providing a flexible and empowering regulatory framework was one of the key design principles for the reforms (see section 3.2 below for discussion on the criteria used to assess the likely impacts of the options).

For resolution and crisis management, the proposed package of proposals would increase the range of resolution options and deliver resolution in an orderly manner without causing disruption to critical financial services or damage to financial stability. In particular, it would ensure continuity of systemically important financial services, and payment, clearing and settlement functions, and allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims. This will support pre-crisis preparedness and mitigate delay in responding to a crisis.

For deposit insurance, we expect that there will be benefits to deposit takers from a more stable deposit funding base. We expect depositors would see benefits in the form of hardship mitigation in the event of a deposit taker failure, and enhanced trust in the financial system. Deposit insurance can reduce incentives for protected depositors to join bank runs by ensuring timely access to funds up to a known limit. Prior to any failures occurring, we expect the government would see benefits from shifts from an uncertain implicit guarantee, to a managed, limited, and user-pays explicit guarantee, and the public would have increased confidence in the safety of deposits.

In addition, as for resolution and crisis management, there would be benefits from alignment with international best practice as international investors would have clarity and certainty about the risk they face in the event of a resolution.

The contribution of the proposals considered in this regulatory impact analysis to financial stability should be considered against the significant cost of financial crises. Indeed, studies show financial crises can lead to a permanent loss of economic output equivalent to between 20 and 160 percent of annual GDP[3]. To a large extent the proposals have been designed as a package of reforms and their contributions should be evaluated as such.

Impact of proposals on well-being

The Treasury's Living Standards Framework can act as a vehicle to consider the well-being impacts of the proposals, and to communicate to the public a broader view of the impact of the changes.[4] Using the framework, the analysis can be informed by the systemic impacts on the financial sector, the role of public trust, and opportunities for the future. For example: the ways that financial stability supports positive technological change, and can mitigate climate change (through, for example, allowing climate change risk to be properly priced in the financial market).

3 Guthrie, Susan - Reserve Bank of New Zealand. Capital Review Background Paper: An outline of the analysis supporting the risk appetite framework. (April 2019). Accessed at: https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Policy-development/Banks/Review-capital-adequacy-framework-for-registered-banks/Capital-Review-An-outline-of-the-analysis-supporting-the-risk-appetite-framework.pdf?revision=058df82e-5fc8-4e4c-9431-5f2dfff5aa4a&la=en

4 The Treasury. Living Standards Framework: Background and Future Work (December 2018). Accessed at: https://www.treasury.govt.nz/sites/default/files/2018-12/lsf-background-future-work.pdf

This regulatory impact statement addresses the more direct costs and benefits (mostly in terms of efficiency and stability) of the proposals, and their impacts on the wider economic and financial system. These proposals can also be seen can be seen in conjunction to a broader well-being framework, and can be considered in terms of their impact on everyday depositors and other stakeholders. Moreover, the financial policy objectives proposed for the DTA are not ends in themselves, but should be read in light of the overarching statutory purpose of the Reserve Bank Act to “promote the prosperity and *well-being* of New Zealanders and contribute to a sustainable and productive economy” (emphasis added).

The Living Standards Framework divides well-being into 12 domains, which reflect the well-being of New Zealanders at a ‘point in time’. No single framework will capture all that matters for everyone, but domains of particular relevance to these proposals are:

- **Income and consumption**: people's disposable income from all sources, how much people spend and the material possessions they have.
- **Jobs and earnings**: the quality of people's jobs (including monetary compensation) and work environment, people's ease and inclusiveness of finding suitable employment and their job stability and freedom from unemployment.
- **Safety:** people's safety and security (both real and perceived) and their freedom from risk of harm, and lack of fear.

The 12 domains are underpinned by four capitals, which serve as foundations of well-being. These include the skills and knowledge of New Zealanders, the natural environment we live in, the social connections, community and institutions we have, as well as the buildings and machines we use. Of particular relevance to these proposals is New Zealand’s financial and physical capital. This captures the country's physical, intangible and financial assets that have a direct role in supporting incomes and material living conditions.

Financial and physical capital is a critical component of well-being. International agencies like the World Bank, the World Health Organization, and the United Nations have investigated the economic and social impacts of financial crises. They report that banking crises almost always lead to a general downturn in the economy, associated with rising unemployment and lost output, with consequential societal effects. These impacts go beyond the financial realm as they affect the health and quality of life, often of people who had little involvement in creating the crisis. As we saw in the global financial crisis and in global shocks (such as COVID-19), well-being is impacted when physical and financial capital stocks are depleted. The Global Financial Crisis of 2008/2009 was a prime example, as this crisis led to a widespread global downturn and higher rates of unemployment. While many countries have since fully recovered from this crisis, or are on the path to recovery, some countries are still trying to find their footing.[5]

5 Bascand, Geoff (2019). Safer banks for greater wellbeing. Speech delivered to the Institute for Governance and Policy Studies, Victoria University in Wellington. Available at: https://www.rbnz.govt.nz/research-and-publications/speeches/2019/speech2019-02-26

The global economic shock related to COVID-19 saw financial capital depleted around the world as incomes and employment fell and resulted in governments and central banks engaging in unprecedented monetary and fiscal stimulus to support their economies. For New Zealand, with its bank-dominant financial system, a vibrant, innovative and sustainable banking sector is crucial to our collective well-being.[6]

Since the 1970s, there have been more than 140 banking crises around the world. And they have had large costs to affected economies and societies. Unemployment rates and GDP figures are the more easily quantifiable impacts of banking crises. But what can sometimes get lost in the discussion surrounding bank failures is the deep personal impacts they can have, not only on those directly impacted, but also on those indirectly impacted. Economic models and statistics can only go so far in telling this story. Bank failures can be damaging, not just in economic terms, but more broadly in terms of mental and physical health, and general societal well-being. Further, societal impacts tend to go well beyond the initial year of a banking crisis.[7]

Risk and resilience is the third element of the framework (as well as the domains, and the capitals), at individual, community, and national levels. Risk and resilience relate directly to the capital stocks. The quality and quantity of the capital stocks, which can be degraded, and in some cases actively drawn down, influence the ability of our people and the country to withstand shocks.

The COVID-19 crisis has reinforced the focus of the Reserve Bank on resilience in regulatory policy settings, including the imperative of strong capital and liquidity requirements.

To-date, New Zealand’s financial sector has proved resilient to the dual health and economic shocks, and indeed, supported the business and household sectors through strong business continuity arrangements, the accommodation of many customers through the restructuring of borrowing terms, and only a relatively modest tightening of lending standards. Looking ahead, ensuring the ongoing health of New Zealand’s financial institutions and provision of credit will be crucial to our economic recovery. A financial crisis and ‘credit crunch’ on top of an economic crisis would be hugely disruptive for New Zealanders’ wellbeing. The ability of financial institutions to absorb shocks, manage risk and continue lending in the face of shocks is foundational to our regulatory framework.

The Reserve Bank’s focus on risk management is evolving so as to be attuned to changing structures and dynamics in the financial sector, including the implications of cyber risks, FinTech, climate risks, financial inclusion and the economy’s increasing reliance on payments system stability. These longer-term structural changes highlight the importance of a regulatory system and perimeter that can adapt to non-traditional financial entities, which is a key consideration of Phase 2 of the Review.

6 Bascand, Geoff (2020). Banking the economy in post-COVID Aotearoa. Speech delivered to livered to banking industry representatives in Wellington. Available at: https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Speeches/2020/Speech2020-07-31.pdf?revision=c569a6f7-e584-467e-9d6e-ec926a178120

7 Bascand, Geoff (2019)

Prudential regulation

The proposal is a reformed and more robust framework for prudential regulation – a much strengthened financial system safety net for New Zealand. The new prudential framework will enable the Reserve Bank to better manage risks that arise both to and from the New Zealand financial system, thereby supporting both the financial health of individual deposit takers and financial stability. In turn this will help protect the financial capital of New Zealanders. A stable financial system, in which the public has confidence, protects people's jobs and earnings, and income and consumption, from unforeseen shocks arising from the financial system.

Resolution and crisis management

A fit for purpose crisis management regime allows the failures of financial institutions to be managed, and ensures that the financial system will be resilient to failures of financial institutions, both large and small – preventing shocks from spilling out into the broader economy and threating the economic and social well-being of New Zealanders. The proposals relating to the new crisis management regime will support the resilience of New Zealand at the national level.

Depositor protection

The deposit insurance scheme ultimately supports the financial safety of New Zealanders, and provides security and confidence from risk of financial harm. This supports the resilience of individuals and whānau. A credible deposit insurance scheme builds public confidence, and therefore promotes financial stability.

Where do the costs fall?

Financial sector

We expect that there will be costs to the financial sector associated with the new prudential framework for deposit takers, although the extent of any cost increase will be dependent on how the Reserve Bank chooses to operationalise some of the legislative changes (e.g. whether the Reserve Bank undertakes on-site inspections in the context of a more intensive model of supervision). There will be one-off costs to the financial sector to implement the changes introduced by the new prudential framework. Some of these costs may be passed on to customers of deposit takers, although the extent of this is difficult to determine. Customers will also be among the main beneficiaries of the strengthened financial system safety net described in the previous section.

Deposit takers will continue to face costs arising from being subject multiple regulatory regimes, both domestically (the Financial Markets Authority and the Commerce Commission) and in some cases from overseas (for example, branches and subsidiaries of Australian banks also come under the regulatory regime of the Australian Prudential Regulation Authority (APRA)).

For crisis management, there may be additional funding costs to the financial sector in relation to debt instruments that will be eligible for bail-in[8], offset by the low risk of bail-in being used due to the Reserve Bank's capital requirements.

For deposit insurance, there will be costs to deposit insurance scheme members in the form of levies to cover the costs of a deposit insurance scheme, and costs to upgrade their systems to implement the scheme (e.g. a single customer view). To the extent that costs of the insurance scheme would be passed on to customers, depositors could receive lower returns on their deposits, or other customers could bear (some of) the costs via increased rates on loans. The Crown is also committing to provide a funding backstop for the scheme.

Reserve Bank

To the extent that the proposed changes to the Reserve Bank's prudential regulation increase its operating costs, future dividends to the Crown may be reduced if they can't be covered by revenue from a levy. The proposed levying power for the Reserve Bank's prudential functions under the RBNZ Bill, if implemented, would shift costs from taxpayers (reflected by the dividend) to regulated entities, with those costs potentially passed on by industry to deposit takers' customers. The costs directly associated with changes to the Reserve Bank's prudential regulation function have not generally been quantified as they are not expected to be significant, are dependent on how the Reserve Bank chooses to implement the regime, and are generally not a determining factor in assessing appropriate prudential regulation by the Reserve Bank.

What are the likely risks and unintended impacts? how significant are they and how will they be minimised or mitigated?

The Deposit Takers Act, and the overall system that the Reserve Bank operates in, are complex, and the proposed changes are part of a large-scale package of related reforms. The proposals involve significant changes to the Reserve Bank's prudential regulation framework and introduce new functions, including the implementation of deposit insurance and the establishment of a new resolution and crisis management framework. There are inherent risks associated with this large scale of proposed change to the regulatory regime for deposit taking institutions. These changes include the need for operational and cultural changes, both by deposit takers and at the Reserve Bank.

There are risks associated with whether the proposed new prudential framework has struck the appropriate balance in *proportionately* responding to financial stability risks (for example, imposing prudential regulation on the entities that are most likely to present financial stability risks). These risks are mitigated through three rounds of public consultation, reliance on domestic and international best practice, and by explicitly considering these factors when evaluating policy options.

8 For bail-in to be a credible and orderly resolution option, it is essential that there is ex ante transparency on the scope of eligible bail-in instruments (i.e., liabilities subject to write-down or conversion). This enables investors and creditors to assess the risks associated with, and the pricing of, liabilities potentially subject to bail-in. See section 4.7, specifically issue V, for further information.

The timeframe for these reforms is tight. The Government intends to introduce a bill progressing the Deposit Takers Bill by late 2021. These time pressures, as well as the extensive interactions with other reforms (particularly the institutional reforms via the Reserve Bank Act of New Zealand Bill, currently before Parliament), mean there is a greater risk of errors and unintended consequences. These risks are being mitigated by close interagency cooperation by the Reserve Bank, including with members of the Council of Financial Regulators (COFR) and with the Parliamentary Counsel Office. In addition, these risks will be further mitigated by the release of an exposure draft of the Bill and a full parliamentary process, which would provide time and opportunity to correct any issues that emerge from the drafting process.

There are significant risks associated with the implementation of the Deposit Takers Act, and the potential for unintended consequences. The Reserve Bank is planning to increase resourcing in affected areas and additional resources on the part of the Reserve Bank were sought as part of the development of its 2020 funding agreement. The costs of some elements of the proposed package, where there was a high degree of uncertainty in costs, were excluded from the funding agreement.[9] There will also be a transitional period, which would allow: the Reserve Bank to closely engage with industry, the licensing of entities that will form the new 'deposit taking' prudential perimeter, as well as the development of the new prudential standards. The Reserve Bank will engage with stakeholders during this transition period to guide the implementation of the new regime and provide information to consumers about the nature of the changes.

The introduction of deposit insurance has the potential to cause an unintended increase in risk-taking by deposit takers. Deposit takers that offer higher returns may attract large inflows of deposits following the implementation of the scheme and subsequently engage in higher risk lending, which could undermine financial stability. The framework provides for the mitigation of this risk through prudential supervision of all deposit takers by the Reserve Bank, charging levies that are differentiated according to the risk of deposit takers, and by placing limits on the amount of insurance provided.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?

Overall, there is good, but not conclusive, evidence to support the proposed reforms. The proposed reforms are informed by our practical experience of current prudential regulation in New Zealand, other forms of financial regulation, and the experience of other financial regulators internationally, especially their experience during the Global Financial Crisis. We have drawn heavily on reviews of prudential regulation and regulatory practice, and advice from entities and individuals, such as:

- the International Monetary Fund's 2016/2017 Financial Sector Assessment Programme (FSAP) of New Zealand;
- the Basel Committee's 2012 Core principles for effective banking supervision;
- the Productivity Commission's 2014 Regulatory Institutions and Practices inquiry

9 For further details on the 2020 Funding Agreement, see https://www.rbnz.govt.nz/about-us/funding-agreements/2020-funding-agreement

- the Government Expectations for Good Regulatory Practice;
- the Legislation Design and Advisory Committee's Legislation Guidelines;
- input from relevant specialists at the Reserve Bank, Treasury, the Finance Markets Authority and other agencies, and the Independent Expert Advisory Panel appointed by the Minister of Finance;
- reports from the Bank for International Settlements relating to central banks and banking regulators;
- a review of international prudential frameworks, including arrangements in Australia;
- engagement meetings and workshops with domestic and international stakeholders and relevant experts, including the Australian Prudential Regulation Authority, the Australian Treasury, the Reserve Bank of Australia, and the Australian Securities and Investments Commission[10]; and
- formal feedback from submitters through three rounds of public consultation.

While there is not a prescriptive set of prudential arrangements for the regulation of deposit takers that will be suitable for every jurisdiction, there are established principles and examples of good practice.

In addition to the sources noted above, the proposals have been informed by advice and input from an Independent Expert Advisory Panel.[11]

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
A quality assurance panel (QA Panel) with representatives from the Reserve Bank of New Zealand, the Treasury and from the Regulatory Impact Analysis Team at the Treasury has reviewed the Regulatory Impact Statement (RIS) "A New Prudential Framework for the regulation and supervision of deposit takers and the introduction of deposit insurance".
Quality Assurance Assessment:
The QA Panel considers that it **meets** the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The Regulatory Impact Statement is clear and comprehensive despite the wide scope of decisions. It clearly sets out the key elements of the reform, distinguishing the aspects of the previous legislation being strengthened (prudential regulation and resolution) and new elements being introduced (depositor protection). The set of decisions is intended to function as a package with different sections of the RIS interacting with each other. While the Reserve Bank and the Treasury both support the need for reform, they have different recommendations on macro-prudential policy, the approval process in changing the scope of lending standards, the deposit insurance limit and depositor preference. The panel notes that judgement makes a significant part of the basis for those recommendations. Notably, the recommended deposit insurance limit stems from different judgements on moral hazard risks between the Reserve Bank and the Treasury. Several chapters included within this RIS interact significantly with proposed changes included in the RBNZ Bill and accompanying RIS. The proposed Ministerial powers

discussed within the Macroprudential chapter should be considered alongside the wider governance changes, such as the financial policy remit.

10 This engagement included discussion on the operational responses to these reforms. Since 2006, the Reserve Bank is required to implement its powers vis-à-vis the banking system in such a way as to avoid any detrimental impact on financial system outcomes in Australia, to the extent reasonably practicable. A reciprocal provision was included in Australian legislation.

11 For further information on the Independent Expert Advisory Panel, see https://www.treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act/independent-expert-advisory-panel

Impact Statement: A New Prudential Framework for the regulation and supervision of deposit takers and the introduction of deposit insurance

Section 1: General information

1.1 Purpose

This analysis and advice has been produced to inform key policy decisions to be taken by Cabinet on the new prudential framework for the regulation and supervision of deposit takers and a deposit insurance scheme. There are some elements of the DTA that we anticipate will be progressed through delegated decision-making later in 2021. These are largely second-order policy decisions, for example, an offences and penalties framework under the proposed regime, and whether and how some of the powers currently vested in a statutory manager in the Reserve Bank Act 1989 would be carried over to the DTA.

This Regulatory Impact Assessment (RIA) summarises the Reserve Bank's best advice on the Impact Analysis relating to the regulatory proposals. The Reserve Bank's analysis is based on Phase 2 of the Review of the Reserve Bank Act (the Review), which is being jointly led by the Treasury and the Reserve Bank. An Independent Expert Advisory Panel has been established to inform and test the Review's recommendations. The Reserve Bank's responsibility for this assessment is a function of its administration of the new Deposit Takers Act.

Where the Treasury or the Independent Expert Advisory Panel do not concur with the analysis, as presented in this RIA, this has been noted.

1.2 Key Limitations or Constraints on Analysis

Scoping of the problem

The overall objective of the Review (as set out in its terms of reference[12]) is to modernise the Reserve Bank's legislation to support the development of a New Zealand economy that is productive, sustainable and inclusive. While the Reserve Bank Act has been amended several times since it was enacted in 1989, the core prudential provisions have been in place since the start. This Review aims to create a similarly enduring and trusted framework that promotes financial stability and supports the economy.

Phase 1 was completed in 2018. As a result, "supporting maximum sustainable employment" has been added to the economic objectives for the Reserve Bank and a Monetary Policy Committee (MPC) has been created with responsibility for formulating monetary policy.

12 Review of the Reserve Bank Act 1989, Phase 2 – Terms of Reference. Available at:
https://www.treasury.govt.nz/sites/default/files/2018-06/rbnz-3933712.pdf

Phase 2 is a comprehensive review of the legislative framework, seeking to ensure that the Act is fit for purpose, flexible, and enduring. Phase 2 of the review is not revisiting decisions made as part of Phase 1[13] relating to monetary policy, except where consequential changes are required.

The first tranche of Phase 2 reforms to be legislated are the institutional reforms, which modernise the institutional design and accountability requirements of the Reserve Bank of New Zealand and import certain transparency and accountability features of the Crown entity regime. The RBNZ Bill is currently before Parliament.

The second tranche of Phase 2 reforms, for which the DTA is the culmination, considered the prudential framework for regulating banks and other deposit takers on a first principles basis, limited only by its terms of reference.

The problem considered in this RIA has been broken down into eight issues, each with its own analysis of the key reform options, to allow for the broad range of different issues and options to be worked through in a logical manner. The analysis of some issues necessarily assumes that a particular approach has been taken to earlier, more fundamental issues. These options must work together as a coherent package in order to enable the Reserve Bank to fulfil its financial stability objective, and seek to strike an appropriate balance and complementarity between flexibility, clarity and legitimacy.

Evidence of the problem

Evidence of the problem in relation to the Reserve Bank's prudential regulation inherently relies on subjective assessments of the impact of the current settings on its decision-making and performance, and outcomes for the financial sector, over time.

We engaged extensively with stakeholders at the start of the review process to understand better the nature of any concerns they had about the current Reserve Bank Act. This informed the scope of our terms of reference.

The terms of reference for the review was also informed by the IMF's FSAP conducted over 2016/17, which identified a number of gaps in New Zealand's prudential framework with respect to international standards.

We have sought to strengthen this evidence by drawing on analysis of practice by other regulators, both domestically and internationally.

Multiple rounds of public consultation and a large number of stakeholder workshops, as well as input from an Independent Expert Advisory Panel, have helped to test our understanding of the problem, providing a broad range of perspectives on these issues.

13 The Treasury. Regulatory Impact Analysis for the Reserve Bank Review (March 2018). Accessed at: https://www.treasury.govt.nz/sites/default/files/2018-04/ria-tsy-rba-mar18.pdf

Range of options considered

Potential responses to topics have been grouped together into packages of potential changes in order to allow for coherent and efficient analysis of policy options. While a wide range of variations on these packages could be considered, the proposed packages are the most internally consistent responses to the issues considered.

While we have considered non-regulatory options where relevant (e.g. operational improvements), generally legislative solutions are necessary because the problems this review is endeavouring to solve stem from existing settings in the Reserve Bank Act.

The terms of reference provide that the operational independence of the Reserve Bank remains paramount and will be protected.[14]

Accordingly the range of options considered reflects the need for central banks and prudential regulators to retain a significant degree of independence from Ministers, particularly in relation to the operations of regulatory functions.

Assumptions and quality of data underpinning impact analysis

We have generally not sought to quantify costs and benefits due to the difficulty of doing so in relation to changes to the legislative framework for prudential regulation. Assessments reflect a judgement about the relative impact of options against the established criteria.

Much of the analysis outlined in this RIA was formally consulted on in three rounds, providing an opportunity for stakeholders to challenge our assumptions and analysis.

Consultation and testing

All significant issues and proposals considered in this RIA have been publicly consulted on and discussed directly with interested stakeholders.

For some issues and proposals, the Review did not consult stakeholders due to the nature of the issue (where the impact of the proposed approach on external stakeholders would be marginal), and some timing and sequencing constraints. However, we do not consider that wider consultation would have provided materially different evidence or feedback from stakeholders.

14 The primacy of operational independence reflects that both prudential regulatory policy and monetary policy are potentially subject to politicisation, with operational independence mitigating the 'time inconsistency' problem where the executive understands the long-term benefits to society from price stability and financial stability, but may not always act in ways over the short-term that ensures the realisation of these objectives. In addition, both monetary and prudential policy are technical in nature, where the benefits of expert judgement are best achieved through the independent pursuit of politically specified objectives. The delegation of various financial system tasks to an autonomous body therefore reflects a form of pre-commitment on the part of government to the long-run goal of a sound and efficient financial system. Further, financial sector regulation decisions weigh a powerful private interest (or set of interests) against a dispersed public interest. The finance industry may be a powerful interest group with deep pockets, potentially able to lever such power over the executive branch of government – and this pressure can be more acute where the sector is dominated by a few large players as in the case of New Zealand's banking system. See Hunt, Chris (2017) Independence with accountability: financial system regulation and the Reserve Bank (Reserve Bank Bulletin) Accessed at https://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2017/rbb2017-80-11

1.3 Responsible Manager (signature and date):

Tamiko Bayliss
Director
Reserve Bank Act Review – Phase 2
7 April 2020

Section 2: Overall context

2.1 What is the current state within which action is proposed?

The Reserve Bank of New Zealand – Te Pūtea Matua – is New Zealand's central bank and prudential regulator. It formulates and implements monetary policy, registers and licenses entities to promote a sound and efficient financial system, and has the sole right to issue currency in New Zealand. It is now more than 30 years since the Reserve Bank of New Zealand Act 1989 was passed. Phase 1 of the current review addressed aspects of monetary policy, resulting in amendments to the Act in 2018. Phase 2 is addressing further aspects of governance and financial policy.

The Reserve Bank was first established in 1934 as New Zealand's central bank, centralising the issuing of bank notes (which had previously been issued by individual trading banks). While the Reserve Bank was initially partially privately owned, it was nationalised shortly after its establishment. The responsibilities of the Reserve Bank have varied over time, with significant reforms in the 1980s giving it operational independence from government and establishing the Policy Targets Agreement for monetary policy between the Minister of Finance and the Governor of the Reserve Bank. These reforms also established the basis for the Reserve Bank's role in the prudential regulation of banks, but its approach was comparatively minimalist compared to international practice today, with significant reliance on self-discipline and market discipline.

In the time since the Act was passed, there have been many changes to the economy and the financial sector globally. Financial institutions have grown in size relative to the global economy and in the range of financial services that they offer. As a result, the global financial system is larger and more interconnected than in 1989.Consumers' pattern of use of financial services and financial products has also changed significantly over this period.

In addition, there has been a growing dominance of Australian-owned banks within the New Zealand banking system. The early 2000s saw a growing focus by the Reserve Bank on local incorporation and outsourcing, reflecting this obvious dominance and an associated 'hollowing out' of functions (the shift of key tasks to Australia). A joint trans-Tasman working party considered options for closer integration of banking supervision and ultimately agreed to an enhanced home-host model, which emphasised information sharing and coordination by the respective national authorities (rather than the Australian Prudential Regulation Authority (APRA) as sole regulator and supervisor of Australian banks operating in New Zealand).[15]

The regulation of financial markets has come under extensive scrutiny following the global financial crisis (GFC). Internationally and domestically, financial regulation has increased in scope and detail in response to the GFC. The pace has increased over the last ten years as most advanced countries undertook significant reforms. At the same time, international standards have been developed that increase the attention given to consistency and comparability across jurisdictions. The Reserve Bank has responded to these changing global expectations by also increasing the intensity of its regulatory framework.

15 Hunt, Chris (2016) A short history of prudential regulation and supervision at the Reserve Bank (Reserve Bank Bulletin). Accessed at: https://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2016/rbb2016-79-14

The failure of a large number of non-bank deposit takers in the 2000s also highlighted shortcomings in the disclosure-based regime that applied to these entities and in their oversight by trustees. Standards for insurers have similarly been increased.

Extensive changes were subsequently made to financial sector regulation in New Zealand, in particular through:

- making the Reserve Bank the prudential regulator of non-bank deposit takers through amendments to the Act, and then through the Non-Bank Deposit Takers Act 2013 (NBDT Act);
- making the Reserve Bank the prudential regulator and supervisor of insurers under the Insurance (Prudential Supervision) Act 2010 (IPS Act);
- the establishment of the Financial Markets Authority (FMA), to replace the Securities Commission;
- reform of conduct and disclosure requirements through the Financial Markets Conduct Act (FMC Act) and associated legislation, and
- changes to Conditions of Registration for banks, such as changes to liquidity, funding and capital requirements, and the introduction of macro-prudential tools.

COVID-19

The COVID-19 health crisis posed significant challenges for the New Zealand economy and financial system. The crisis reinforced the focus of the Reserve Bank on resilience in regulatory policy settings, including the imperative of strong capital and liquidity requirements. The Reserve Bank's focus on risk management is also evolving so as to be attuned to changing structures and dynamics in the financial sector, including the implications of cyber risks, FinTech, climate risks, financial inclusion and the economy's increasing reliance on payments system stability. These longer-term structural changes highlight the importance of a regulatory system and perimeter that can adapt to non-traditional financial entities, which is a key consideration of this Review.

Financial Inclusion and Te Ao Māori

Financial inclusion has become an increasingly important part of the Reserve Bank's policy agenda in its capacity as a Council of Financial Regulators (CoFR) member and the Reserve Bank's Te Ao Māori strategy. The Strategy helps to guide the Reserve Bank in understanding the unique prospects of the Māori economy, how Māori businesses operate, and what lessons the Bank may learn in setting systemically-important policy with this view in mind. An important part of the Strategy is making clearer the unintended consequences of our policies on unique economies like the Māori economy.

The COVID-19 pandemic has demonstrated the disproportionate impact of such economic downturns on both Māori and Pasifika communities. These compounding economic impacts have necessitated the Reserve Bank proactively reaching out to its regulated entities, Government and Māori partners to form a fuller view of the issues. The feedback has highlighted a role for banks in bolstering financial inclusion through greater access to capital to alleviate the financial stress of these unique economies. For example, finding innovative ways to manage the difficulty of securing lending against collectively-owned land could yield significant benefits. As with the needed credit response to the pandemic, there is opportunity to enhance both soundness and prosperity objectives, so that a more diverse spectrum of New Zealanders are being serviced by their banking sector while still prudently managing the risks at hand.

Phase 2 of the Reserve Bank Act Review

Phase 2 of the Reserve Bank Act Review is a wide-ranging review of the financial policy provisions of the Reserve Bank of New Zealand Act 1989, including those that provide the legislative basis for prudential regulation, supervision, and the crisis management framework.

The first tranche of Phase 2 reforms to be legislated are the institutional reforms, which update the institutional design and accountability requirements of the Reserve Bank of New Zealand and make them closer to those of a Crown entity. The RBNZ Bill introduced on 28 July 2020 covers these updates. A copy of the Bill is available at the Parliamentary Counsel Office's New Zealand Legislation website[16].

The counterfactual assumes no changes to the prudential regulation framework or Reserve Bank functions beyond those implemented through Phase 1 of the Review and through the institutional reforms as part of the first tranche of Phase 2. While there is an element of complementarity between the institutional reforms and the DTA, for the purposes of this analysis, the status quo assumes that the institutional reforms are enacted and that the current prudential framework remains in place.

2.2 What regulatory system(s) are already in place?

The Reserve Bank of New Zealand Act 1989 (the RBNZ Act) establishes the Reserve Bank as a body corporate responsible for:

- *Monetary policy:* The maintenance of price stability and support of maximum sustainable employment through the setting of the Official Cash Rate (OCR), which is reviewed around seven times a year.
- *Issuing currency:* The Reserve Bank is the only organisation authorised to issue currency for New Zealand. Banks buy currency in wholesale amounts from the Reserve Bank at face value and return it to the Reserve Bank for replacement.
- *Financial markets operations:* The Reserve Bank holds and manages foreign exchange reserves. The Reserve Bank also operates in New Zealand's domestic markets to implement its monetary policy objective and provide liquidity to the banking system.
- *Payments and settlements:* The Reserve Bank oversees and operates New Zealand's wholesale payment and settlement systems – the Exchange Settlement Account System (ESAS) and the NZClear system, which financial institutions use to complete transactions with each other.

16 Reserve Bank of New Zealand Bill. Available at https://www.legislation.govt.nz/bill/government/2020/0315/latest/LMS286978.html?search=ts_act%40bill%40regulation%40deemedreg_reserve+bank_resel_25_a&p=1

- *Registration and prudential regulation of banks:* In order to help maintain a sound and efficient financial system, the Reserve Bank registers and monitors banks and requires them to meet criteria, such as relating to capital adequacy, liquidity and risk management. This includes macro-prudential requirements, such as lending standards, which aim to manage systemic risks. This role is discussed further below.

New Zealand operates a 'twin peaks' model for financial regulation. The twin peaks model sees regulation split into two broad functions across two agencies: conduct regulation and prudential regulation.

- Conduct regulation focuses on behaviours and outcomes in financial markets. Conduct regulation aims to ensure that consumers are adequately informed and that regulated entities act fairly, transparently, and with integrity.
- Prudential regulation aims to ensure that institutions adequately manage both their own financial risks and the risks they collectively pose to the financial system.

In New Zealand's twin peaks model, the Reserve Bank is currently responsible for prudential regulation and the Financial Markets Authority (FMA) is responsible for conduct regulation. Both agencies have operational independence from government, and have their objectives and functions set out in legislation. The twin peaks agencies are complemented by a number of other financial regulators and policy agencies (summarised in Figure X below), each of which has specific objectives and functions that interact with the others.

The Financial Markets Authority

As conduct regulator, the FMA's overarching objective is to promote and facilitate the development of fair, efficient, and transparent financial markets. The FMA's financial system functions include:

- enforcing securities, financial reporting, and company law as they apply to financial services and securities markets
- regulating securities exchanges, financial advisers and brokers, auditors, trustees, and issuers (including issuers of KiwiSaver and superannuation schemes)
- jointly overseeing designated settlement systems with the Reserve Bank.

The other agencies supporting New Zealand's twin peaks

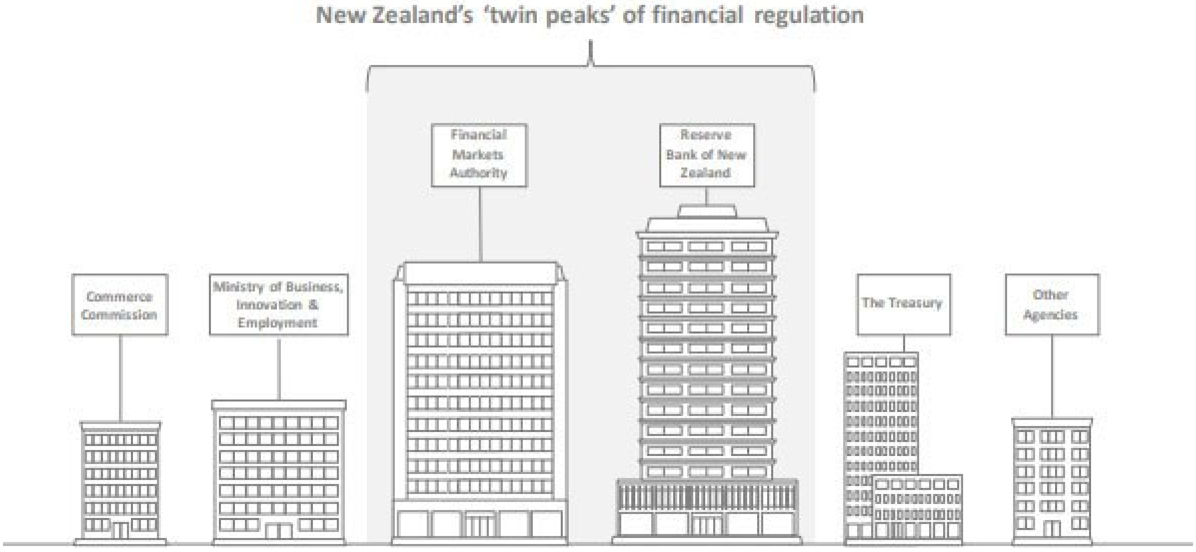
The twin peaks of the Reserve Bank and the FMA are complemented by a number of government departments and independent regulators that address other aspects of regulation.

- The Commerce Commission is the competition and fair-trading regulator responsible for protecting consumers and promoting competition across the economy by enforcing New Zealand's competition, fair-trading, and credit contract laws.
- The Treasury and the Ministry of Business, Innovation and Employment (MBIE) are key Government representatives in the financial regulatory system. They represent the Government's interests and priorities and help to coordinate policy development between the regulatory institutions.
- The Department of Internal Affairs, alongside the Reserve Bank and the FMA, supervises various entities under the AML/CFT Act. The Ministry of Justice is responsible for AML/CFT policy development.

As policy and regulatory responsibilities are distributed across a number of agencies, it is important to have mechanisms to coordinate policy among them, where appropriate. This is particularly true in a twin peaks model. The objectives of financial stability and conduct regulation can at times diverge, requiring a mechanism for efficient and effective resolution of conflicts.

Financial markets regulators and policy agencies coordinate through the Council of Financial Regulators (CoFR), which is currently a non-statutory body. The Reserve Bank of New Zealand Bill provides a statutory basis for CoFR, together with a formal cooperation function for the Reserve Bank.

Figure 1: New Zealand's system of financial regulation



Other financial sector entities

All providers of financial services must register on the Financial Service Providers Register. These providers must also be members of approved dispute resolution schemes so that consumers have avenues to resolve issues with financial market service providers.

The Reserve Bank of New Zealand – New Zealand's prudential regulator

The role of the Reserve Bank expanded over the late 2000s to include oversight of insurers and non-bank deposit takers. The scope, focus, and intensity of regulation and supervision have also evolved over the last 30 years, enabled by the flexibility provided by the current statutory framework. Change to the statutory framework has occurred through a series of separate, targeted amendments rather than through a comprehensive review.

As New Zealand's prudential regulator, the Reserve Bank is responsible for promoting the maintenance of a sound and efficient financial system.

The Reserve Bank promotes the maintenance of a sound and efficient financial system by monitoring the build-up of risks and vulnerabilities in the system, and through its role as the prudential authority for banks, NBDTs, and insurers. Prudential regulations, such as the requirement for banks to hold certain levels of capital, ensure that these institutions adequately manage their risks and the risks they collectively pose to the financial system.

The Reserve Bank supervises banks and insurers (but not NBDTs) to ensure that they abide by the regulations and undertakes enforcement action when necessary.[17] The Reserve Bank is also responsible for managing the impact on the financial system when a regulated entity is in financial distress. Specifically, the Reserve Bank's regulatory and supervisory functions include:

- banks – registration, prudential regulation, supervision, and crisis management
- insurers – licensing, prudential regulation, supervision, and crisis management
- NBDTs – licensing, prudential regulation, and crisis management
- macro-prudential policy – systemic risk monitoring, policy formulation and implementation
- payment and settlement systems - oversight and settlement systems designation (jointly with the FMA)
- anti-money laundering / countering financing of terrorism - supervising banks, NBDTs, and life insurers in relation to their obligations under the Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) Act 2009.

In addition, New Zealand and Australia operate a trans-Tasman Council on Banking Supervision (TTBC) as a way of enhancing the coordination of home-host regulatory issues between the two countries. The TTBC is jointly chaired by the Australian and New Zealand Treasuries, and its membership includes senior officials from the Reserve Bank of Australia, the Australian Prudential Regulation Authority, the Reserve Bank of New Zealand and the New Zealand Financial Markets Authority. An important role of the TTBC is promoting and reviewing crisis preparedness for trans-Tasman banks under a Memorandum of Cooperation on Trans-Tasman Bank Distress Management.

Since 2006, the Reserve Bank has been required to implement its powers vis-à-vis the banking system in such a way as to avoid any detrimental impact on financial system outcomes in Australia, to the extent reasonably practicable. A reciprocal provision is included in Australian legislation.

Financial sector

In New Zealand, there are 20 registered non-bank deposit takers and 27 registered banks (of which 12 are branches of foreign banks).

As at September 2020, registered banks managed $614 billion in assets, non-bank deposit takers managed $2.9 billion in assets and non-deposit taking finance companies (not regulated by the Reserve Bank) managed $16.1b in assets.

The New Zealand financial system is dominated by the banking sector, with banking assets accounting for a very large share of overall financial system assets. In contrast, capital markets are relatively less developed in New Zealand, with total market capitalisation of equities at the New Zealand Stock Exchange around $169 billion, while the domestic bond market is around $145 billion (excluding government debt). The managed fund industry is also small compared to banks, with around $160 billion of assets under management.

17 NBDTs are separately supervised by trustees, licensed by the FMA.

The banking system comprises the majority of lending to the non-financial private sector in New Zealand. Direct capital market funding (issuance of corporate bonds) and non-bank lending institutions (NBLIs) together account for only 6 percent of non-financial private sector borrowing.

2.3 Other changes being progressed

In addition to the substantive issues that are considered in this regulatory impact analysis, the Deposit Takers Act will also deal with a range of less significant changes, such as procedural requirements for the Reserve Bank's exemption power. These changes are either consequential to other changes, involve modernising or formalising the current approach, or are minor and technical or deal with redundancies. These issues will have no or low levels of regulatory impact, or be of limited public or stakeholder interest more broadly.

There are some elements of the DTA that we anticipate will be progressed through delegated decision-making later in 2021. These are largely second-order policy decisions, for example, an offences and penalties framework under the proposed regime, and whether and how some of the powers currently vested in a statutory manager in the Reserve Bank Act 1989 would be carried over to the DTA.

2.4 Are there any constraints on the scope for decision-making?

The following matters are explicitly excluded from the scope of the Phase 2's terms of reference[18]:

- Fundamental change to the New Zealand-Australian home-host relationship[19], whereby the Australian Prudential Regulation Authority (APRA) becomes the sole regulator and supervisor of Australian-owned banks operating in New Zealand.
- The IPS Act 2010, the NBDT Act 2013, and the Financial Markets Infrastructures Bill, except where consequential changes are necessary or could encourage alignment.
- Covered bonds or netting, except to the extent that any issues requiring change are identified during the Review process (for example, if work on crisis management or depositor protection created the need to also look at how encumbrance limits are set).[20]
- Clearing, payment, and settlement systems, and the regulation of Financial Market Infrastructures.
- AML/CFT functions – statutory review of operation of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 will commence following referral by the Minister of Justice no later than 1 July 2021 (AML/CFT Act s. 156A).

18 Review of the Reserve Bank Act 1989, Phase 2 – Terms of Reference. Available at: https://www.treasury.govt.nz/sites/default/files/2018-06/rbnz-3933712.pdf

19 Australian-owned banks are regulated by both their "home" regulator on a consolidated basis (the Australian Prudential Regulation Authority) and their "host" regulator in relation to their New Zealand operations (the Reserve Bank).

20 Covered bonds have a security over a bank's assets and rank ahead of unsecured depositors in a resolution. Encumbrance limits set the maximum proportion of a bank's assets can be used as collateral, such for a covered bond. Netting entails offsetting the value of multiple positions or payments due to be exchanged between parties, such as in relation to derivative contracts. These provisions of the Act were recently enacted.

- Other financial system functions within the Reserve Bank such as market operations, other than those that are relevant to the areas for Phase 2.

The terms of reference also provided guidance on the desired outcomes for the Review, noting in particular that the operational independence of the Reserve Bank remains paramount and will be protected.

In addition, matters that were considered as part of Phase 1 of the Review, such as the objectives of monetary policy and the monetary policy decision-making process, are not being revisited as part of Phase 2, except where consequential changes are necessary.

While a number of the matters considered as part of this RIS were subject to in-principle decisions by the Government in June 2019 and December 2019, this does not impose a constraint on the analysis or the options considered. In-principle decisions were taken in order to facilitate further consultation on the design of core elements of the regime. We have noted where in-principle decisions have been made.

Section 4 below considers the key policy issues for the Deposit Takers Act in turn, grouped under the key components of the proposals. Each impact analysis identifies the options available to address the problem and, where appropriate, notes options ruled out of scope or not considered.

Section 3: Options identification

3.1 What options are available to address the problem?

For each issue we have identified and analysed a range of reform options. We describe the reform options in detail in section 4 below. These options must work together as a coherent package in order to proportionately respond to financial stability risks, including striking an appropriate balance and complementarity between flexibility, clarity and legitimacy.

3.2 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

While there is no prescriptive set of arrangements that will be suitable for every entity, there are established principles and examples of good practice.

We have assessed options based on a multi-criteria analysis framework, with criteria determined for each issue examined (set out in section 4 below). These criteria generally reflect the broad range of ways that prudential regulation can influence New Zealanders' well-being.

In considering the criteria for each issue, we have been mindful that the DTA should provide the Reserve Bank with the tools it needs to achieve its financial stability objective and fulfil the purposes of the Deposit Takers Act. Failing to do so would reduce the effectiveness and credibility of both the regulatory system and the regulator (the Reserve Bank). Prudential regulation is most likely to be desirable in relation to firms that generate:

- ‘negative externalities’, where the failure of a firm would disrupt key functions in the financial system and have significant negative impacts on the wider economy (i.e. the impacts of a firm failing are potentially large, wide ranging, and largely fall upon entities other than the firm itself),
- ‘moral hazard’, where financial firms are incentivised to take excessive risks out of a belief that the Government will bail them out if they fail,
- ‘information asymmetries’, where customers of a firm are presented with particular challenges when assessing the underlying credit risks, liquidity risks or operational risks associated with the firm’s business model.

We have generally not sought to establish formal weightings for these criteria, with the preferred option reflecting a judgement about which option is likely to achieve best an appropriate balance of the selected criteria. Where criteria have been given a higher weighting, this has been noted.

Section 4: Specific problem definition, option identification and impact analysis

This section considers the following key policy issues for the Deposit Takers Act in turn, set out under the key components of the proposals:

Section	Policy issue
4.1 Creation of a single regulatory regime	A. Creation of a single regulatory regime
4.2 Purposes and principles	B. Purposes and principles
4.3 Regulatory perimeter	C. Scope of regulatory perimeter D. Treatment of small deposit takers within the perimeter
4.4 Standards and licensing	E. Core prudential rule-making instrument F. Scope of standard-setting power G. Macro-prudential policy H. The role of the Minister of Finance in changing the scope of lending standards I. Licensing
4.5 Liability and accountability	J. Enhanced director accountability K. Liability
4.6 Supervision and enforcement	L. Supervisory approach M. Enforcement approach
4.7 Resolution and crisis management	N. Grouped analysis for: - Who should be the resolution authority? - Objectives of the resolution authority

	- Functions of the resolution authority - Statutory bail-in as a resolution tool - Creditor safeguards O. Powers of the resolution authority P. Direction powers Q. Triggers for resolution R. Liabilities that would be subject to statutory bail-in S. Role of the Minister during resolution planning T. Responsibilities for triggering resolution U. Managing fiscal risk to the financial position and interests of the Crown in a resolution V. Incurring expenditure without appropriation in a financial crisis
4.8 Depositor protection	W. Implementation of deposit insurance and the insurance limit X. Depositor preference Y. Institutional location and governance Z. Product boundary / design details AA. Funding framework
4.9 Appeal rights	BB. Appeal rights

These issues have been considered separately because different decision-making criteria are relevant and because the response to each issue has consequential impacts on the context for, and response to, subsequent issues.

Ratings

In the impact analysis section of each chapter, the options for dealing with the issues set out in the problem definition are generally assessed against the status quo. The key for the assessment is as follows:

Key *compared with doing nothing (the status quo)* ++ much better + better 0 about the same - worse - - much worse

Where there is no status quo (for example because the issue being considered is not relevant in the current regime), one of the options has been used as a baseline (rated as 0) with other options assessed against this.

The overall assessment for each option is essentially an average of the rating against each criterion. Judgement is applied in determining the overall rating for each option. We have generally not sought to establish formal weightings for these criteria, with the preferred option reflecting a judgement about which option is likely to achieve best an appropriate balance of the selected criteria. Where criteria have been given a higher weighting (see section 4.3.C and section 4.3.D, for example) this has been noted.

Section 4.1: Creation of a single regulatory regime

Overview

New Zealand currently has two parallel regulatory regimes that apply to deposit takers: the banking regime and the non-bank deposit takers (NBDT) regime. This could give rise to differential costs, barriers to entry or differential regulatory treatment between entities that provide essentially the same service.

The banking regime

The Reserve Bank had a long-standing responsibility for 'regulating' trading banks, trustee banks and the Post Office Savings Bank (POSB), which was subsequently bolstered by the Reserve Bank of New Zealand Amendment Act 1986, which created a 'light-handed' supervisory regime for what became known as 'registered banks'.

The banking regime is 'name-based', which means that if an entity undertakes financial services and wishes to use certain restricted words in its name or advertisements (e.g. 'bank' or 'banking'), it must register with the Reserve Bank. It does not need to register as a bank just to undertake certain activities (e.g. deposit taking). The existing regime has been in place since 1989, at a time when the Reserve Bank did not regulate any entities other than banks.[21]

To date, deposit takers that could be considered systemically important in New Zealand have chosen to register as banks – in part owing to the brand value of using 'bank' in marketing to potential customers, including wholesale customers.

Prudential requirements are primarily applied to banks currently through 'conditions of registration', an administrative instrument controlled by the Reserve Bank. These conditions pertain to banks' ability to carry on business in a prudent manner by, among other things, maintaining an adequate level of capital for the nature of the operation of the bank in question, as well as maintaining adequate various internal controls and risk management systems. In order for financial firms to remain registered banks, they have to continually adhere to these conditions and meet the Reserve Bank's regulatory standards.

The current RBNZ Act provides the Reserve Bank with a set of graduated intervention measures to manage banking sector risks. At one end of the spectrum is business-as-usual prudential supervision; at the other sits statutory management. The RBNZ Act essentially provides for three channels of crisis management intervention: Reserve Bank directions, director replacement and statutory management.

21 Bank registration was introduced in the Reserve Bank Amendment Act 1986. This created a prudential framework for the first time in New Zealand. At that time the perimeter also included authorised dealers in foreign exchange and any other financial institutions specified by the Reserve Bank. The 1989 Reserve Bank Act narrowed the regulatory perimeter to banks alone.

The non-bank deposit takers regime

Outside the banking system, the Reserve Bank assumed responsibility for the regulation of non-bank deposit-takers (NBDTs) following the passage of the Reserve Bank of New Zealand Amendment Act 2008.[22] Following the 2003/04 IMF Financial Sector Assessment Programme (FSAP) for New Zealand, the regulatory perimeter for prudential regulation was expanded to capture non-bank lenders that are funded by borrowing from retail investors. These NBDTs included finance companies, credit unions, and building societies. At the time that the prudential regulation of NBDTs was being designed, it was considered more efficient to not reopen the banking regime and, instead, leverage the NBDT regime off other existing regulatory arrangements (for example, the role of trustees).

In contrast to the banking regime, the NBDT regime operates on an 'activities-based' framework that is linked to securities law. An entity is defined as an NBDT if it:

- makes an 'NBDT regulated offer' of debt securities (this is largely the same as a regulated offer under the Financial Markets Conduct Act 2013, and in broad terms is an offer made to at least some retail investors, and / or
- carries on the business of borrowing and lending money, or providing financial services.

NBDTs must be licensed by the Reserve Bank. They must also meet certain minimum prudential requirements (e.g. in relation to capital ratios).

The prudential requirements applying to NBDTs are primarily applied through regulations, which means they require Government approval. The Reserve Bank also has a series of legislative and administrative tools in the NBDT Act:

- It can impose individual requirements on NBDTs through licence conditions.
- It can require information and reports from and about licensed NBDTs.
- It can issue directions to a licensed NBDT under certain circumstances.
- It can remove and appoint directors to an NBDT under certain circumstances.
- It can grant exemptions.

While NBDTs are licensed by the Reserve Bank, they are primarily supervised by private sector companies known as 'financial markets supervisors' (FMSs). An FMS must oversee an NBDT's compliance with the trust deed for its offer of debt securities. FMSs also have specific requirements under the NBDT Act in relation to risk management.

Summary of proposed approach

Section 4.1.A below proposes a single regime, which would merge New Zealand's two existing regimes for regulating banks and non-bank deposit takers into a single deposit-taking regime. This would bring New Zealand's framework into line with similar models in most other jurisdictions.

22 Hunt, Chris (2016) A short history of prudential regulation and supervision at the Reserve Bank (Reserve Bank Bulletin). Accessed at: https://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2016/rbb2016-79-14

A. Creation of a single regulatory regime

4.1.A.1 What is the specific problem?

The case for potential change

At a high level, the banking and NBDT regimes are interlinked. New Zealand's largest and most systemically important entities are banks, and they are subject to a comprehensive set of prudential requirements as well as supervision by the Reserve Bank. The NBDT regime ensures that all other entities that both take deposits from retail customers and lend are licensed and subject to a minimum level of prudential regulation. FMSs provide a frontline oversight of NBDTs.

However, the two regimes are not fully integrated, and there is nothing to stop a larger, more systemically important, entity operating under the NBDT regime if it did not use the word 'bank'. This raises a range of potential issues:

- **Neutrality and effectiveness:** because the bank and NBDT policy frameworks have developed under different legislation and delegated policy instruments, there are areas where they meaningfully diverge.
- While NBDTs are subject to generally less prescriptive capital and operational requirements than banks, the differences in treatment between banks and NBDTs are not explicitly risk based. There are differences in how some specific requirements for banks and NBDTs are designed, and these differences create inefficiency and unnecessary complexity; that is, they result in requirements that are not always as coherent or consistent across the two sectors as they would be if both sectors were covered by a single regulatory regime. These divergences can have consequences for both competitive neutrality and the effective operation of the regulatory regime. A notable example is the difference in resolution tools available for banks as opposed to NBDTs. This was identified as a risk by the IMF in their 2016/17 FSAP.[23]
- **Growth compatibility:** given that the NBDT regime has lower minimum capital requirements than the banking regime, the NBDT regime is the likely location for challenger or new entrant deposit takers. Aspects of the NBDT regime, such as its current supervisory model, may not be conducive to the introduction of innovative business models, or adequately address the financial stability risks associated with future growth in the sector.
- **Regulatory efficiency**: maintaining two regulatory regimes adds complexity to the regulatory system, and introduces the risk of the regimes diverging. A number of important differences have emerged between the bank and NBDT regimes over time, such as the application of macro-prudential policy to banks but not NBDTs, and differences in crisis management tools.
- **Deposit protection**: customers may not fully understand the difference in risk profile associated with depositing funds in banks and NBDTs in the current regulatory regime. The current regime does not provide sufficiently consistent regulatory and

23 IMF (2017) New Zealand: Financial Sector Assessment Programme: Financial System Stability Assessment. Accessed at: https://www.imf.org/en/Publications/CR/Issues/2017/05/08/New-Zealand-Financial-Sector-Assessment-Program-Financial-System-Stability-Assessment-44886

supervisory arrangements to support the introduction of a competitively neutral depositor protection (i.e. one that applies to both banks and non-banks). Given the proposal to establish a deposit insurance regime for New Zealand (see section 4.8), this raises the question as to whether current arrangements provide a sufficiently robust regulatory regime to manage moral hazard and other risks associated with deposit insurance.

4.1.A.2 What options are available to address the problem?

The following options have been identified and were consulted on as part of the consultation process:

- **Status quo:** continue to have two parallel regimes that regulate entities that apply to deposit takers: the banking regime and the NBDT regime
- **Single regime:** merge New Zealand's two existing regimes for regulating banks and non-bank deposit takers into a single deposit-taking regime. This would bring New Zealand's framework into line with similar models in most other jurisdictions, including Australia, where all deposit-taking lenders are regulated as 'authorised deposit-taking institutions' (ADIs), and the UK, where the same entities are regulated as 'credit institutions'.

We note that Cabinet has made an in-principle decision to bring the banking and NBDT regimes together into a single 'licensed deposit taker' framework.

4.1.A.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have identified the following assessment criteria in considering whether to create a single regime:

- **Regulatory efficiency:** multiple regulatory regimes add complexity to the regulatory system, and introduces the risk of the regimes diverging.
- **Credibility / coherency:** a regulatory system that is clear, understandable and credible to the public, particularly in a downturn, can minimise implicit government guarantees and therefore mitigate against moral hazard.
- **Regulatory neutrality:** a regulatory system should regulate similar firms and activities in the same way, where possible.
- **Growth compatibility:** a regulatory system should be enable the introduction of innovative business models, and adequately address the financial stability risks associated with future growth in the sector.

4.1.A.4 What other options have been ruled out of scope, or not considered, and why?

The proposed options are representative of the main options considered in our analysis.

4.1.A.5 What do stakeholders think?

The first consultation asked whether it would improve the efficiency and coherence of the regulatory framework for both the banking and NBDT sectors to sit within the same regulatory regime. Submissions were generally supportive of the creation of a single licensed deposit-taking framework.

4.1.A.6 Impact analysis

	Status quo	Single regime
Regulatory efficiency	0	++ Would reduce complexity and address the risks of the two regulatory regimes diverging.
Credibility / coherency	0	+ A single regime would provide a regulatory system that is clear, understandable and credible to the public, particularly in a downturn.
Regulatory neutrality	0	++ Supports a more coherent approach across the banking and NBDT sectors so that similar firms and activities are regulated, where possible, in the same way.
Growth compatibility	0	++ Compared to the status quo, would better enable the introduction of innovative business models and address the financial stability risks associated with future growth in the sector. A more coherent approach across sectors, competitive neutrality, and the removal of unnecessary costs and inefficiencies associated with different approaches (e.g. trustee supervisory model) would support a more growth compatible regime.
Overall assessment	0	++

4.1.A.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers a single regime. As noted above, a single regime would provide a regulatory system that is clear, understandable and credible to the public, particularly in a downturn. In addition, a single regime supports a more coherent approach across the banking and NBDT sectors so that similar firms and activities are regulated, where possible, in the same way.

The Treasury supports the proposed approach.

4.1.A.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional one-off costs associated with the implementation of a new regulatory regime, for example updating documentation. Scale of costs will depend on the type of sector (bank vs NBDT) and scale of entity.	Medium (short-term impact only)	Medium
Regulators	Additional costs associated with the implementation of a new regulatory regime integrating the prudential regulation of banks and NBDTs, for example updating documentation and explaining the new approach.	Medium (short-term impact only)	Medium
Wider government			
Other parties	*Deposit takers' customers* Some of the higher costs on deposit takers from the implementation of the new regulatory regime may be passed on to customers.	Medium (short-term impact only)	Medium
Total Monetised Cost			
Non-monetised costs		Low-Medium	Medium
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits associated with reductions in compliance costs from a more transparent regulatory framework, providing participants with a clearer sense of the Reserve Bank's approach. Benefits associated with innovative business models being enabled.	Medium (impacts are ongoing and therefore medium-long term)	Low
Regulators	Benefits associated with a more cohesive and flexible regime	Medium (ongoing)	Low
Wider government	Benefits associated with financial stability risks associated with future growth in the sector being managed	Medium (ongoing)	Medium
Other parties	Benefits associated with improved clarity for public about the levels of regulation to	Medium (ongoing)	Medium

	which different entity types are subject, which can minimise implied government guarantees and therefore mitigate against moral hazard.		
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.1.A.9 What other impacts is this approach likely to have?

There will be a number of implementation challenges for many regulated entities and for the Reserve Bank itself.

For the regulated sector, the creation of a single regulatory regime would largely entail short- to medium-term impacts. For the banking sector, these implementation challenges would be most significant in the short-term. For the NBDT sector, and for small institutions in particular, the new prudential framework (as set out in this regulatory impact analysis) will represent a considerable shift in the sector's prudential supervision.

Section 4.2: Purposes and principles

Overview

Context

Clear objectives are the bedrock of an independent regulator's role: they define the regulator's purpose for its staff, allowing them to prioritise and establish boundaries for their work; and they provide the means for the Minister of Finance, the Treasury (as the Reserve Bank's monitor), and the public to hold the regulator to account.

The Reserve Bank is delegated substantial independent powers as a prudential regulator, which makes it important that Parliament carefully defines the objectives and purposes for which those powers should be used. There is also an opportunity to establish a set of principles to guide the exercise of powers in the Deposit Takers Act (DTA).

Previous decisions

Cabinet has previously made a number of decisions about the Reserve Bank's objectives, decision-making principles and Financial Policy Remit (the Remit), including that:

- The Reserve Bank will have an overarching financial stability objective of "protecting and promoting the stability of New Zealand's financial system". This objective features in the Reserve Bank of New Zealand Bill 2020 (RBNZ Bill) and will apply across the Reserve Bank's prudential functions and relevant sectoral Acts.[24] A key change is the focus on financial stability, compared with the Reserve Bank's current dual objective of "soundness and efficiency", which is set out in the Reserve Bank of New Zealand Act 1989 (1989 Act).
- The financial stability objective is to be interpreted broadly in light of the RBNZ Bill's overarching statutory purpose to "promote the prosperity and well-being of New Zealanders and contribute to a productive economy". This is intended to clarify that the Reserve Bank's economic objectives, financial stability objective and central banking objective are not ends in themselves, but a means to "promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy".
- The Minister of Finance will be required to issue a Financial Policy Remit to the Reserve Bank. The new Reserve Bank governance board must have regard to the Remit when setting financial stability policy.

These changes have been incorporated into the RBNZ Bill, which is currently going through the legislative process.

Summary of proposed approach

Section 4.2.B below proposes the following option for the DTA's purposes and decision-making principles. This builds on the proposal set out in consultation, and has been amended to reflect the views put forward in submissions.

24 Currently sectoral Acts comprise the Insurance (Prudential Supervision) Act 2010, the NBDT Act, and the Financial Markets Infrastructures Bill. Once implemented, the Deposit Takers Act will subsume the NBDT Act.

Purposes

- Promote the safety and soundness of deposit takers
- Promote public confidence in the financial system
- Mitigate the risks that arise to and from the financial system
- … and, in doing so, contribute to protecting and promoting the stability of New Zealand's financial system

Decision-making principles

- the desirability of minimising unnecessary costs of regulatory actions
- the desirability of taking a proportionate approach to regulation and supervision, and ensuring that similar institutions are treated consistently
- the desirability of sectors regulated by the Reserve Bank being competitive, taking account of the size of the market
- the value of transparency and public understanding of the Reserve Bank's objectives and how the Reserve Bank's functions are exercised
- consideration of the practice by relevant international counterparts carrying out similar functions, as well as guidance and standards from international bodies
- the desirability of taking into account long-term risks to financial stability.

B. Purposes and principles

4.2.B.1 What is the specific problem?

Purposes

- As a matter of legislative design, the DTA will need a purpose or set of purposes, to guide the interpretation of the Act. In addition to these considerations, Cabinet has also made an in-principle decision that the Reserve Bank will have statutory objectives in performing the resolution function (see section 4.7.N).

Decision-making principles

- The Reserve Bank will have to take account of decision-making principles in exercising its financial regulatory powers. Principles in legislation support and enable decision-making in line with the legislation's policy intent. The principles are designed to guide the exercise of powers under the DTA, ensuring that a wide range of considerations are taken into account when pursuing the financial stability objective and the purposes of the DTA. In particular, the principles will capture the relevant concepts of efficiency (for example, the need to consider the net benefits of proposed regulation).

Financial Policy Remit

- The Minister of Finance will specify, through the Remit, matters that the Reserve Bank board must have regard to when acting in relation to the Reserve Bank's strategic intentions and the setting of prudential requirements. The Remit would not apply to decisions relating to individual regulated entities or persons, such as licensing and enforcement actions.

Problem definition and opportunity

The purpose clauses of the DTA will set out the way in which the Act intends to protect and promote the stability of New Zealand's financial system through the regulation and supervision of entities within the 'regulatory perimeter'. The purpose statement would explain 'why' the legislation is being enacted, while the substantive provisions in the Act would provide for 'what is required'.[25] In doing so, it will shape how the legislation is interpreted when there is uncertainty and the way in which the functions and powers provided for under the DTA are exercised.

The reality of objectives and principles is that they do not provide rules that must be followed but rather a framing for debate, discussion, and regulatory judgements, about which there will necessarily be differences of opinion. The professional judgements cannot be settled by parsing of the objectives and principles, but rather will be settled by their ongoing interpretation and re-interpretation in the context of the environment the regulators find themselves in.

While the Reserve Bank's financial policy decisions focus on safeguarding the financial system, they also affect the everyday lives and wellbeing of New Zealanders in a multitude of ways – from influencing the cost of borrowing and the returns to saving on financial capital, to affecting the availability of credit for households to buy homes and businesses to invest and the build-up of physical capital. Financial and physical capital are critical components of well-being.

As we saw in the global financial crisis and in global shocks (such as COVID-19), well-being is impacted when physical and financial capital stocks are depleted. The global economic shock related to COVID-19 has seen financial capital depleted around the world as incomes and employment and have fallen and governments and central banks have engaged in unprecedented monetary and fiscal stimulus to support their economies.

Throughout the scoping and consultation process, stakeholders raised a number of questions and potential issues with the Reserve Bank's current financial policy objective in the 1989 Act, reflecting the overarching problem that the current specification of the Reserve Bank's financial policy objective has not provided the Reserve Bank or stakeholders with an ideal level of clarity. In particular, the concept of "efficiency" has been difficult to interpret.

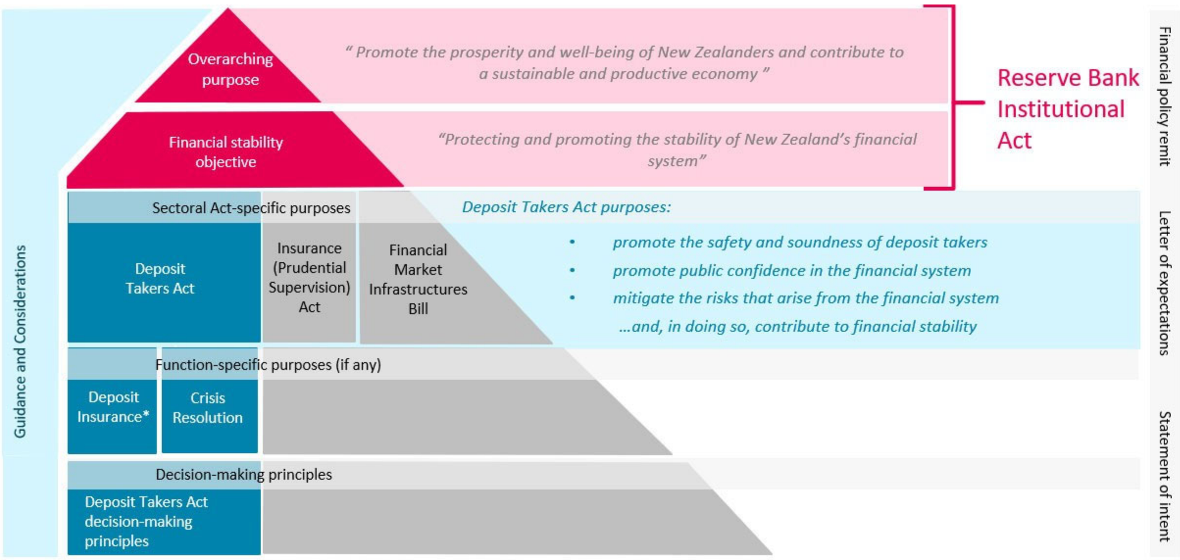
25 Purpose statements and clauses in legislation can serve a number of functions, including making the basic rationale of a regime clear and providing a context for more detailed provisions (see guidance from the Legislation Design and Advisory Committee (LDAC), a body responsible for setting guidelines for making good legislation, available at http://www.ldac.org.nz/guidelines/legislation-guidelines-2018-edition/what-is-the-legislation-design-and-advisory-committee/).

Without articulating a sufficiently clear purpose on how the DTA, as well as its decision-making principles, contribute towards the financial stability objective, there is a risk that the Reserve Bank's approach in this area is too dependent on the perspectives of particular decision makers and makes transparency and accountability more challenging.

A set of decision-making principles also provides an opportunity to bring in a range of other considerations for the exercise of the powers in the DTA.

Figure 2 below illustrates the relationships between the purposes, the Reserve Bank's financial stability objective, the decision-making principles, and the Financial Policy Remit, Letter of Expectations and the Statement of Intent[26].

Figure 2: Purposes, objectives and principles in the Reserve Bank's legislation



Interplay with the Reserve Bank's financial policy objectives and hierarchy

Throughout the consultation process, the Review has proposed increasing the specificity with which the Reserve Bank's objectives and purposes are articulated in legislation.

The Review considered a number of options for the Reserve Bank's financial policy objectives and hierarchy. The first consultation put forward a number of options for the Reserve Bank's high-level objectives, including retaining 'soundness and efficiency', and adding one or more of 'competition', 'public confidence', and 'protecting consumers'. Some of these alternatives are important considerations that we considered could be included elsewhere in the Reserve Bank's objective set.

26 See the following document for further information on these instruments. Reserve Bank Act Review (March 2020). Safeguarding the future of our financial system – Further consultation on the prudential framework for deposit takers and depositor protection. Consultation Document 3. Available at: https://www.treasury.govt.nz/sites/default/files/2020-03/rbnz-further-consultation-phase-2.pdf

We decided against including these alternative objectives at the highest level of the objective hierarchy (see Figure 2 above) given stakeholder feedback, and the desirability of having a single high-level objective to provide role clarity. We instead have considered them as lower-tier objectives that could be included in the purposes or decision-making principles of the DTA (see below).

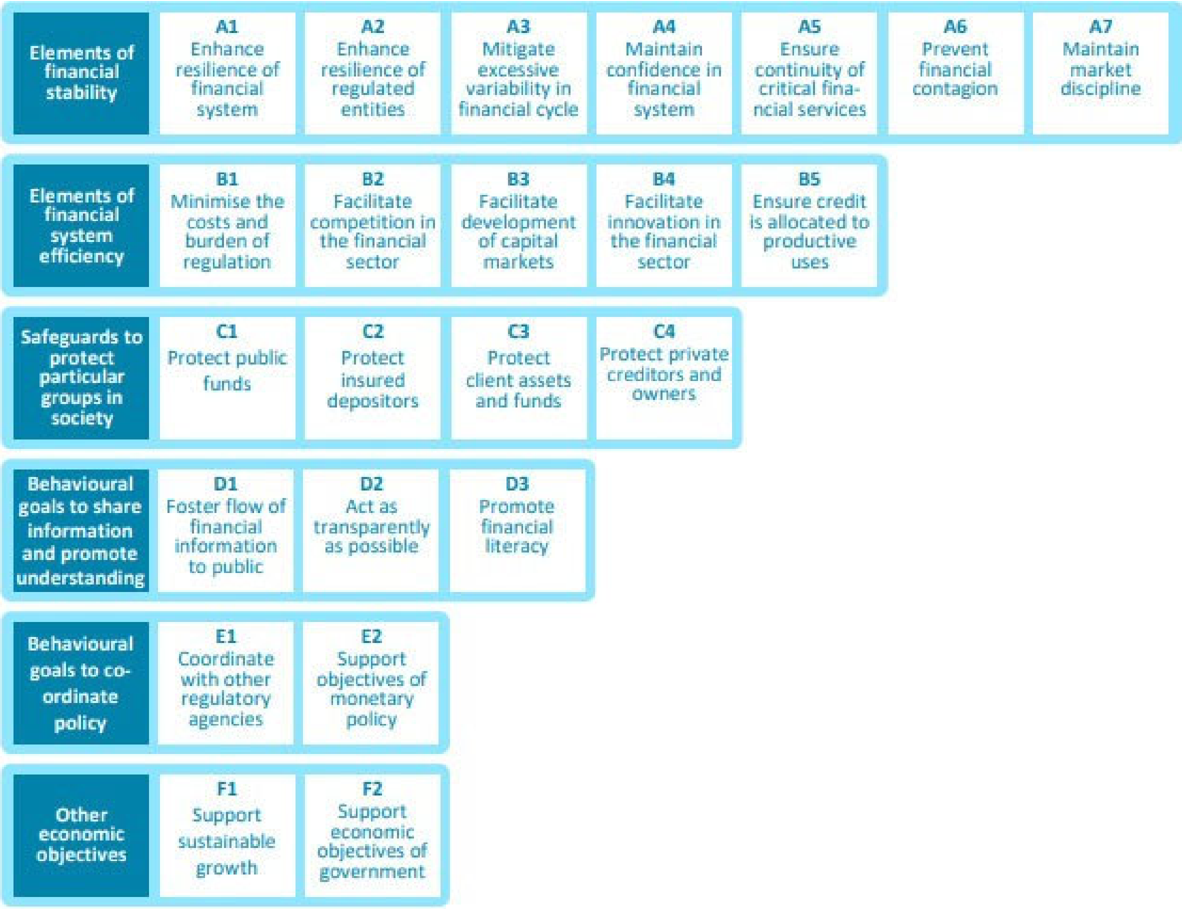
The second consultation covered, in detail, a wide range of possible sub-objectives for the Reserve Bank in relation to the financial stability objective and the forms they could take in legislation. Submitters were broadly supportive of a financial stability objective, while some raised concerns over dropping the efficiency consideration in the current ‘soundness and efficiency’ objective.

4.2.B.2 What options are available to address the problem?

There have been a number of individual purposes and decision-making principles considered as part of the Review process. The following diagram demonstrates the range of sub-objectives for the Reserve Bank. This was included in the second consultation and based on the survey of 100 central banks.

Some of these objectives are broad and apply to financial policy in general (such as maintaining public confidence in the financial system). Others are more specific and apply to particular policy areas (such as the need to protect public funds when resolving a failing bank). Still others are less policy goals and more ‘behavioural principles’ that encourage the Reserve Bank to act in particular ways (such as coordinating with other regulatory agencies).

Figure 3: A possible range of sub-objectives for the Reserve Bank, based on a survey of 100 central banks



Proposed approach for the DTA's purposes and decision-making principles

Our proposed approach is that set out below, which was consulted on as part of the third consultation.

However, as noted above, there have been a number of individual purposes and decision-making principles considered as part of the Review process, with a range of packages and permutations. For the purposes of providing illustrative analysis that highlights the inherent trade-offs, the purposes and decision-making principles have been packaged in the impact analysis (see 4.2.B.4 below) with a view that one suite may emphasise an objective / purpose against another suite that may emphasise a different objective / purpose. The impact analysis below compares and contrasts the package as consulted on, to packages where efficiency and well-being are given more prominence in the hierarchy.

The purpose of the Deposit Takers Act

The purpose clause of the DTA will set out the way in which the Act helps to contribute towards the Reserve Bank's financial stability objective. As part of the third consultation, the Review identified and consulted on the following design for the purpose statement in the DTA:

- Promote the safety and soundness of deposit takers
- Promote public confidence in the financial system

- Mitigate the risks that arise from the financial system
- … and, in doing so, contribute to protecting and promoting the stability of New Zealand's financial system

Decision-making principles

In the third consultation, the Review team identified and consulted on six decision-making principles for the DTA:

- the desirability of minimising unnecessary costs of regulatory actions, taking into account the benefits of the outcomes to be delivered
- the desirability of taking a proportionate approach to regulation and supervision, and ensuring that similar institutions are treated consistently
- the desirability of sectors regulated by the Reserve Bank being competitive, taking account of the size of the market
- the value of transparency and public understanding of the Reserve Bank's objectives and how the Reserve Bank's functions are exercised
- consideration of the practice by relevant international counterparts carrying out similar functions, as well as guidance and standards from international bodies
- the desirability of taking into account long-term risks to financial stability.

4.2.B.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The purposes and decision-making principles need to be designed to guide the exercise of powers and duties under the DTA, consistent with guidance from the Legislative Design and Advisory Committee. There is also an opportunity to ensure that a wide range of implications is taken into account when pursuing the statutory objectives. We have identified the following assessment criteria as being critical to the design of the Deposit Takers Act:

- the need to **provide clarity** by, and accountability for, achieving a **balance in providing enough detail** to guide the Reserve Bank's regulation of deposit takers and **avoiding an overly prescriptive objective** set that limits the Reserve Bank's ability to alter the regulatory approach over time
- **financial stability is not pursued at all costs** – so principles should include efficiency-related considerations, such as the need to consider net benefits in undertaking regulatory actions
- ensuring that a wide range of implications is taken into account when the Reserve Bank is pursuing its objectives.

4.2.B.4 What other options have been ruled out of scope, or not considered, and why?

Cabinet's decision that the Reserve Bank's high-level financial stability objective will be to "protect and promote the stability of New Zealand's financial system" acts as the key boundary or constraint on the analysis. Although there are compelling reasons for having a single, clear high-level objective, there are other worthwhile considerations that can add something extra. Many of the features in the purposes and decision-making principles can be traced back to the analysis that developed the financial stability objective.

For the purposes of this analysis we have not separately examined every potential combination of purposes and principles. Instead, we have considered the combined effect of the preferred package of purposes and principles and analysed particularly salient concepts that could be given more prominence in the hierarchy.

We considered the addition of an objective relating to deposit insurance, but decided that this would fit more appropriately in the deposit insurance context, rather than across the prudential regulation system. As discussed in section 4.8, the Deposit Insurance Scheme would have an objective of "protecting depositors to the extent they are covered by the scheme, and thereby contributing to financial stability".

4.2.B.5 What do stakeholders think?

During the third consultation round, just under half of submissions expressed broad support for the proposed purposes and principles. The most common reason for not supporting the proposals was concern that efficiency and its related concepts (including economic growth, competition and market diversity, and allocative efficiency) would not have sufficient prominence within the legislative structure. Common themes from these submitters include:

- some concerns that the overarching statutory well-being purpose was inadequately integrated into the DTA's legislative framework
- some concerns that the proposals would further hinder access to funding for alternative housing projects
- some support for the net benefits (benefits minus costs) decision-making principle, although concerns around the framing of the principle.

Many submitters suggested that concepts of efficiency and the overarching statutory purpose needed more prominence. The concerns were tied to the apparent absence of a primary focus on the effective functioning and efficiency of the financial system itself. Some submitters expressed this as disagreement with Cabinet's in-principle decision to remove efficiency as a primary financial policy objective for the Reserve Bank. Submissions from some of the large banks suggested that efficiency should be incorporated into the DTA's purposes, with some submitters suggesting wording of a fourth purpose to "promote the maintenance of an efficient financial system".

Some submitters proposed a number of additional concepts to be incorporated into the purpose provisions. The most common of these, contained in three submissions, was that the purposes should go further and require the Reserve Bank to promote access to, and the growth of, a diverse and innovative financial system.

Other purposes suggested in submissions, many overlapping, included:

- to promote and stimulate the growth of the New Zealand economy
- to promote competition and diversity in the lending and deposit taking sectors in order to stimulate economic growth
- expansion of the purpose of mitigating risks *from* the financial system to make it clear it also encompasses risks *to* the financial system

- protection of depositors.

On decision-making principles, some submitters put forward suggestions for improving or adding to the principles or improving the hierarchy of objectives and purposes as a whole. There was some support for the net benefits test, proportionality and competitiveness decision-making principles.

However, there were opposing views on the principles, with some submitters arguing there were a mix of potentially competing and unclear principles that do not adequately substitute an efficiency objective. Some submitters also argued that it is unclear how they would be balanced.

Some submitters proposed a number of additional concepts to be incorporated into the purpose provisions, including:

- **Competition:** An individual submitter suggested the competitiveness principle should be clear that the Reserve Bank has a role in considering competition, but not in promoting or increasing competition. This is in contrast to some submitters who, as previously mentioned, proposed that competition be incorporated into the purposes of the DTA. Submissions from small deposit takers also suggested that supporting an inclusive and diverse financial system should be a principle.
- **Proportionality:** Another individual submitter proposed that proportionality should be broadened to ensure that there was a level and fair playing field for all participants in the financial system, regardless of their systemic importance.
- **Housing:** There were a few submitters who argued that the decision-making principles should also include factors such as housing affordability, innovation in housing, and the well-being of communities. One submitter proposed that a housing related principle should guide the allocation of credit to ensure that it serves the economy’s need for productive investment and the wider social need for access to affordable housing.
- **Other additional principles:** Three submitters suggested the net benefits principle should be re-worded to the effect of “promoting efficiency, including through the desirability of minimising unnecessary costs”. While long term risks had some support, one submitter (from the finance company sector) suggested that the Reserve Bank should consider concentration and systemic risk to the financial system as a principle.

4.2.B.6 Impact analysis

Packages of purposes and principles	Option A: Proposal in the consultation, but with refinements	Option B: Proposal in the consultation, but with *efficiency* to be given more prominence in the hierarchy	Option C: Proposal in the consultation, but with *well-being* to be given more prominence in the hierarchy
Description of the option	This option builds from the proposal set out in the third consultation, and has been amended to reflect the views put forward in submissions. *Purposes* - Promote the safety and soundness of deposit takers - Promote public confidence in the financial system - Mitigate the risks that arise to and from the financial system - … and, in doing so, contribute to protecting and promoting the stability of New Zealand's financial system *Decision-making principles* - the desirability of minimising unnecessary costs of regulatory actions - the desirability of taking a proportionate approach to regulation and supervision, and ensuring that similar institutions are treated consistently - the desirability of sectors regulated by the Reserve Bank being competitive, taking account of the size of the market - the value of transparency and public understanding of the Reserve Bank's objectives and how the Reserve Bank's functions are exercised - consideration of the practice by relevant international counterparts carrying out similar functions, as well as guidance and standards from international bodies - the desirability of taking into account long-term risks to financial stability.	This could be achieved by adding in a fourth purpose, for example "promoting efficiency, including through the desirability of minimising unnecessary costs." The term "efficiency" could also be added into the decision-making principles.	This could be achieved by adding in an additional purpose relating to well-being, or adding in a consideration of well-being as a decision-making principle.
The need to provide clarity by achieving a balance in providing enough detail to guide the Reserve Bank's regulation of deposit takers, but avoiding being overly prescriptive	++ This option provides more detail and clarity about the way in which the Reserve Bank should pursue its statutory objective of financial stability. It makes clear that financial stability should encompass both macro-prudential objectives (this being risks that arise to and from the financial system) and micro prudential objectives (this being the safety and soundness of individual deposit takers). A macro-prudential purpose gives the Reserve Bank a clear macro-prudential mandate, empowering it to use system-wide tools including lending standards. The micro-prudential purpose reflects the fact that the Reserve Bank regulates and supervises many institutions that may not pose risks to the financial system and seeks to ensure that the regulation and supervision of these entities receives an appropriate amount of focus and resourcing, and acknowledges the substantial impact that a failure of a smaller institution can have on depositors and on particular places or sectors. The Reserve Bank's ability to promote public confidence in the financial system relates directly to the Reserve Bank's regulatory and supervisory functions. Its breadth means that it could overlap with the broad objective(s) of other agencies. However, this is mitigated by its subordination to the financial stability objective, the two other purposes, and the prudential functions and powers of the DTA. The decision-making principles provide detail and clarity on the considerations the Reserve Bank should take into account before exercising its prudential powers for the purposes specified.	+ This option would not provide as much clarity. Previously the Reserve Bank had a dual objective of "soundness and efficiency", which in practice proved difficult to interpret. Efficiency is a concept that can be interpreted very broadly to cover ideas such as regulatory efficiency, competitive efficiency, dynamic efficiency, or allocative efficiency among other ideas. Having efficiency present too high in the hierarchy affects clarity because weighing two competing objectives dilutes the core purpose of the organisation and, typically, results in the agency prioritising one over another. Also, efficiency does not always align with the Reserve Bank's financial stability objective and functions. For example, in certain cases, market driven allocative efficiency may lead to externalities that require regulation for the attainment of the financial stability objective.	+ As a purpose of the RBNZ Bill, well-being is a key component in the legislative framework. Adding it in as a purpose or principle in the DTA would reduce clarity and potentially cause confusion. This is because the promotion of financial stability is already understood as promoting the prosperity and well-being of New Zealanders, and contributing to a sustainable and productive economy. In addition, well-being does not appear to be a common objective of other central banks, based on a review of international practice.
Financial stability is not pursued at all costs	+ Limiting the purposes to 'promote' and 'mitigate' avoids the implication that the Reserve Bank should run a zero failure regime or eliminate all risks that arise to and from the financial system.	++	+

Packages of purposes and principles	Option A: Proposal in the consultation, but with refinements	Option B: Proposal in the consultation, but with *efficiency* to be given more prominence in the hierarchy	Option C: Proposal in the consultation, but with *well-being* to be given more prominence in the hierarchy
	The decision-making principles include concepts of regulatory efficiency, proportionality, and competition. This makes clear that the Reserve Bank must take these issues into account and not pursue financial stability at all costs.	This option would go the furthest towards ensuring that financial stability is not pursued at all costs. This is because efficiency considerations can moderate regulatory requirements if they might otherwise be disproportionately burdensome or would unduly hinder dynamic and allocative efficiency of the market.	The addition of a well-being purpose or principle in the DTA would potentially temper the pursuit of financial stability by reinforcing that financial stability is not an end in itself. However, this may be either redundant or confusing given financial stability is intended to contribute to well-being (the purpose of the RBNZ Bill). In addition, financial and physical capital is a critical component of well-being. As we saw in the global financial crisis and in global shocks (such as COVID-19), well-being is impacted when physical and financial capital stocks are depleted. The global economic shock related to COVID-19 has seen financial capital depleted around the world as incomes and employment have fallen and governments have engaged in unprecedented fiscal stimulus to support their economies.
Ensuring that a wide range of implications is taken into account	++ The second purpose (promoting public confidence in the financial system) is a very broad concept that may encourage the Reserve Bank to take a broader range of matters into account when regulating and supervising individual entities. The third purpose (mitigating risks that arise to and from the financial system) makes clear that the Reserve Bank must monitor and take into account risks emanating not just from its regulated population (deposit takers), but the financial system more broadly. The decision-making principles will ensure that other important considerations are taken into account, including long-term risks to financial stability like climate change. Four of the decision-making principles contain elements relating to efficiency concepts (for example, minimising unnecessary costs, proportionality and market diversity, competitiveness, and long-term risks).	+ Retaining a broad concept of efficiency would go the furthest towards ensuring that a wide range of implications are taken into account. However, to the extent that various aspects of efficiency need to be taken into account, this can be addressed through the regulatory principles. Some other jurisdictions do have aspects of efficiency higher up in their legislative hierarchy (for example, as a sub-objective), or in the case of Australian Prudential Regulation Authority (APRA), as a "to the extent not inconsistent with financial stability". International examples show that efficiency is not typically ranked as high as financial stability. Post the global financial crisis, most other jurisdictions have financial stability as the key objective. The proposed approach incorporates competition, as well as other efficiency considerations, into the decision-making principles. This means that these concepts will be very influential as the Reserve Bank exercises its prudential power. However, having financial stability as the singular objective will bring New Zealand more into line with the international approach, while still ensuring that efficiency concepts play a role in the application of prudential regulation.	+ Adding a well-being purpose or principle would increase the range of issues that are taken into account when the Reserve Bank is exercising its powers and pursuing its objectives. However, the breadth of issues would create potential for confusion about the extent of the Reserve Bank's role and how it is to pursue the financial stability objective and the other purposes of the DTA.
Overall rating	++	+	+

4.2.B.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank considers that the approach outlined in consultation remains sound. As noted in the impact analysis above, this approach provides more detail and clarity about the way in which the Reserve Bank should pursue its statutory objective of financial stability. It makes clear that financial stability should encompass both macro-prudential objectives (this being risks that arise to and from the financial system) and micro prudential objectives (this being the safety and soundness of individual deposit takers).

The Reserve Bank's ability to promote public confidence in the financial system relates directly to the Reserve Bank's regulatory and supervisory functions. Its breadth means that it could overlap with the broad objective(s) of other agencies. However, this is mitigated by its subordination to the financial stability objective, the two other purposes, and the prudential functions and powers of the DTA.

The decision-making principles provide detail and clarity on the considerations the Reserve Bank should take into account before exercising its prudential powers for the purposes specified.

The Treasury supports the proposed approach.

4.2.B.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	Potential that a clearer focus on financial stability could create a more intensive approach to prudential regulation, with flow on costs to the sector.	Medium	Low
Regulators	Potential that a clearer focus on financial stability could require increases to the resourcing of prudential functions.	Low	Low/Medium
Wider government			
Other parties			
Total Monetised Cost			

Non-monetised costs		Low	Low/Medium

Expected benefits of proposed approach compared to taking no action			
Regulated parties	Broad benefits associated with improved accountability, transparency and decision-making.	Medium	Low
Regulators	Clarified focus on high-level objectives.	Low/Medium	Low
Wider government	Improved role clarity relative to other regulators.	Low	Low
Other parties	A clearer focus on financial stability should, over the long term, reduce the risk of spill-over effects that could threaten the real economy. Clear objectives also better enable the public to hold regulators to account.	Low/Medium	Low
Total Monetised Benefit			
Non-monetised benefits		Medium	Low

4.2.B.9 What other impacts is this approach likely to have?

No other impacts have been identified.

Section 4.3: Regulatory perimeter

Overview
The regulatory perimeter is a core building block of the prudential regulatory system. It defines the types of firms that are subject to prudential regulation and supervision, and those that are not. The perimeter needs to be set so that it provides the Reserve Bank with the tools it needs to achieve its financial stability objectives and fulfil the purposes of the Deposit Takers Act (DTA). Failing to do so would reduce the effectiveness and credibility of both the regulatory system and the regulator (the Reserve Bank). Prudential regulation is most likely to be desirable in relation to firms that generate:

- 'negative externalities', where the failure of a firm would disrupt key functions in the financial system and have significant negative impacts on the wider economy (i.e. the impacts of a firm failing are potentially large, wide ranging, and largely fall upon entities other than the firm itself)
- 'moral hazard', where financial firms are incentivised to take excessive risks out of a belief that the Government will bail them out if they fail
- 'information asymmetries', where customers of a firm are presented with particular challenges when assessing the underlying credit risks, liquidity risks or operational risks associated with the firm's business model.

Deposit takers perform functions that are critical for economic activity to take place. They provide services that are essential for day-today living, enabling participation in, and the smooth running of, the wider economy. Customers include individuals, businesses, other organisations, and local and central government – and all require an ability to make and receive payments and conduct other financial transactions.

Deposit takers are particularly likely to raise financial stability issues on a large scale due the interconnectedness of the deposit-taking system (where the insolvency of one deposit taker can cause widespread problems in financial markets) and the range of essential services it provides to customers and other industries. If a deposit taker fails, the knock-on effects for the wider economy of abruptly discontinuing (or even disrupting) these financial services can be far greater than the losses incurred by the deposit takers itself.

The creation of a single regulatory regime for deposit takers will capture a number of non-bank deposit takers (NBDTs) that are significantly smaller than any of the registered banks. These entities are largely credit unions, building societies and finance companies (noting that additional considerations associated with finance companies are outlined below). The Review has explored how the regime should accommodate a differential approach for these entities, noting that creating a single licensed deposit-taker framework could mean they have to meet requirements designed for larger and more complex firms.

The regime should not place unnecessary barriers to entry to the deposit-taking sector and should allow for competition and innovation within the sector. A flexible and proportionate regulatory regime should provide a responsive regulatory environment for new business models, such as technologically enabled FinTech businesses, allowing the businesses to develop and grow while managing risks to financial stability appropriately. It is also important to emphasise that a robust regulatory framework provides benefits for small deposit takers and their customers.

Summary of proposed approach

Scope of regulatory perimeter

Under the proposed approach set out in section 4.3.C, lenders that issue retail debt securities and/or wholesale deposits would be captured in the regulatory perimeter. Lenders that borrow from retail customers, such as banks, credit unions, building societies and finance companies, present the strongest case for prudential regulation. This is due to their role in providing credit intermediation, retail customer base and the negative externalities associated with their failure.

On balance, we think it would be desirable to also capture those firms that take wholesale 'deposits' as opposed to those that issue other sorts of wholesale debt securities.

As part of our proposed approach, the Reserve Bank would be able to designate individual entities as deposit takers where they are providing services that have the economic substance, but not the legal form, of deposit taking. The Reserve Bank would also be able to exempt an entity or class of entity from requirements that are unnecessary or unjustified in relation to that entity's or class's business model and operations.

Treatment of small deposit takers within the regulatory perimeter

Under the proposed approach set out in section 4.3.D, the Reserve Bank would have the flexibility to calibrate its regulatory approach to small, less systemically significant deposit takers, without providing for specific tiers of deposit takers in legislation.

In addition, there would be a restriction on the use of the word 'bank'. This approach would restrict the use of the words 'bank' and 'deposit' (and related words) by financial service providers that are not licensed deposit takers

C. Scope of regulatory perimeter

4.3.C.1 What is the specific problem?

As noted above, the regulatory perimeter needs to be set so that it provides the Reserve Bank with the tools it needs to achieve its financial stability objectives and fulfil the purposes of the DTA. Failing to do so would reduce the effectiveness and credibility of both the regulatory system and the regulator (the Reserve Bank).

An appropriate regulatory perimeter:

- balances the benefits of managing the above factors and the costs associated with regulation. While prudential regulation can limit the probability of failure, it also imposes costs on regulated entities and creates barriers to entry that can limit competition and the diversity of business models in the sector.
- is clear, understandable and credible to the public, particularly in a downturn. Ensuring that the public is clear about the levels of regulation to which different entity types are subject can minimise implied government guarantees and therefore mitigate

against moral hazard. Well understood labels for the different regulated entity types can also support public understanding.

- considers the interactions with other regulatory regimes. A regulatory perimeter needs to work coherently with other regulatory regimes, and avoid unnecessary overlaps and gaps with other regulatory regimes. This is particularly important in relation to financial markets conduct legislation, which is enforced by the Financial Markets Authority (FMA) and in relation to trans-Tasman prudential regulation.

4.3.C.2 What options are available to address the problem?

There are four general categories of entities that engage in borrowing and lending:

	Takes '**deposits**' (i.e. transactional accounts, savings accounts etc)	No deposits, but issue **'capital market' type** debt securities (e.g. bonds, commercial paper, debentures)
Borrows from **retail**	1. Retail banks, credit unions, building societies	2. Finance companies
Borrows only from **wholesale** (issuing debt securities to wholesale investors such as high-net-worth persons and investment businesses)	3. Wholesale bank branches (lenders (typically branches of overseas banks) who take transactional deposits solely from corporate clients)	4. Securitisers and many other non-bank lending institutions (NBLIs[27])

The following options have been identified and were consulted on as part of the consultation process:

Option 1: All lenders that issue retail debt securities

The perimeter would capture all firms that are in the business of both lending and borrowing by issuing retail debt securities (as defined in the FMC Act).
This perimeter would broadly be the same as that of the NBDT Act and has been treated as the status quo for the purposes of providing a baseline for our analysis. It would capture retail banks, credit unions, building societies and finance companies, while wholesale bank branches would only need to be captured to the extent that they need to be licensed to use the word 'bank'.

Option 2: all lenders that take retail 'deposits'

The perimeter would only capture lenders if they take 'deposits' from retail customers as opposed to other sorts of debt securities (e.g. bonds). Deposits are generally transactional, savings and term deposit accounts.

27 Some NBLIs may borrow solely in other ways (e.g. from owners or affiliates) – we do not consider that these entities should be in scope.

This perimeter would be narrower than Option 1 and would not capture most finance companies, which issue debentures (which are usually categorised as negotiable debt securities) and do not offer transactional or savings accounts.

Option 3: all lenders that issue retail debt securities or take wholesale deposits

The perimeter would capture lenders that issue retail debt securities, as well as those that take 'deposits' (but not other sorts of debt securities) from wholesale customers. Deposits in this context may be easiest to define in the negative (e.g. by excluding certain categories of wholesale debt securities, such as negotiable instruments, borrowing from other financial institutions, and borrowing from associated persons).

This perimeter would capture a similar range of entities to those captured collectively by the RBNZ Act and the NBDT Act, except that a number of wholesale-only bank branches would be captured on the basis of their activities (i.e. taking wholesale deposits) rather than because they use the word bank. It would also capture any future firms that take wholesale deposits in New Zealand but do not use the word bank (unlike the current regime).

Option 4: all lenders that issue debt securities (retail or wholesale)

The perimeter would capture all lenders who borrow by issuing debt securities, regardless of the type of customer (retail or wholesale) or the type of debt security (deposit or otherwise). This option would capture the broader range of firms within the perimeter, including potentially securitisers and other sorts of lenders that are in the business of borrowing. This option would probably necessitate the broadest reliance on the Reserve Bank's exemption powers to address inadvertent over capture.

All of the above options would need to be supported by tools for the Reserve Bank to monitor the perimeter (such as information gathering powers) and to provide flexibility at the margins of the perimeter.

As part of our proposed approach, the Reserve Bank would be able to designate individual entities as deposit takers where they are providing services that have the economic substance, but not the legal form, of deposit taking. This should discourage regulatory arbitrage and encourage entities that are setting up just outside the perimeter to engage with the Reserve Bank. The use of this tool would be limited to entities whose activities are very similar in substance to deposit taking.

The Reserve Bank would also be able to exempt an entity or class of entity from requirements that are unnecessary or unjustified in relation to that entity's or class's business model and operations. This would provide the Reserve Bank with significant additional flexibility in applying the framework, particularly in responding to new and innovative business models that may not have been anticipated in the legislation. Within reasonable limits, the intention is that the use of exemptions would be part of a flexible regime, rather than a reserve power that would only be used in exceptional circumstances. There would be implementation and ongoing costs to the Reserve Bank in operating the exemption process (such as considering the application and publication requirements).

4.3.C.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We identified the following assessment criteria as being critical to the design of the regulatory perimeter:

- **Proportionately responds to financial stability risks** – the regulatory perimeter should capture entities and business models that present identified risks to the stability of New Zealand's financial system. Prudential regulation is most likely to be desirable in relation to firms that generate negative externalities, moral hazard or information asymmetries.
- As discussed in section 4.3.C.1 above, deposit takers are particularly likely to raise financial stability issues on a large scale due the interconnectedness of the deposit-taking system (where the insolvency of one deposit taker can cause widespread problems in financial markets) and the range of essential services it provides to customers and other industries.
- **Flexible and durable** – the regulatory perimeter can adapt to the economic substance and risks of an activity and has the capacity to evolve in response to changing circumstances.
- **Provides clarity and legitimacy** – the DTA should seek to provide clarity on the entities that will be subject to prudential regulation. Clarity of the regulatory perimeter is important for customers when choosing the financial institutions they deal with. While a degree of flexibility is desirable, the design of the regulatory perimeter is a significant policy decision for Parliament and should not be delegated unless there are compelling reasons to do so.
- **Supports competition and diversity** – the regulatory perimeter should seek to accommodate competition from a range of business models and avoid imposing unnecessary regulatory costs.

We place greater weight on responding to financial stability risks and providing clarity and legitimacy, given the critical importance of financial stability to economic performance and the added importance of clarity and legitimacy in the context of a regime that has very broad delegations to the Reserve Bank in other areas.

4.3.C.4 What other options have been ruled out of scope, or not considered, and why?

The proposed options are representative of the main options considered in our analysis. A wide range of variations on these options is possible, such as by adopting alternative definitions of borrowing and lending, or by including or excluding specific type of debt securities from the perimeter.

The Review did consider Fintech-related issues but concluded that most models (which tend to be forms of stored value facilities) do not present the same sorts of systemic risks that deposit-taking lenders do. Some other models, such as peer-to-peer lenders, do not involve credit intermediation so do not present the same systemic risk and, in addition, are subject to regulatory requirements under the Financial Markets Conduct Act 2013 to manage conduct concerns.

Insurance provision was out of the scope of the Review, given that insurers are already prudentially regulated under the Insurance (Prudential Supervision) Act 2010.

4.3.C.5 What do stakeholders think?

Through engagement on the first consultation, a number of submitters raised concerns about any extension of the regulatory perimeter to cover wholesale funded firms, arguing that it was not necessary to support financial stability.

The second consultation sought further feedback on how the boundary of the deposit-taking perimeter should be defined, proposing a focus on firms that take deposits from the public, with both finance companies and wholesale funded lenders sitting outside of the 'inner perimeter'. The second consultation argued that these firms should not be prudentially regulated as they do not generate the same systemic risks or moral hazard concerns as firms that take retail deposits.

The second consultation also argued that wholesale-funded lenders such as securitisers are not well suited to the conventional types of prudential regulation that apply to deposit takers (e.g. liquidity and capital requirements), while any financial stability risks could be mitigated by managing the exposures of licensed deposit takers to these entities and by extending macro-prudential tools to outer perimeter firms. Submissions generally supported this approach.

The third consultation sought feedback on the regulatory scope of the legislation and the way it treats different entity categories. Submissions expressed support for the overall approach to the regulatory perimeter, including the adoption of a perimeter based on the activity of borrowing and lending. There was also general support for a single, flexible regime for deposit takers, although a few submitters advocated for establishing tiers of deposit takers in legislation. There was some concern about the prospect of capturing certain wholesale funded lenders within the perimeter, and opposing views on the question of whether a separate licence category should be established for lenders that solely want to issue uninsured retail debt securities. Submitters also expressed support for the Reserve Bank having a role to monitor an 'outer perimeter' of non-deposit taking lenders, and providing flexibility through designation and exemption powers

4.3.C.6 Impact analysis

	Option 1: Lenders that issue retail debt securities – treated as status quo	**Option 2:** Lenders that take retail deposits	**Option 3:** Lenders that issue retail debt securities and/or wholesale deposits (preferred)	**Option 4:** All lenders that issue debt securities
Proportionately responds to financial stability risks	0 Captures the firms most likely to present financial stability risks (retail-funded deposit takers), due to: • the high externalities associated with their failure • the moral hazard associated with stronger implicit government guarantees on retail deposits • relatively high levels of information asymmetries between depositors and deposit takers.	0 Captures the firms most likely to present financial stability risks (retail banks, credit unions, building societies).	+ Focusses the regulatory perimeter on the entities that are most likely to present financial stability risks (retail-funded deposit takers), while capturing those wholesale funded lenders that offer 'bank-like' deposit accounts.	- Capture all firms engaged in borrowing and lending. However, lenders that solely borrow via wholesale capital markets are unlikely to generate the kinds of financial stability risks that tend to justify prudential regulation and supervision.
Flexible and durable	0 Designation and exemption powers should provide the Reserve Bank with some flexibility to adjust the perimeter, although there is still the potential that risks could build up outside the perimeter (e.g. in the wholesale deposit taking sector).	- Compared to Option 1, some additional scope for risks to build up in the finance company sector.	+ Captures the firms that have the most scope to address financial stability risks in future. Other tools, such as the application of lending standards to non-deposit taking lenders, allow for risks outside of the deposit taking sector to be managed.	+ Captures the greatest range of firms that have the potential to present financial stability risks in future.

Clarity and legitimacy	0 Provides clarity in legislation on what entities are within the core regulatory perimeter, although it would be reliant on the use of restricted words to capture some wholesale bank branches.	0 Similar to Option 1.	+ Provides clarity in legislation on what entities are within the core regulatory perimeter and is not overly reliant on either the use of restricted words or Reserve Bank exemptions to shape the perimeter.	- - Does not provide clarity to Parliament or the sector on the ultimate shape of the regulatory perimeter, given that broad use of Reserve Bank exemption powers is likely to be required to address inadvertent over capture, as well as to adjust the operation of the regime to a broader range of firms.
Competition and diversity	0 Does not capture any wholesale funded lenders, allowing scope for the growth of these models outside of the regulatory perimeter.	+ Reduction in compliance costs for finance companies may improve their ability to compete in both investment and lending markets and more easily allow for new entrants to the market.	- Slightly broader scope than option 1, may negatively impact on competition and diversity at the margins. Does not impose prudential requirements on most wholesale funded non-bank lenders and allows scope for the continued growth of securitisation models outside of the regulatory perimeter.	- - Negative impact on competition and diversity, given that it would impose potentially significant costs on alternative business models such as securitisers.
Overall assessment	0	0	+	-

4.3.C.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 3. Our view is that lenders that borrow from retail customers, such as banks, credit unions, building societies and finance companies, present the strongest case for prudential regulation. This is due to their role in providing credit intermediation, retail customer base and the negative externalities associated with their failure.

On balance, we think it would be desirable to also capture those firms that take wholesale ‘deposits’ as opposed to those that issue other sorts of wholesale debt securities. Conceptually, the failure of a firm that takes deposits solely from large corporate clients could still create negative externalities if depositors lost access to transactional funds, potentially impacting their ongoing viability or ability to make various payments, and potentially impacting confidence in the New Zealand banking system. We note that many of these entities would already be required to be licensed in order to use the word ‘bank’. This would also ensure that the activities-based perimeter captures the full range of entities intended to be licensed under the DTA, without having a class of entities whose capture is dependent on whether or not they use the word bank.

The term ‘deposit’ (as distinct from other sorts of debt securities) is very difficult to define in a positive manner, despite being well-understood in practice.[28] We therefore envisage defining the act of borrowing broadly (issuing debt securities), then excluding certain other classes of borrowing, which could include:

- Borrowing via a credit facility provided by an investment business. This would exclude, for example, lenders who borrow from a bank as part of their normal business, as well as securitisers who borrow from a bank warehouse facility prior to the securitisation process.
- Borrowing via issuing negotiable wholesale debt securities to wholesale investors (as defined in the FMC Act). This would exclude lenders that raise funds on wholesale bond markets and are already subject to strong market discipline.
- Borrowing from an associated person, such as a parent company or a subsidiary.

Other wholesale funded lenders do not present these same risks, given that many are funded via securitisation (and bank warehousing facilities) or via issuing capital market debt instruments to wholesale investors. Our view is that the case for including these kinds of wholesale funded lenders within the perimeter is not justified. Wholesale funded lenders do not tend to generate the same potential negative externalities, such as contagion risks, as retail funded lenders and do not present significant moral hazard concerns. Risks to banks can be managed by requirements on those institutions, while wholesale bond markets are comparatively well placed to avoid information asymmetries.

The Treasury supports the proposed approach.

28 For example, in the United Kingdom a deposit is defined broadly, with a number of non-deposit debt securities then excluded from the definition.

4.3.C.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional costs associated with the implementation of new regulatory regime.	Low	Medium
Regulators	Additional costs associated with the implementation of a new regulatory regime.	Medium	Medium
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low-Medium	Medium
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits associated with reductions in compliance costs from a more transparent regulatory framework, providing participants with a clearer sense of the Reserve Bank's approach. Benefits associated with innovative business models being enabled.	Medium	Low
Regulators	Benefits associated with a more cohesive and flexible regime.	Medium	Low
Wider government	Benefits associated with financial stability risks associated with future growth in the sector being managed.	Medium	Medium
Other parties	Benefits associated with improved clarity by public about the levels of regulation to which different entity types are subject, which can minimise implied government guarantees and therefore mitigate against moral hazard.	Low	Medium
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.3.C.9 What other impacts is this approach likely to have?

There will be a number of implementation challenges for many regulated entities and for the Reserve Bank itself.

D. Treatment of small deposit takers within the perimeter

4.3.D.1 What is the specific problem?

The proposed regulatory perimeter (as proposed in section 4.1.A) will capture a broad range of different entities, differing significantly in both their size and their business models. It is critical that the design of the regulatory perimeter can accommodate this variety without undermining the overall financial stability purposes of the legislation.

Small deposit takers

The creation of a single regulatory regime for deposit takers will capture a number of NBDTs that are significantly smaller than any of the registered banks. These entities are largely credit unions, building societies and finance companies (noting that additional considerations associated with finance companies are outlined below). The Review has explored how the regime should accommodate a differential approach for these entities, noting that creating a single licensed deposit-taker framework could mean they have to meet requirements designed for larger and more complex firms.

Putting credit unions, building societies and other small deposit takers into the same regulatory regime as banks will require careful attention to the design of prudential standards and the overall supervisory and enforcement approach. It will be important that the regime strikes the right balance between:

- providing sufficient assurance, including to consumers, of the soundness of all deposit takers in the regulatory perimeter (particularly given the introduction of deposit insurance), and
- considering the benefits associated with deposit takers of different sizes and business models operating in the market, and the lower level of systemic risk that small deposit takers present.

The regime should not place unnecessary barriers to entry to the deposit-taking sector and should allow for competition and innovation within the sector. A flexible and proportionate regulatory regime should provide a responsive regulatory environment for new business models, such as technologically enabled FinTech businesses, allowing the businesses to develop and grow while managing risks to financial stability appropriately. It is also important to emphasise that a robust regulatory framework provides benefits for small deposit takers and their customers. Prudential regulation paired with deposit insurance can reduce both the likelihood and the consequences of the failure of a small deposit taker, promoting confidence in the sector.

Finance companies

As outlined in section 4.1.A, we consider that finance companies should continue to be prudentially regulated and captured within the overall regulatory perimeter. However, the fact that the business model of most finance companies differs significantly from many other deposit takers raises the question of whether they should be subject to different requirements within this perimeter.

Finance companies seek to fill a gap in the credit market by undertaking a range of lending that banks may not be willing to undertake, including certain personal, car, business and property lending. In doing so, they provide customers with valuable access to finance and improve the diversity of New Zealand's credit markets. Because finance companies are willing to lend for riskier ventures on the basis of lower credit security than banks, they charge higher interest rates – and in turn they attract funding from investors by offering higher interest rates than are offered on many deposit products. These firms issue retail debt securities, but do not typically take on-call deposits or offer transactional services. Finance company debt securities are often referred to as debentures but are also marketed as 'term deposits' and 'secured term deposits'.

If finance companies are to be treated the same as other firms within the regulatory perimeter, this would raise questions on whether they should be able to offer insured deposits. Finance companies do not have some of the key characteristics that necessitate the provision of deposit insurance:

- they do not offer products that play the 'public utility' role of transactional deposit accounts, which are necessary for participation in the modern financial system
- they are subject to different product disclosure requirements aimed at promoting an understanding of risk
- given the lower negative externalities associated with the failure of a finance company, it is less obvious that there is an implicit guarantee that should be managed by a formal pre-funded deposit insurance scheme.

Coverage of finance company debt securities by deposit insurance is likely to generate more significant moral hazard concerns than banks and other deposit takers. Finance companies present a particular moral hazard risk as their business models are premised on being able to offer superior returns by engaging in higher risk lending niches. To the extent that finance companies have access to deposit insurance and are able to maintain this return premium over lower risk institutions, they are more likely to attract insured funds.

4.3.D.2 What options are available to address the problem?

We have identified the following options for the treatment of small deposit takers within the regulatory perimeter.

Option 1: Flexible regime

Under this option, the Reserve Bank would have the flexibility to calibrate its regulatory approach to small, less systemically significant deposit takers, without providing for specific tiers of deposit takers in legislation. Decision-making principles should support a proportionate approach that minimises compliance costs and takes account of their role in facilitating competition. Ministers may also choose to reflect broader public policy objectives in the Financial Policy Remit.

Option 2: Formal tiering

The main alternative to the flexible approach proposed above would be establishing tiers of deposit takers in the Deposit Takers Act.

A benefit of this approach is that it would provide small deposit takers with clarity and certainty that they will be treated differently from larger deposit takers. It would also not require a separate licence category for small deposit takers, as regulatory requirements would be based on their size rather than whether they use the word 'bank' or not. However, it would create an arbitrary 'cliff edge' in legislation that could inhibit the growth of small deposit takers.

Any formal tiers established through the Deposit Takers Act would likely only provide certainty on which entities are in which tiers, not on the standards that would apply to each tier. These standards would continue to be set by the Reserve Bank, although the Deposit Takers Act could specify that the Reserve Bank should have particular regard to certain factors (such as the desirability of proportionality) when calibrating standards and its overall regulatory approach for the tier of small deposit takers.

While establishing a defined tier for small deposit takers would have some benefits in ensuring their differential treatment, having a single deposit-taking licence category, flexibly applied as outlined above, would likely better accommodate the broad range of deposit takers that either currently operate or may seek to enter the market. The Reserve Bank would still have the flexibility to adopt elements of this approach, including setting standards particular to different entity classes and taking a risk-based approach to supervision.

Option 3: Restriction on the use of the word 'bank'

This approach would restrict the use of the words 'bank' and 'deposit' (and related words) by financial service providers that are not licensed deposit takers.

While the Deposit Takers Act will have an activity-based regulatory perimeter (as outlined in section 4.3.C), it is also important to maintain a restriction on the use of these words to minimise the risk of the public being misled about the regulatory requirements applying to an entity and the risks to their investments. This approach also aligns with the Basel Committee on Banking Supervision's Core Principle (BCP) 4 (Permissible activities), which requires the use of the word 'bank' to be controlled.

Incorporating NBDTs into the same regulatory regime as banks raises the question of whether all or only some licensed deposit takers should be permitted to use the words 'bank', 'banker' and 'banking'.

On the one hand, all licensed deposit takers would be subject to the same overall regulatory framework and be part of the deposit insurance scheme, and would offer many similar services. On the other, the regulatory and supervisory approach to smaller deposit takers may be less intensive than that applied to banks (as discussed above) and many small deposit takers are significantly smaller and have substantially lower credit ratings than registered banks.

Stakeholder feedback suggests that the current restrictions on the words ‘bank’, ‘banker’ and ‘banking’ are significant impediments to the ability of small NBDTs such as credit unions to compete with banks. This aligns with the Australian Productivity Commission’s conclusion that similar restrictions in Australia “may have acted as a significant deterrent for new entities and existing non-bank authorised deposit taking institutions (such as credit unions) that might aim to compete with banks in some markets. A difference in naming conventions can create confusion for some consumers”.[29]

This option has been considered in the context of a restriction of the word ‘bank’ introducing differential treatment to those deposit takers that could use the word ‘bank’ and those deposit takers that could not. However, this issue could equally be a distinct topic of its own (i.e. that restrictions around who can call themselves a bank does not automatically flow through to differential treatment for smaller deposit takers).

Option 4: Separate finance company licence category

Under this option, entities that did not want to take insured deposits would not be described as ‘deposit takers’ or be able to describe their products as ‘deposits’. There would be full product disclosure requirements, including clear labelling that products are uninsured. The entities would not be able to offer transactional accounts or on-call or very short maturity products (e.g. less than 31 days), and would be subject to separate prudential standards targeted at finance company business model risks, and could continue to be supervised by an independent supervisor. The entities would not be subject to the crisis management provisions of the DTA.

Note that while Options 1 and 2 are mutually exclusive, the other options are not and that more than one could be adopted in response to the identified problem.

4.3.D.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

As for our consideration of the inclusion of finance companies within the regulatory perimeter, we have identified the following assessment criteria as being critical to the design of the regulatory perimeter:

- **Proportionately responds to financial stability risks** – the regulatory perimeter should capture entities and business models that present identified risks to the stability of New Zealand’s financial system. Prudential regulation is most likely to be

29 Productivity Commission (2018) Competition in the Australian Financial System (Productivity Commission Inquiry Report). Accessed at: https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system-overview.pdf

desirable in relation to firms that generate negative externalities, moral hazard or information asymmetries.

- **Flexible and durable** – the regulatory perimeter can adapt to the economic substance and risks of an activity and has the capacity to evolve in response to changing circumstances.
- **Provides clarity and legitimacy** – the DTA should seek to provide clarity, including to consumers, on the entities that will be subject to prudential regulation. While a degree of flexibility is desirable, the design of the regulatory perimeter is a significant policy decision for Parliament and should not be delegated unless there are compelling reasons to do so.
- **Supports competition and diversity** – the regulatory perimeter should seek to accommodate competition from a range of business models and avoid imposing unnecessary regulatory costs.

There are trade-offs between these assessment criteria and there will be a range of views on their relative weighting. The Reserve Bank places greater weight on responding to financial stability risks and providing clarity and legitimacy, given the critical importance of financial stability to economic performance and the added importance of clarity and legitimacy in the context of a regime that has very broad delegations to the Reserve Bank in other areas.

4.3.D.4 What other options have been ruled out of scope, or not considered, and why?

The proposed options are representative of the main options considered in our analysis.

4.3.D.5 What do stakeholders think?

During the third consultation, most submitters supported the inclusion of small deposit takers within a single flexible regime. A number of submitters argued that proportionality in the setting and application of prudential standards would be essential and suggested the government and Reserve Bank should be encouraging greater diversification and competition in the financial sector. Other submitters suggested that different tiers of deposit takers should be provided for in legislation (e.g. systemically significant bank, bank, small deposit taker, restricted deposit taker), on the basis that this would provide clarity and consistency over time and that entities could be provided time to transition from one tier to another.

All submitters who addressed the question were supportive of restricting the use of the words ‘bank’, ‘banker’ and ‘banking’ to licensed deposit takers although there were differing views on whether all licensed deposit takers should be able to use these words. Submitters were generally in favour of restricting the use of the words ‘deposit’ and ‘deposit taker’, other than one individual submitter who argued that restricting the ability to describe a product as a deposit would be excessive.

Submitters had a range of views on the best approach to finance companies. There were two options provided within the third consultation. Option 1 proposed the establishment of a restricted license category for lenders that solely want to issue uninsured debt securities but not take insured deposits or offer transactional facilities. Option 2 on the other hand, would require finance companies to be licensed as deposit takers to issue any type of retail product, both insured and uninsured.

Some submitters were in favour of the establishment of a restricted license category, on the basis that it would enable a more proportionate regulatory approach for finance companies with lower compliance costs and avoid the moral hazard risks associated with an influx of insured deposits into the finance company sector. Some submitters also noted that this would allow for finance companies to be treated differently to deposit takers under the FMC Act.

Other submitters were supportive of requiring finance companies to be licensed as deposit takers. These submissions generally favoured this option in order to provide consistency of treatment and to allow finance companies to effectively compete with banks and other deposit takers, including by having deposit insurance. These submissions argued that moral hazard concerns associated with finance companies were overstated and that any risks could be managed with similar regulatory requirements that exist at present.

4.3.D.6 Impact analysis

	Option 1: Flexible regime (preferred – treated as baseline for this analysis)	Option 2: Tiered regime	Option 3: Restriction on th use of the word 'bank' (preferred)
Proportionately responds to financial stability risks	0 The Reserve Bank's flexibility in calibrating standards and using exemption powers would enable it to establish regulatory requirements that are both proportionate and responsive.	0 Similar to Option 1, though with less flexibility given tiering and with some risks of an arbitrary 'cliff edge'.	+ Would ensure only those who r the requirements of a financial strength requirements framewo can use the word 'bank', allowi for more proportionate treatmen non-banks and mitigating conc that the failure of a smaller enti could undermine confidence in overall banking sector.
Flexible and durable	0 As above, the Reserve Bank's flexibility in calibrating standards and using exemption powers would enable it to establish regulatory requirements that are both proportionate and responsive. While the Reserve Bank could set different requirements for different classes of entities, these classifications could evolve over time.	- - Having explicit tiers of entities would provide for significantly less flexibility, as it would establish permanent tiers that may not be appropriate across different types of requirements and in relation to different business models.	- Retains flexibility as the restrict on the use of the word bank co be tailored and adapted to char in the market.

Provides clarity and legitimacy	0 Would provide sufficient assurance of the soundness of all deposit takers in the regulatory perimeter (particularly given the introduction of deposit insurance)	+ Would provide small deposit takers with clarity and certainty that they will be treated differently from larger deposit takers. May help to communicate to depositors the regulatory intensity levels for the different entity classes.	++ Would mitigate against the public being misled about the regulatory requirements applying to an entity and the risks to their investments.	- - Complexity and scope for confusion.
Supports competition and diversity	0 Would provide a responsive regulatory environment for new business models, allowing the businesses to develop and grow while managing risks to financial stability appropriately.	- A defined tier for small deposit takers would have some benefits in ensuring their differential treatment, but would create an arbitrary 'cliff edge' in legislation that could inhibit the growth of small deposit takers.	- Restrictions on the use of the word 'bank' can significantly impede the ability of small NBDTs, such as credit unions, to compete with banks.	+ Without the need to manage moral hazard risks associated with deposit insurance, there should be more scope within this approach for higher risk/return business models to continue to operate, under a somewhat lower level of regulatory and supervisory intensity.
Overall	0	-	+	-

4.3.D.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Options 1 and 3.

Option 1 provides for a flexible regime. The flexibility provided to the Reserve Bank in calibrating standards and using exemption powers (as discussed in Section 4.4.E) should enable it to establish regulatory requirements that are both proportionate to different deposit taker classes and responsive individual deposit taker's business models.

Under this model, the Reserve Bank's approach to small deposit takers would be guided by the Deposit Takers Act's purposes, the Reserve Bank's decision-making principles and the Remit (as outlined in Section 4.2) appropriately guide decisions on the design of the framework for small deposit takers.

The Treasury supports the proposed approach.

4.3.D.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional costs associated with the implementation of a new prudential regulation framework.	Low (short-term)	Medium
	Finance companies Finance companies may struggle to comply with the licensing, prudential standards, supervisory intensity and risk-based pricing requirements under their current business models. The requirements may limit the ability of finance companies to offer the higher returns that underpin their business model, either by directly constraining their ability to engage in their current lending practices, or by imposing additional compliance costs that finance companies would struggle to absorb.	Medium (medium/long-term)	Medium
Regulators	Additional costs associated with the implementation of a new prudential regulation framework.	Low	Medium

Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Medium
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Reductions in compliance costs from a more transparent regulatory framework, providing participants with a clearer sense of the Reserve Bank's approach and focus in relation to regulatory issues.	Low	Medium
Regulators	Benefits associated with a more flexible regime and one that is more - compliant with the Basel Committee on Banking Supervision's Core Principles. Benefits through enabling the Reserve Bank to respond to identified risks.	Medium	Low
Wider government			
Other parties	May help to communicate to depositors the regulatory intensity levels for the different entity classes.	Low	Low
Total Monetised Benefit			
Non-monetised benefits		Medium	Low

4.3.D.9 What other impacts is this approach likely to have?

No other impacts have been identified.

Section 4.4: Standards and licensing

Overview

Banks

The framework for prudential regulation of banks in New Zealand is found mainly in the Reserve Bank of New Zealand Act 1989 (Reserve Bank Act). The Reserve Bank Act sets out the Reserve Bank's objectives, and the objectives for the prudential regulatory system. The Reserve Bank Act also sets out the regulatory perimeter, and provides the Reserve Bank with a number of regulatory tools:

- a framework for 'registering' banks (equivalent to licensing under other Acts such as the Insurance (Prudential Supervision) Act 2010 [IPSA] or the Non-bank Deposit Takers Act 2013 [NBDT Act])
- delegated rule-making powers that allow rules to be made that apply to those banks
- regulatory tools that allow the Reserve Bank to monitor, supervise and – where appropriate ─ take regulatory action against registered banks.

To a large degree, the detailed rules applying to registered banks are not found in the Reserve Bank Act itself. Instead, they are set through delegated rule-making powers. The most notable delegated rule-making powers in the Reserve Bank Act are:

- Conditions of registration (CoRs), which define most of the rules that registered banks must adhere to in order to operate in New Zealand.
- Orders in Council (OiCs), which set out certain information that both registered banks and certain individuals must disclose to the market.

CoRs are a form of administrative instrument, while OiCs are delegated legislation.

CoRs are used to set the primary rules applicable to registered banks, such as capital, liquidity or corporate governance. The Reserve Bank has a list of areas it is allowed to consider when registering banks or imposing CoRs. The list can also be added to through regulations. CoRs are applied to each bank individually. However, in practice the Reserve Bank prepares detailed policies that either apply to all banks, or to classes of banks. As an example, the Reserve Bank sets some rules that apply only to locally incorporated banks, or branches of foreign-owned banks.

The detailed policies prepared by the Reserve Bank are set out in the Banking Supervision Handbook. The Banking Supervision Handbook has not been made under a rule-making power, and does not have legal force on its own. Instead, the policies in the Banking Supervision Handbook apply as rules due to their inclusion in CoRs: this is known as 'incorporation by reference'.

NBDTs

The framework for the prudential regulation of NBDTs is provided under the NBDT Act, with prudential requirements for NBDTs primarily set via regulations.

Licensed NBDTs are required to comply with prudential requirements outlined in the NBDT Act, the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010 and the Deposit Takers (Liquidity Requirements) Regulations 2010.

The prudential requirements can be categorised into the following six areas:

- Credit ratings;
- Governance;
- Risk management;
- Capital;
- Related party exposure limits; and
- Liquidity.

Some licensed NBDTs may be exempted from particular prudential requirements. The Reserve Bank can exempt a licensed NBDT, class of NBDTs, or trustee from compliance with any provision of the Act or regulations.

Summary of proposed approach

The following section proposes:

- that standards would be the primary tool for imposing prudential requirements on deposit takers (section 4.4.E)
- that the DTA clarifies the scope of the Reserve Bank's authority to impose standards (section 4.4.F) and
- the process that the Reserve Bank will follow for imposing prudential standards (discussed in section 4.4.H.2).
- that the Reserve Bank would be required to follow a process for licensing deposit takers (section 4.4.I).

This section also discusses macro-prudential policy and the role of the Minister of Finance in changing the scope of lending standards.

Macro-prudential policy

Section 4.4.G provides an overview of the problem and the options considered. For this issue, the Reserve Bank prefers the second option presented, with types of lending that lending standards may apply to be prescribed by regulation, leaving the types of borrowers and the types of macro-prudential instruments used to be set by standards. This option is reflected in the Cabinet paper. The Treasury prefers the first option presented, with types of lending and the types of borrowers that lending standards may apply to and the types of macro-prudential instruments that may be included in lending standards prescribed by regulation.

The role of the Minister of Finance in changing the scope of lending standards

Section 4.4.G provides an overview of the problem and the options considered. For this issue, the Reserve Bank prefers the first option, that there is a requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards only in accordance with a recommendation of the Reserve Bank. The Treasury prefers the second option, that there is a requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards after consultation with the Reserve Bank. The second option is reflected in the Cabinet paper.

E. Core prudential rule-making instrument

4.4.E.1 What is the specific problem?

Banks

The framework for prudential regulation of banks in New Zealand is found mainly in the Reserve Bank Act. The Reserve Bank Act sets out the Reserve Bank's objectives, and the objectives for the prudential regulatory system. The Reserve Bank Act also sets out the regulatory perimeter, and provides the Reserve Bank with a number of regulatory tools:

- a framework for 'registering' banks (equivalent to licensing under other Acts such as the IPSA or the NBDT Act)
- delegated rule-making powers that allow rules to be made that apply to those banks
- regulatory tools that allow the Reserve Bank to monitor, supervise and – where appropriate – take regulatory action against registered banks.

To a large degree, the detailed rules applying to registered banks are not found in the Reserve Bank Act itself. Instead, they are set through delegated rule-making powers. The most notable delegated rule-making powers in the Reserve Bank Act are:

- Conditions of registration (CoRs), which define most of the rules that registered banks must adhere to in order to operate in New Zealand.
- Orders in Council (OiCs), which set out certain information that both registered banks and certain individuals must disclose to the market.

CoRs are a form of administrative instrument, while OiCs are delegated legislation.

CoRs are used to set the primary rules applicable to registered banks, such as capital, liquidity or corporate governance. The Reserve Bank has a list of areas it is allowed to consider when registering banks or imposing CoRs. The list can also be added to through regulations. CoRs are applied to each bank individually. However, in practice the Reserve Bank prepares detailed policies that either apply to all banks, or to classes of banks. As an example, the Reserve Bank sets some rules that apply only to locally incorporated banks, or branches of foreign-owned banks.

The detailed policies prepared by the Reserve Bank are set out in the Banking Supervision Handbook. The Banking Supervision Handbook has not been made under a rule-making power, and does not have legal force on its own. Instead, the policies in the Banking Supervision Handbook apply as rules due to their inclusion in CoRs: this is known as 'incorporation by reference'.

NBDTs

The framework for the prudential regulation of NBDTs is provided under the NBDT Act, with prudential requirements for NBDTs primarily set via regulations.

Licensed NBDTs are required to comply with prudential requirements outlined in the NBDT Act, the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010 and the Deposit Takers (Liquidity Requirements) Regulations 2010.

The prudential requirements can be categorised into the following 6 areas:

- Credit ratings;
- Governance;
- Risk management;
- Capital;
- Related party exposure limits; and
- Liquidity.

Some licensed NBDTs may be exempted from particular prudential requirements. The Reserve Bank can exempt a licensed NBDT, class of NBDTs, or trustee from compliance with any provision of the Act or regulations

Problem

With the new regulatory perimeter applying to both banks and NBDTs, there is a need for one integrated approach to rule-making. At present rules are applied to banks through CoRs and OiCs, whereas for NBDTs rules are applied through regulations. Creating one approach to rule making will improve efficiency and coherence in the regulation and supervision of two sectors that would now share the same perimeter.

A key issue examined by the Phase 2 Review was the Reserve Bank's use of CoRs. It was noted that the Reserve Bank's use of CoRs to set prudential requirements:

- has expanded to cover areas of prudential regulation that were not directly contemplated at the time the Reserve Bank Act was enacted; and
- was not subject to Ministerial oversight, or other form of scrutiny.

There is value in clear empowering provisions that do not restrict the Reserve Bank in making rules related to its financial stability objective functions, and that allow the Reserve Bank to develop rules as risks to deposit takers and the financial system evolve. This would allow the Reserve Bank to develop the prudential rulebook in line with the Basel Committee on Banking Supervision's Core Principles (as recommended by the IMF FSAP), should the Reserve Bank consider this appropriate. This also provides an opportunity to ensure that the scope of these rule-making powers is sufficiently clear, and that appropriate checks and balances apply to prudential rule-making.[30]

30 Legislative Design and Advisory Committee (March 2018) Legislation Guidelines. Accessed at: http://ldac.org.nz/assets/documents/Legislation-Guidelines-2018-edition-2020-06-25.pdf

Cabinet has made the in-principle decision that 'standards' – a form of secondary legislation under the Legislation Act 2019, subject to parliamentary oversight and potential disallowance via the Regulations Review Committee – would be the primary tool for imposing regulatory requirements on deposit takers.[31] This move from CoRs to standards was judged to maintain the Reserve Bank's independence in setting prudential rules, align better with international practice, and provide a greater degree of transparency and oversight.

The third consultation[32] set out the remaining issues as:

- Scope of standards: the matters to which standards can relate
- Macro-prudential policy: whether macro-prudential powers should be subject to the same general framework as other standards
- Procedural requirements for standards

Cabinet had already agreed in principle that there should be a high degree of flexibility to tailor requirements to individual deposit takers and classes of deposit takers. The third consultation consulted further on the flexibility of standards and the ability of the Reserve Bank to modify standards, or set different standards for different classes of deposit taker, to reflect the different risks they may present, and to accommodate the broad range of deposit takers' business models.

4.4.E.2 What options are available to address the problem?

There are several potential options that could create an enhanced framework for making prudential rules.

Option 1: Enhanced status quo

This model would retain the current CoRs rule-making framework, supplemented by greater specificity in relation to both objectives and the scope of CoRs. There would also be a broader refresh of safeguards such as consultation requirements, and potentially oversight of decisions. As part of this refresh, the Banking Supervision Handbook could receive statutory recognition.[33]

This option acknowledges that there are ways to address some of the issues identified with the current model without changing the rule-making instrument. For example, the transparency of the current regime could be improved through enhanced regulatory practices, such as the clearer separation of rules and guidance, and through a centralised register of CoRs. Work is underway to address a number of these process issues as a follow-on from the Reserve Bank's 2015 'Regulatory Stocktake'. Progress has been subject to Reserve Bank resourcing constraints.

31 DEV-19-MIN-0346. Accessed at: https://www.treasury.govt.nz/sites/default/files/2019-12/prudential-regulation-deposit-takers-dev-19-min-0346-4223655.pdf

32 Reserve Bank Act Review (March 2020). Safeguarding the future of our financial system – Further consultation on the prudential framework for deposit takers and depositor protection. Consultation Document 3. Available at: https://www.treasury.govt.nz/sites/default/files/2020-03/rbnz-further-consultation-phase-2.pdf

33 Every-Palmer (August 2017) Reserve Bank Prudential Regulation of Banks. Available at: https://www.treasury.govt.nz/sites/default/files/2018-04/rbnz-rev-prudential-regulation-banks.pdf

Under an enhanced status quo, rules would not be subject to oversight from Parliament, or to publication requirements. As has been discussed, there are legitimacy and transparency benefits if rules that apply to all banks, or to classes of banks, are accessible.

Option 2: Standards

This model would seek to enhance legitimacy and accessibility by replacing CoRs with delegated legislation. Standards would be set by the Reserve Bank and be classified as secondary legislation under the Legislation Act 2019, which means they would be subject to parliamentary oversight and potential disallowance via the Regulations Review Committee. The Regulations Review Committee does not consider matters of policy. Rules would continue to be made by the Reserve Bank, but in a manner more akin to IPSA's 'solvency standards', or (in the Australian context) APRA's 'prudential standards'.

Parliamentary scrutiny would serve as a useful discipline. Shifting to standards would also ensure greater clarity, for example by discouraging the inclusion of guidance-type materials within rule-making instruments.

As a starting point, the same flexibility is not available for standards as under CoRs. It is nonetheless possible to build in this flexibility through the empowering provision. Standards can be designed to allow for discretionary variations, modifications, and approvals on the part of the Reserve Bank, subject to appropriate safeguards. This would allow the Reserve Bank to, for example, set a range in which a tool like a loan-to-value ratio restriction (LVR) or a capital buffer could operate, and then vary the level through time using the process set out in the relevant standard.

The use of standards would in some cases be more efficient than CoRs (by avoiding the need to update CoRs for all banks), and would also be more reflective of the nature of rule-making (with rules made for classes of entities and developed through public consultation processes).

Option 3: Regulations

Shifting from CoRs to a system of regulations would improve legitimacy by giving the government a role in approving rule changes. Prudential rules can have meaningful broader impacts, supporting a case that the government should have a voice in rulemaking.

As delegated legislation, regulations would also enhance transparency. Regulations are disallowable. Regulations are also subject to further safeguards: they must be drafted and certified by the Parliamentary Counsel Office (PCO), receive Cabinet scrutiny, and are subject to the 28-day rule (meaning that there is a minimum 28 day exposure period before they come into force).

A regulations model nonetheless appears inconsistent with the degree of regulatory independence seen as best practice in prudential rule-making and could introduce political risk into the prudential regulatory process.[34] The content of prudential rules is also highly technical: while government may have an interest in the broader impact of certain rule settings, the elements of rules that could be considered 'significant policy' are not readily separable from the detail. This suggests that a government voice in rule-making (if considered appropriate) may be more effectively expressed through other channels, such as the financial policy remit or comments by the Minister on the Reserve Bank's statement of intent.

4.4.E.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

In assessing the Reserve Bank Act framework, an important issue is whether an appropriate balance has been struck between the use of primary legislation and delegated rule-making powers. This balance can be assessed against the following criteria:[35]

- **Legitimacy** – important policy content should be a matter for Parliament to determine in primary legislation through an open democratic process.
- **The durability and flexibility of the law** – delegation can be important to how a law (and the regulatory system it is part of) performs over time in terms of responding to changing or unforeseen circumstances or allowing minor flaws to be addressed.
- **The certainty or predictability of the law** – if too much policy content is delegated or delegations are given to different decision makers without clearly scoped mandates, clarity about what is required by the law can be undermined.
- **The transparency of the law** – layers of delegated legislation can create complexity and fragmentation in a regime, making it difficult for readers to find and understand the law. However, too much technical detail in an Act might make it difficult to navigate.
- **Regulatory independence** – delegation is important in signalling a commitment to financial stability, free of short-term political trade-offs. This is seen as good practice under the Basel Core Principles of Effective Banking Supervision.

Changes should only be considered where they can address the issues of legitimacy, transparency, and proportionality identified, without unnecessarily impacting on flexibility and operational independence.

34 Operational independence for prudential regulators is seen as addressing the 'instability bias' caused by politicians being reluctant to tighten credit conditions and other prudential settings during a boom period, increasing imbalances which could ultimately trigger a financial crisis. For further details see Haldane, Andy – Bank of England (November 2020). Speech: What has central bank independence ever done for us? Available at: https://www.bankofengland.co.uk/speech/2020/andy-haldane-ucl-economics-conference-2020

35 See Legislative Design and Advisory Committee (March 2018) Legislation Guidelines. Accessed at: http://ldac.org.nz/assets/documents/Legislation-Guidelines-2018-edition-2020-06-25.pdf

4.4.E.4 What other options have been ruled out of scope, or not considered, and why?

The options that have been selected are based on a review of international practice, as well as submissions through the public consultation. There is a range of relatively minor variations on these options that could also be considered, but which we do not think would have a substantive impact on the analysis.

4.4.E.5 What do stakeholders think?

The second consultation[36] proposed three broad models for prudential rulemaking: an "enhanced status quo" model, a standards model, or a regulations model. All of the submitters who addressed the issue supported a standards-based approach to setting prudential rules, with parliamentary oversight and review processes.

36 See Reserve Bank Act Review (June 2019). Safeguarding the future of our financial system – The Reserve Bank's role in financial policy: tools, powers, and approach. Consultation Document 2B. Available at: https://www.treasury.govt.nz/sites/default/files/2019-06/rbnz-safeguarding-future-financial-system-2b.pdf

4.4.E.6 Impact analysis

	Option 1: Enhanced status quo	Option 2: Standards	Option 3: Regulations
Legitimacy	+ Would provide minor improvements compared to status quo.	++ Would enhance legitimacy by replacing CoRs with delegated legislation.	++ Would improve legitimacy by giving the government a role in approving rule changes.
The durability and flexibility of the law	0	0 Standards are expected to be highly flexible – able to apply to all, a class of, or a single deposit taker. This has efficiency gains relative to CoRs. Standards are also expected to be at least as durable as CoRs.	- Less flexible a process than either CoRs or Standards. Could introduce a time inconsistency problem by introducing political decision-making and thus prove less durable as well.
The certainty or predictability of the law	+ Would provide greater specificity in relation to both objectives and the scope of CoRs.	+ Would provide certainty and clarity.	+ Would provide certainty and clarity.
The transparency of the law	+ Transparency of the current regime could be improved through enhanced regulatory practices, such as the clearer separation of rules and guidance, and through a centralised register of CoRs.	++ Would enhance transparency by moving away from reliance on CoRs. Standards would be subject to scrutiny by the Regulations Review Committee and could be 'disallowed' on certain technical grounds.	++ As delegated legislation, regulations would also enhance transparency. Regulations are disallowable. Regulations are also subject to further safeguards.
Regulatory independence	0	0	-- Could introduce a time inconsistency problem. Appears inconsistent with the degree of regulatory independence seen as best practice in prudential rule-making.
Overall assessment	+	++	+

4.4.E.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank considers that Option 2: standards would best address the issues identified in relation to the framework for making prudential rules.

This approach maintains the Reserve Bank's independence in setting prudential rules (thereby aligning with international best practice), while providing a greater degree of transparency and oversight than the current approach, which primarily uses CoRs. Submitters were supportive of this approach, emphasising that standards would strengthen the legitimacy of prudential rules as long as appropriate procedural requirements were in place. There was broad acknowledgement that prudential rules would need to be flexible enough to accommodate a wide range of entities and enable the Reserve Bank to respond to identified risks.

We note that since the second round of consultation, Cabinet has agreed in-principle that 'standards' will be the core prudential rule-making instrument under the Deposit Takers Act. The Minister of Finance has also noted that he expects the Reserve Bank will be able to set standards in relation to all the matters on which it currently sets CoRs.

The Treasury supports the proposed approach.

4.4.E.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional costs associated with the implementation of a new framework for making prudential rules (short-term).	Low	Medium
Regulators	Additional costs associated with the implementation of a new framework for making prudential rules (short-term), and with strengthened regulatory, reporting and transparency requirements (ongoing).	Medium	Medium
Wider government		Low	Medium
Other parties			
Total Monetised Cost			

Non-monetised costs		Low	Medium

Expected benefits of proposed approach compared to taking no action			
Regulated parties	Reductions in compliance costs from a more transparent regulatory framework, providing participants with a clearer sense of the Reserve Bank's approach and focus in relation to regulatory issues (ongoing).	Low/Medium	Medium
Regulators	Benefits associated with a more efficient and flexible regime as well as greater certainty of scope, and enhanced legitimacy (ongoing).	Medium	Low
Wider government			
Other parties	Benefits associated with improved public confidence in the Reserve Bank, through stronger transparency and accountability requirements.	Medium	Low
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.4.E.9 What other impacts is this approach likely to have?

There will be a number of implementation challenges for deposit takers and for the Reserve Bank itself. In particular, the Reserve Bank would need to translate the current CoRs for banks and regulations for NBDTs into standards and determine whether those standards should be applied to different classes of deposit takers, and whether supervisory adjustments were appropriate in respect of individual deposit takers, during the legislative process for the Deposit Takers Act. This process, including consultation and impact analysis, would need to be completed during the transitional period, with enough time for deposit takers to adjust to any changes and proceed through the final licensing process.

F. Scope of standard-setting power

4.4.F.1 What is the specific problem?

Cabinet has agreed in principle that the Deposit Takers Act will define the matters on which the Reserve Bank can set standards, with the Minister of Finance being able to add matters to which standards could relate via regulations. The Minister has also noted that he expects the Reserve Bank will be able to set standards in relation to all the matters on which it currently sets CoRs (subject to the discussion on macro-prudential requirements).

The Reserve Bank Act currently empowers the Reserve Bank to impose CoRs in relation to any of the factors to which it is required to have regard in determining a bank registration application. In relation to a bank's ability to carry on its business in a prudent manner (see Reserve Bank Act, section 78), these factors are limited to:

- capital adequacy
- loan concentration and risk exposures
- the separation of the business from other interests of the bank's owner
- internal controls and accounting systems
- risk management systems and policies
- outsourcing arrangements
- other prescribed matters, which currently include anti-money laundering and countering financing of terrorism (AML/CFT) policies, systems and procedures.

The broad framing of some of the current matters has created some uncertainty as to their scope and led to suggestions that they have been used in ways that were not initially anticipated. For example, the Reserve Bank has sought to provide clarity on the purpose and instruments of macroprudential policy (imposed by a CoR relating to 'risk management systems and policies') through a 2013 memorandum of understanding (MoU) with the Minister of Finance. The MoU sets out the scope of the macro-prudential requirements the Reserve Bank will impose and establishes consultation requirements.

It would be preferable to define more clearly the scope of the Reserve Bank's standard-setting powers so that Parliament and stakeholders have clarity on how they will be used and to support their ongoing legitimacy. LDAC's Legislation Guidelines are clear that empowering Acts should clearly and precisely define the permitted subject matter of secondary legislation and the purposes for which it may be made. The issue of legitimacy is particularly critical in the case of standards, given that they can cover significant policy decisions and are delegated to an independent regulator.

This desire for clarity and legitimacy needs to be balanced with the need to provide the Reserve Bank with an appropriate degree of flexibility to respond to the changing nature of financial stability risks. The benefits of providing flexibility were illustrated in the Reserve Bank's leading role in introducing new liquidity requirements after the Global Financial Crisis (under the 'risk management systems and policies' provision in the current Reserve Bank Act). The scope should also be broad enough to enable standards to be set in relation to all the relevant Basel Committee on Banking Supervision's Core Principles.

The IMF's 2016/17 FSAP for New Zealand found that the Reserve Bank's prudential rulebook was not as broad or comprehensive as required to meet international standards.[37] However, the scope of powers set out in the current Reserve Bank Act appears to be broad enough to enable requirements to be set in relation to these matters in future.

37 See the assessment of the Reserve Bank's compliance with the core principles via International Monetary Fund (May 2017). New Zealand Financial Sector Assessment Program – Detailed Assessment of Observance of the Basel Core Principles for

4.4.F.2 What options are available to address the problem?

We have identified two broad options to clarify the scope of the Reserve Bank's standard-setting power:

- **Option 1: Status quo** – the Reserve Bank would issue standards (given the preferred approach in 4.4.E above) on the list of areas it is allowed to consider when registering banks or imposing CoRs, or conditions of licences for NBDTs.
- **Option 2: Enhanced status quo –** Enable the Reserve Bank to issue standards if it considers it necessary or desirable to achieve the purposes of the Deposit Takers Act, in relation to the matters identified in the table below.

	Intended scope	**Current Banking Supervision Handbook equivalents**
Capital requirements	Setting minimum capital requirements to allow relevant credit and operational risks to be managed adequately and thus support deposit takers' resilience to shocks.	BS2A: Capital adequacy framework (standardised) BS2B: Capital adequacy framework (internal models) BS6: Market risk guidance notes BS12: Internal capital adequacy assessment BS16: Capital recognition
Liquidity requirements	Minimum liquidity ratios and encumbrance limits to manage the risk that a deposit taker cannot meet its financial obligations as they fall due. Separated from risk management.	BS13: Liquidity policy BS13A: Liquidity policy annex
Ownership, incorporation and governance requirements	Standards that manage risks associated with the ownership or governance of a deposit taker, including the standing and regulatory framework of any parent entity.	BS9: Acquisitions of banks BS14: Corporate governance BS15: Significant acquisitions policy

Effective Banking Supervision. Available at: https://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/FSAP/Detailed-assessment-of-observance-Basel-core-principles-for-effective-banking-supervision.pdf?la=en&revision=e74d011c-d566-400d-9e65-7b732d30258f

	Intended scope	Current Banking Supervision Handbook equivalents
Internal risk management systems, controls and policies	Requirements relating to internal risk management systems, controls and policies, including standards relating to a number of the Basel Committee on Banking Supervision's Core Principles (BCPs) that the Reserve Bank does not currently cover in CoRs, such as BCP 17 (Credit risk). More specific requirements such as liquidity or lending standards, which are currently made under 'risk management systems', would instead be provided for separately.	
Crisis management and resolution	Standards relating to preparing for, managing and resolving crises.	BS17: Open bank resolution prepositioning
Loan concentration and risk exposures	Standards managing risks associated with high exposure to particular risks or particular entities.	
Related party transactions	Requirements, policies and procedures to manage the risks associated with related-party transactions.	BS8: Connected exposures policy
Public disclosure of information	Regular public disclosure requirements for deposit takers. Includes financial reporting and external audit requirements.	Disclosure requirements for banks set via Orders in Council, and BS7 and BS7A BS4: Audit obligations Could replace some FMC Act disclosure for NBDTs
Outsourcing arrangements	Standards relating to managing and limiting outsourcing risks.	BS11: Outsourcing policy
AML/CFT	Standards relating to deposit takers' obligations under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009.	BS5: Guidelines on AML/CFT
Fit and proper standards	Requiring procedures and policies designed to provide assurance of the ongoing fitness and propriety of deposit takers' directors and senior managers and requirements to seek Reserve Bank approval prior to new appointments. The requirement for directors and senior managers to be fit and proper persons (and associated procedural protections) would be directly provided for in the Act.	BS10: Review of suitability of bank directors and senior managers

	Intended scope	Current Banking Supervision Handbook equivalents
Deposit insurance	Standards to support the implementation and operation of the deposit insurance scheme (noting that the institutional location of the scheme is discussed in section 4.8 below).	
Lending standards in relation to mortgages	The rationale for the proposed scope of macro-prudential standards (e.g. lending standards) is discussed in section 4.4.G below.	BS19: Framework for restrictions on high-LVR residential mortgage lending
Matters prescribed in regulations	Providing a regulation-making power to enable the Minister of Finance to extend the scope of matters on which the Reserve Bank could set standards.	

Overview of Option 2: Enhanced status quo

In general, the proposed approach would cover the range of matters currently provided for via CoRs, but with more clarity where required (for example, the addition of liquidity requirements and lending standards, which are currently provided for under the broader heading of 'risk management systems and policies'). The proposed scope of standards is intended to be broad enough to enable the Reserve Bank to set standards in relation to the full range of matters covered by the Basel Committee on Banking Supervision's Core Principles, should it choose to do so. The rationale for the proposed scope of macro-prudential standards (e.g. lending standards) is discussed in section 4.4.G below.

It is intended that the specified matters in the scope of standards would be strictly construed, with Ministerial approval required to expand the scope, via regulations. This approach aims to provide a balance between clarity on the scope of the powers being delegated to the Reserve Bank and the flexibility for these powers to be adjusted in future to accommodate a changing regulatory environment.

The proposed approach would also shift disclosure requirements from an Order in Council mechanism to their being set in the same way as other prudential rules – through standards. This would improve flexibility, allow disclosure requirements to integrate more easily with developments such as the Reserve Bank's Financial Strength Dashboard, and reduce fragmentation in the overall regulatory regime.

As discussed in section 4.4.I below, it is proposed that licence conditions continue to be used to set requirements in relation to matters on which a standard has not been set for a particular class of deposit taker, and to provide for restrictions on the scope of licences. It is intended that the bulk of the prudential requirements for deposit takers will be set through standards, except where it is difficult to do so (such as for foreign bank branches).

Prudential standards will be developed and set independently by the Reserve Bank, subject to the procedural requirements outlined in section 4.4.H below. The initial process of developing standards will be a very significant policy project, and will need to progress in parallel with the development of the Deposit Takers Act. While to some extent these standards could be based on the existing Banking Supervision Handbook, these requirements will need to be reconsidered in light of the purposes of the Deposit Takers Act and the relevant decision-making principles, and the need to integrate NBDTs within the single deposit takers regime. The Reserve Bank has been restructuring the current Handbook in a major project that began in 2016 and is still underway. Establishing different standards for different deposit taker classes (including finance companies) will require further significant work.

The Reserve Bank has indicated that it expects to start work on translating the current CoRs to standards and developing any new standards during the legislative process for the Deposit Takers Act. This process, including consultation and impact analysis, would need to be completed during the transitional period, with enough time for deposit takers to adjust to any changes and proceed through the final licensing process.

4.4.F.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have identified the following criteria as being critical to the design of the standard-setting power's scope:

- **clarity** on the scope of the powers being delegated to the Reserve Bank
- **legitimacy** of the scope of the standard-setting power being delegated to the Reserve Bank
- **flexibility** for these powers to be adjusted in future to accommodate a changing regulatory

4.4.F.4 What other options have been ruled out of scope, or not considered, and why?

The proposed options are representative of the main options considered in our analysis. A wide range of variations on these options is possible.

4.4.F.5 What do stakeholders think?

During the third consultation, the majority of submissions supported the proposed scope of standards in the consultation document – outlined above under Option 2 (Enhanced status quo). The proposed approach would cover the range of matters currently provided for via Conditions of Registrations, but with clarity and specificity where required.

4.4.F.6 Impact analysis

	Option 1: Status quo	Option 2: Enhanced status quo
Clarity	0	+ The proposed approach would cover the range of matters currently provided for via CoRs, but with more clarity and specificity where required, as well as consistency of legislative instrument (CoRs v OICs).
Legitimacy	0	+ The proposed approach would improve transparency and legitimacy by confirming the scope of requirements currently imposed, with ministerial approval required to expand the scope, via regulations.
Flexibility	0	+ The proposed scope of standards is intended to be broad enough to enable the Reserve Bank to set standards in relation to the full range of matters covered by the Basel Committee on Banking Supervision's Core Principles, should it choose to do so.
Overall assessment	0	+

4.4.F.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 2: Enhanced status quo. This would enable the Reserve Bank to set standards in relation to the full range of matters covered by the Basel Committee on Banking Supervision's Core Principles, should it choose to do so.

The Treasury supports the proposed approach.

4.4.F.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional costs associated with the implementation of a new framework for making prudential rules (short-term).	Low (short-term only)	Medium
Regulators	Additional costs associated with the implementation of a new framework for making prudential rules (short-term).	Medium/High (short-term only)	Medium
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Medium
Expected benefits of proposed approach compared to taking no action			

Regulated parties	Reductions in costs from a more clarified and specific regulatory framework, providing participants with a clearer sense of the Reserve Bank's approach and focus in relation to regulatory issues (ongoing).	Low	Medium
Regulators	Benefits associated with a more efficient and flexible regime as well as greater certainty of scope, and enhanced legitimacy (ongoing).	Medium	Low
Wider government			
Other parties	Benefits associated with improved public confidence in the Reserve Bank, through stronger transparency and accountability requirements (ongoing).	Medium	Low
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.4.F.9 What other impacts is this approach likely to have?

There will be a number of implementation challenges for many regulated entities and for the Reserve Bank itself.

G. Macro-prudential policy

4.4.G.1 What is the specific problem?

The specific problem is determining the scope of macro-prudential powers that should be delegated to the Reserve Bank.

Macro-prudential policy is an approach to prudential regulation that emphasises the risks to the financial system as a whole, as a result of the interaction of deposit takers with the financial system and the economy. Since the GFC, many countries (including New Zealand) have added a macro-prudential overlay to their approach to prudential regulation. A variety of tools have been used internationally to help mitigate the build-up of systemic risk, such as Loan-to-Value Ratio (LVRs) restrictions (which have been used in New Zealand), restrictions on Debt-To-Income ratios (DTIs), and counter-cyclical capital buffers.

Macro-prudential tools that are targeted at lending standards, such as LVRs and DTIs, may generate distributional consequences that raise questions about the scope of those powers and the level of discretion prudential regulators like the Reserve Bank have in using them.[38] For example, while bank capital requirements may affect loan pricing, LVR restrictions can effectively stop certain borrowers being able to obtain credit. On the other hand, there are benefits to these types of tools being implemented by a regulator at arms-length from

38 International research on the distributional effects of macro prudential policy is still a relatively new area, with limited theoretical or empirical work. The limited empirical evidence available on the size of the distributional impacts of macro-prudential policy provides mixed conclusions. See Colciago, Samarina, and de Haan, (2019) Central Bank Policies and Income and Wealth Inequality: A Survey (Journal of Economic Surveys, Vol.33). Accessed at: https://onlinelibrary.wiley.com/doi/full/10.1111/joes.12314

government. Precisely because of the short-term distributional effects, government may find it difficult to commit to a macro-prudential policy that promotes financial stability by mitigating unsustainable growth (boom/bust cycles). This is known as the time inconsistency problem.

The current framework for macroprudential policy is based on conditions of registration imposed by the Reserve Bank on banks, and the non-statutory Memorandum of Understanding (MoU) between the Minister of Finance and the Reserve Bank signed in 2013. Under the MoU, the Reserve Bank has voluntarily agreed to 'consult with the Minister and the Treasury' when the Reserve Bank is actively considering changes to macro-prudential policy and to 'inform the Minister and the Treasury' prior to making a decision on macro-prudential policy changes.

Phase 2 of the Reserve Bank Act Review consulted on the extent of macro-prudential powers, and whether their use should require additional consultative or approval processes (relative to other standards). The third consultation proposed that macro-prudential powers should be subject to the same general framework as other standard-setting powers, and should specifically empower lending-standard tools in relation to property lending (e.g. LVRs and DTIs), and allow for the scope of additional lending restrictions to be introduced via regulations.

To analyse in more detail the appropriate scope of delegation to the Reserve Bank of lending standards, it is helpful to refer to three different features of lending standards:

- The types of lending the tool applies to (e.g. residential, commercial or rural property)
- The types of borrower the tool applies to (e.g. owner occupier, first home buyers, investors)
- The tool itself, i.e. the type of instrument (e.g. LVR, DTI, debt servicing restrictions).

Each of these features could be either delegated to the Reserve Bank through empowering provisions in the DTA or prescribed through regulation and implemented through an Order in Council on the recommendation of the Minister of Finance.

Perimeter

Financial stability risks may arise outside the regulatory perimeter of deposit takers. In these instances, the Reserve Bank may need to extend reporting and lending standards to entities that are outside the regulatory perimeter in order to monitor the financial system effectively, and prevent 'leakage' or 'disintermediation' from the lending standards it applies to deposit takers, and thus fulfil its financial stability mandate. Extending the scope of application of the perimeter set in primary legislation raises questions of transparency and legitimacy. As discussed in section 4.3 above, the Reserve Bank (under our proposed approach) would be able to designate individual entities as deposit takers where they are providing services that have the economic substance, but not the legal form, of deposit taking.

4.4.G.2 What options are available to address the problem?

Internationally, there are a number of governance models for setting the scope of macro-prudential policy. The Financial Stability Board (FSB), IMF and BIS have identified three broad approaches to setting macro-prudential policy:[39]

- policy set by a central bank governor or board (e.g. New Zealand)
- policy set by a committee inside the central bank (e.g. United Kingdom)[40]
- policy set by a committee outside the central bank with other agencies, often chaired by a government minister (e.g. Korea, France, Germany). While some countries have broader ministerial input into the decision-making process for macro-prudential policy, this would be a significant change in New Zealand, and would be a significant departure from the financial stability framework consulted on for the Review. In addition, a key lesson from the international experience is the importance of a clear mandate and assignment of responsibility to reduce the risk of policy inertia and to address the time inconsistency problem.

As part of the development of the RBNZ Bill, the option of establishing a statutory committee for financial stability matters (as in the United Kingdom) was discounted for reasons that have been addressed in the Cabinet paper and the RIS for that legislation. Other options and approaches were considered as part of that process.

It should be noted that the RBNZ Bill will introduce a new requirement for the Minister to issue a financial policy remit, specifying matters of wider government policy. The board of the Reserve Bank will be required, when issuing and reviewing lending standards, to have regard to the financial policy remit.

Within that broader context, we have identified two main options on the ability of the Reserve Bank to set prudential requirements that affect a regulated entity's ability to lend (or an associated person of a regulated entity's ability to lend). There are other potential options, for example empowering the Reserve Bank to set standards that define all three features (instrument, type of borrower and type of lending). However, these are the two main options considered in further detail by the Review.

Summary of options for the scope of lending standards

	Option 1	**Option 2**
Type of lending (e.g. residential property)	Prescribed by regulation	Prescribed by regulation
Type of borrower (e.g. property investors)	Prescribed by regulation	Set by standards
Instrument (e.g. LVR restrictions)	Prescribed by regulation	Set by standards

Option 1: Types of lending and the types of borrowers that lending standards may apply to and the types of macro-prudential instruments that may be included in lending standards will be prescribed by regulation

Under this option, the Reserve Bank would be empowered to create lending standards but the macro-prudential policy instrument (e.g. LVRs or DTIs), types of borrowers and types of lending the instrument would apply to, would need to be authorised by regulations, which would require Ministerial and Cabinet approval.

The argument in favour of Option 1 is that elected representatives have a legitimate interest in all three aspects of the scope of macro-prudential tools, and the use and continued use of these tools. The Treasury considers that, given the potential distributional effects of macro-prudential instruments and their potential conflicts with wider government objectives, Ministerial approval via regulation should include the type(s) of instrument(s) that may be used by the Reserve Bank.

Option 2: Types of lending that lending standards may apply to will be prescribed by regulation, leaving the types of borrowers and the types of macro-prudential instruments used to be set by the standards

Under this option, the Reserve Bank would be empowered to set lending standards that specified the macro-prudential instrument(s) (e.g. LVRs and DTIs) and the different types of borrowers the instrument would apply to. The types of lending that instruments may be applied to would be set via regulation, which would require Ministerial approval.

Empowering the Reserve Bank with instrument independence is consistent with the new financial stability objective the Reserve Bank has been delegated under the Reserve Bank of New Zealand Bill 2020 (RBNZ Bill), and would give it autonomy to choose the optimal policy instrument to achieve its financial stability objective.

The Reserve Bank's ability to implement macro-prudential policy would still depend on the Minister agreeing regulations that defined the type of lending that the instrument would apply to.

Under both options, a decision to adjust the calibration or settings of macro-prudential policy instruments within the *existing* scope of standards (e.g. increasing the level of LVR restrictions on residential property lending) would be made by the Reserve Bank and would not require additional regulations. This is in line with its delegated operational independence to achieve its financial stability objective. The Minister of Finance would be informed of changes to lending standards in line with the new statutory requirement to keep the Minister informed of key financial policy changes.

39 See FSB, IMF and BIS (2011) and Nier et al (2011)

40 The committees may also include external members, such as the UK's Financial Policy Committee (FPC).

4.4.G.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

In assessing the Reserve Bank Act framework, an important issue is whether an appropriate balance has been struck between the use of primary legislation and delegated rule-making powers. The key considerations are:

- **Operational independence** – Operational independence ensures 'credible commitment', as prudential policy actions that achieve long-term benefits may impose short-term costs on regulated entities or their customers (e.g. higher capital requirements or tighter lending standards may result in higher interest rates or denial of credit in some cases) and create a time inconsistency problem.[41] Regulatory independence is also seen as good practice under the Basel Core Principles of Effective Banking Supervision.
- **Democratic legitimacy** – The process requirements for changing the scope of lending standards should balance the legitimate interest of elected representatives to influence the appropriate scope of lending standards given their potential distributional effects against the desirability of operational independence (the time inconsistency problem) and the need to delegate powers to the Reserve Bank to respond to financial stability risks.
- **Flexibility** – The objectives and functions of a regulatory system should sit in primary legislation, but arguably prudential rules should be set in delegated legislation due to their highly technical nature and need to have sufficient flexibility to change prudential rules in response to financial stability risks as they arise. Having a flexible regulatory system means there is less need to change primary legislation. This will make the framework more durable and enduring, which is a feature of a successful regulatory regime.
- **Certainty** – A framework with a clearly defined scope of the Reserve Bank's delegated powers will provide certainty and greater confidence in the Reserve Bank's policy setting powers.
- **Accountability / Transparency** – Operational independence and delegated decision-making for regulators should be balanced by accountability for their actions and transparency of their rules and decision-making processes.

4.4.G.4 What other options have been ruled out of scope, or not considered, and why?

The proposed options are representative of the main options considered in our analysis though, as noted above, alternative options exist.

41 Haldane (2020) argues the time inconsistency problem for financial stability policy may be greater than for monetary policy. He notes governments setting financial stability policy may be prone to 'instability bias' by basing financial stability decisions on electoral considerations, in an analogous way to governments being subject to 'inflation bias' when setting monetary policy.

4.4.G.5 What do stakeholders think?

During the third consultation, the majority of submitters supported the proposal that the Reserve Bank should have the power to set lending standards in relation to mortgages. Several submitters suggested the decision-making framework for lending standards should be more explicitly linked to the overarching purpose of promoting prosperity and well-being of New Zealanders contained in the RBNZ Bill.

However, some lenders argued they should not apply to all institutions. Several submitters noted lending standards should have a neutral impact on competition. The application and scope of lending standards was commented on by several submitters. A number of financial industry group bodies did not agree with setting lending standards for non-bank lenders, concerned that they are a small part of the market and including them would inhibit competition by curtailing options and the points of difference they provide. A couple of individual submitters commented that lending standards should not be restricted to property lending, whereas bank submitters were more cautious about problems with expanding lending standards to commercial or rural property loans.

4.4.G.6 Impact analysis

The status quo, for the purposes of providing illustrative analysis, assumes that the scope of the macro-prudential requirements the Reserve Bank can impose are set through conditions of registration, following consultation by the Reserve Bank with the Minister of Finance in accordance with the non-statutory Memorandum of Understanding (MoU).

	Status quo	**Option 1:** Types of lending and the types of borrowers that lending standards may apply to and the types of macro-prudential instruments that may be included in lending standards will be prescribed by regulation	**Option 2:** Types of lending that lending standards may apply to will be prescribed by regulation, leaving the types of borrowers and the types of macro-prudential instruments used to be set by the standards
Operational independence	0	-- Option 1 would provide significantly less operational independence than either the current framework or Option 2 because all three features of the instrument(s) would need to be prescribed in regulation.	- Option 2 would provide less operational independence than the current framework as the types of lending that are in scope of the instrument(s) would need to be prescribed in regulation.
Democratic Legitimacy	0	+ Would improve legitimacy by providing for lending standards in the DTA, and providing a legislative mechanism to set their scope.	+ Would improve legitimacy by providing for lending standards in the DTA, and providing a legislative mechanism to set their scope.

Flexibility	0	- If risks emerge that cannot be mitigated with existing instrument(s), the Reserve Bank would need to request an extension to either or both its macro-prudential tools and/or the scope of its powers from the Minister, potentially delaying the policy response.	+ As for Option 1, if risks that cannot be mitigated with existing instrument(s), the Reserve Bank would need to request an extension to the scope, potentially delaying the policy response. However, it is less likely to need to do so given the types of borrowers and instruments can be set in standards.
Certainty	0	+ Having lending standards specifically referred to in the DTA would provide greater certainty than the status quo.	++ Having lending standards, instruments and their application to borrowers specifically empowered in the DTA would provide greater certainty than the status quo or Option 1.
Accountability / Transparency	0	+ Regulations would be subject to oversight by the Regulations Review Committee.	+ Regulations would be subject to oversight by the Regulations Review Committee.
Overall assessment	0	+	++

4.4.G.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank's view on the scope of lending standards

The Reserve Bank prefers Option 2: Types of lending that lending standards may apply to will be prescribed by regulation, leaving the types of borrowers and the types of macro-prudential instruments used to be set by the standards. Empowering the Reserve Bank to set lending standards that define macro-prudential tools is important in terms of the Reserve Bank's operational independence in setting macro-prudential policy and in addressing the time inconsistency problem. It also aligns with the Reserve Bank's role as technical expert and is consistent with advice from the IMF.[42]

The Reserve Bank's view is that macro-prudential policy does not differ in substance from other aspects of prudential policy where Parliament will delegate significant decision-making authority. The prudential regime will be clearer and more coherent if lending standards are on the same footing as other standards.

It is difficult to show conclusively which standards or prudential policies have significant distributional effects. A review of the international literature indicates the distributional effects of macro-prudential policy are difficult to determine theoretically and to measure empirically.[43] This is especially true in a New Zealand context due to data limitation. However, given the concerns about distributional consequences, providing the Minister with the ability to decide the scope of the macro-prudential powers through regulations strikes a balance between durability and operational independence on one hand and legitimacy and accountability on the other. Further, under the RBNZ Bill, the board of the Reserve Bank will be required, when issuing and reviewing lending standards, to have regard to the financial policy remit issued by the Minister. The financial policy remit may specify matters that the Minister considers are desirable for the Reserve Bank to have regard to.

This option is reflected in the Cabinet paper.

The Treasury's view on the scope of lending standards

The Treasury prefers Option 1: Types of lending and the types of borrowers that lending standards may apply to and the types of macro-prudential instruments that may be included in lending standards will be prescribed by regulation.

The Treasury considers that elected representatives do have a legitimate interest in the appropriate scope of financial stability tools, and the use and continued use of these tools.

42 International Monetary Fund (2017) New Zealand : Financial Sector Assessment Program: Technical Note-Macroprudential Institutional Framework and Policies

43 Colciago, Samarina, and de Haan, (2019)

The Minister should have the ability to make a decision that is different from the Reserve Bank's recommendation, but he or she would need to set out the reasons for the decision and make this publicly available. For example, if the Reserve Bank were considering new lending standards for interest-only mortgages, the Minister could recommend that a tool to ban interest-only mortgages be added to the Reserve Bank's toolkit via regulations, which may differ from the Reserve Bank advice. However, it would still be up to the Reserve Bank to determine whether or not it would be appropriate to deploy this tool.

The Treasury considers that given the potential distributional effects of macro-prudential instruments and their potential conflicts with wider government objectives, Ministerial approval via regulation should include the types of instrument that may be used by the Reserve Bank. This framework would be similar to the process in the current MoU, in which the development of additional policy instruments beyond the ones prescribed in the MoU is subject to the agreement of the Minister of Finance.

4.4.G.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment***: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional costs associated with the implementation of a potentially broadened scope of lending standards.	Low-Medium	Medium
Regulators	Additional costs associated with the coordination with Treasury on the legal scope of lending standards.	Low-Medium	Medium
Wider government	Additional costs to Treasury in providing advice to the Minister of Finance.	Low	Medium
Other parties			
Total Monetised Cost			
Non-monetised costs		Low-Medium	Medium
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Reductions in compliance costs from a more transparent regulatory framework, providing participants with a clearer sense of the Reserve Bank's approach and focus in relation to regulatory issues.	Low	Medium
Regulators	Benefits associated with a more formalised and transparent regime.	Low	Medium

Wider government	Benefits associated with more certain and formalised role in determining scope of lending standards.	Medium	Medium
Other parties	Benefits associated with improved public confidence in the Reserve Bank, through stronger transparency and accountability.	Medium	Low
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.4.G.9 What other impacts is this approach likely to have?

No other impacts have been identified.

H. The role of the Minister of Finance in changing the scope of lending standards

4.4.H.1 What is the specific problem?

Context

As noted above, the Reserve Bank has operational independence in setting prudential requirements through CoRs. The proposed move to a standards-based approach would put the delegation of these policy-making decisions on a more transparent and accessible footing. It would also import new accountability mechanisms (for example, standards would be a disallowable instrument reviewed by the Regulations Review Committee of Parliament). The new institutional framework in the RBNZ Bill also creates new accountability mechanisms for standards (for example, the new governance board of the Reserve Bank will be required to have regard to the financial policy remit from the Minister of Finance when reviewing and issuing standards) and transparency requirements (for example, the Reserve Bank will be required to publish a regulatory impact analysis for new standards, that explains how the remit was taken into account). More generally, under the RBNZ Bill the Reserve Bank will be required to publish:

- statements of prudential policy to provide transparency about how the Reserve Bank acts, or intends to act, when acting as prudential regulator; and
- a triennial Statement of Intent, explaining how the Reserve Bank intends to manage its prudential functions to meet its prudential strategic intention.

The following procedural safeguards are expected to apply to the Reserve Bank when developing and setting standards:

- A requirement to prepare a regulatory impact analysis
- A requirement to consult affected persons
- Public notification in the Gazette and on the Reserve Bank's website

- Parliamentary oversight, including scrutiny by the Regulations Review Committee scrutiny and potential disallowance
- Judicial scrutiny of the Reserve Bank's decisions on standards via judicial review.

These safeguards should assure stakeholders and the public that:

- an appropriately rigorous level of analysis has been undertaken
- the Reserve Bank has taken into account the relevant statutory purposes and principles
- relevant agencies and affected persons have been consulted appropriately.

Notwithstanding the above, additional safeguards may be necessary for macro-prudential tools (lending standards) because they can generate significant 'distributional' consequences, and may have implications for other areas of government policy.

Role of the Minister of Finance in changing the scope of lending standards

Lending restrictions used for macro-prudential policy may generate 'distributional' consequences, and may have implications for other areas of government policy. It is therefore important to clarify the role of the Minister as it relates to the Reserve Bank's use of such tools. There are trade-offs between the degree of Ministerial involvement in prudential policy and the Reserve Bank's degree of operational independence.

4.4.H.2 What options are available to address the problem?

We have identified two main options for clarifying the role of the Minister of Finance in changing the scope of lending standards. In this section, we assume the scope of standards set by regulations is limited to the types of lending, following on from the Reserve Bank's preferred option in the previous section.

Option 1: A requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards <u>only in accordance</u> with a recommendation of the Reserve Bank

The Reserve Bank's operational independence and its ability to implement macro-prudential policy would depend on the regulations defining the scope of lending. The Reserve Bank prefers that regulations defining the scope should only be made in accordance with a recommendation of the Reserve Bank to the Minister of Finance. This formulation reflects the Reserve Bank's designation as the specialist agency, and subject-matter expert, for prudentially regulating the financial sector, acting in accordance with its financial stability mandate. The Minister is not bound to accept a recommendation from the Reserve Bank and could freely express their views on a recommendation, including by asking the Reserve Bank to re-consider its approach.

If the Minister is able to act independently (either contrary to a recommendation of the Bank or on their own initiative) it would raise questions about whether the Deposit Takers Act should provide more of a framework around decisions of that nature (e.g. whether it should be more specific about what objectives the Minister should be seeking to achieve when acting independently). In addition, to an extent it could undermine the Reserve Bank's status as the specialist agency and its operational independence to deploy macro-prudential instruments in an optimal manner to address financial stability risks. While regulation making powers under the Financial Market Conduct Act 2013 only require Ministerial consultation with the Financial Markets Authority (FMA) this is likely a reflection of the fact that the FMA and the Bank have differently defined functions.

Option 2: A requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards after consultation with the Reserve Bank

This approach would place more weight on the legitimate interests of elected representatives in the appropriate scope of financial stability tools, and the use and continued use of these tools. The Minister should have the ability to make a decision that is different from the Reserve Bank's recommendation given that macroeconomic tools are more likely on average to have distributional impacts than other prudential policies, but he or she would need to set out the reasons for the decision and make this publicly available. For example, if the Reserve Bank were considering new lending standards for interest-only mortgages, the Minister could recommend that a tool to ban interest-only mortgages be added to the Reserve Bank's toolkit via regulations, which may differ from the Reserve Bank advice. However, it would still be up to the Reserve Bank to determine whether or not it would be appropriate to deploy this tool.

4.4.H.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have identified the following key considerations:

- **Operational independence** – The Review's Terms of Reference[44] notes "the operational independence of the Reserve Bank remains paramount and will be protected". Operational independence ensures 'credible commitment', as prudential policy actions that achieve long-term benefits may impose short-term costs on regulated entities or their customers (e.g. higher capital requirements or tighter lending standards may result in higher interest rates or denial of credit in some cases) and create a time inconsistency problem. Regulatory independence is also seen as good practice under the Basel Core Principles of Effective Banking Supervision.[45]
- **Democratic legitimacy** – The process requirements for changing the scope of lending standards should balance the legitimate interest of elected representatives to influence the appropriate scope of lending standards given their potential distributional effects against delegating powers to the Reserve Bank to respond to financial stability risks. This issue would be particularly salient if the Minister of Finance decided to restrict the scope of lending standards.

44 https://www.treasury.govt.nz/sites/default/files/2018-06/rbnz-3933712.pdf

45 Basel Committee on Banking Supervision (2012). Core principles for effective banking supervision. Available at: https://www.bis.org/publ/bcbs230.htm

- **Flexibility** – The objectives and functions of a regulatory system should sit in primary legislation, but arguably prudential rules should be set in delegated legislation due to their highly technical nature and having sufficient flexibility to change prudential rules in response to financial stability risks as they arise. Having a flexible regulatory system means there is less need to change primary legislation. This will make the framework more durable and enduring, which is a feature of a successful regulatory regime.
- **Accountability / transparency** – Operational independence and delegated decision-making for regulators should be balanced by accountability for their actions and transparency of their rules and decision-making processes.

4.4.H.4 What other options have been ruled out of scope, or not considered, and why?

The proposed options are representative of the main options considered in our analysis.

4.4.H.5 What do stakeholders think?

The Review did not specifically consult stakeholders on the role of the Minister of Finance in changing the scope of lending standards due to the nature of the issue, and some timing and sequencing constraints.

Submitters on the third consultation broadly supported the proposed ability for Parliament's Regulation Review Committee to review the Reserve Bank's standards. Other procedural points raised were:

- Several submitters noted that Regulatory Impact Statements should be part of the consultation process.
- An individual submitter noted the requirement to consult the government and government agencies in developing standards should be no stronger than the requirement to consult publicly and should be limited to issues of substance on the standard rather than the actual setting.
- There was some concern that the overly technical presentation of material created a barrier for public consultation.

4.4.H.6 Impact analysis

The status quo, for the purposes of providing illustrative analysis, assumes that the scope of the macro-prudential requirements the Reserve Bank can impose are set through banks' CoRs following consultation by the Reserve Bank with the Minister in accordance with the non-statutory MoU. Under the current MoU, the Reserve Bank has agreed to 'consult with the Minister and the Treasury' when the Reserve Bank is actively considering changes to macro-prudential policy and to 'inform the Minister and the Treasury' prior to making a decision on policy changes. In the absence of the MoU, the Reserve Bank is not explicitly restricted in its ability to impose macro-prudential requirements via the current Reserve Bank Act.

	Status quo	**Option 1:** A requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards only in accordance with a recommendation of the Reserve Bank	**Option 2:** A requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards after consultation with the Reserve Bank
Operational independence	0	0	- Undermines the Reserve Bank's operational independence.
Democratic Legitimacy	0	0	+ May enhance democratic legitimacy.
Flexibility	0	+ Within the scope of the regulations made, the Reserve Bank will have the flexibility to achieve its financial stability objective. And would provide a degree of flexibility to respond to financial stability risks	- Within the scope of the regulations made, the Reserve Bank will have the flexibility to achieve its financial stability objective. However, the Minister may restrict the scope of that flexibility contrary to Reserve Bank advice.
Accountability / Transparency	0	+ Assured transparency on standards that have wide-ranging implications.	0
Overall assessment	0	+	0

4.4.H.7 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank's views on the role of the Minister in changing the scope of lending standards

The Reserve Bank prefers Option 1: A requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards only in accordance with a recommendation of the Reserve Bank.

The Reserve Bank is concerned that giving the choice of instrument to the Minister, allowing the Minister to override or reverse instruments that the Bank is deploying, not only impacts the Reserve Bank's operational independence, it also runs the risk of exposing the process to political pressures. Operational independence is crucial in the deployment of macro-prudential tools as their implementation can often be unpopular (e.g. constraining credit at the upward stage of the business and credit cycle). Providing for the Minister to act on a recommendation from the Bank, thereby relying on the specialist technical expertise of the Reserve Bank, helps insulate the decision-making process from undue political pressures.

The Reserve Bank's preferred framework is consistent with the conclusions by IMF staff conducting the current Article IV review of New Zealand that the Reserve Bank Review is "an opportunity to ensure that the RBNZ has adequate operational autonomy and a sufficient degree of flexibility to respond to financial stability risks by having the full macro-prudential toolkit at its disposal".[46]

The Treasury's views on the role of the Minister in changing the scope of lending standards (reflected in the Cabinet paper)

The Treasury prefers Option 2: A requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards <u>after consultation</u> with the Reserve Bank.

The Treasury agrees that the Reserve Bank should be able to set macro-prudential restrictions via lending standards. However, the Treasury considers that the scope of macro-prudential restrictions (e.g. the type of restriction such as DTA or LVR, the types of lending, and the types of borrowers) that the RBNZ can implement via standards should be set via regulations. The Treasury considers that a Minister should be required to consult the Reserve Bank prior to any such change to regulations. However, it considers that the power to set these regulations should not be limited to situations where the Reserve Bank recommends a change be made (as recommended by the Reserve Bank). Elected representatives have a legitimate interest in setting and changing from time to time the permitted scope of the lending restrictions tools given to the Reserve Bank via regulation because of their potential significant distributional effects, and their potential conflicts with wider governmental objectives. The Reserve Bank would have operational independence to set lending standards within the permitted scope set by the regulations, thereby protecting its operational independence to use (or not) the tools given to it to achieve its objectives.

This option is reflected in the Cabinet paper.

4.4.H.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment***: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	May imply greater uncertainty given role of both the Reserve Bank and the	Low	Medium

46 IMF (March 2021) New Zealand: Staff Concluding Statement of the 2021 Article IV Discussions. Accessed at: https://www.imf.org/en/News/Articles/2021/03/11/mcs031121-new-zealand-staff-concluding-statement-of-the-2021-article-iv-discussions

	Minister in setting lending standards, and potential changes to scope.		
Regulators	Additional costs associated with consultation. May come at the expense of role clarity, perceptions of operational independence.	Medium	Medium
Wider government	Additional costs associated with consultation.	Low	Medium
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Medium

Expected benefits of proposed approach compared to taking no action			
Regulated parties	Gives alternative political avenue to advance commercial objectives.	Medium	Medium
Regulators	Increases democratic legitimacy and transparency at the expense of flexibility and may affect perceptions of operational independence.	Medium	Medium
Wider government	Gives formal opportunity to advance other regulatory objectives and policies.	Low	Low
Other parties	Benefits associated with improved public confidence in the Reserve Bank, through greater transparency.	Low	Low
Total Monetised Benefit			
Non-monetised benefits		Low/Medium	Low / Medium

4.4.H.9 What other impacts is this approach likely to have?

No other impacts have been identified.

I. Licensing

4.5.K.1 What is the specific problem?

Currently, the two parallel regimes that regulate entities that apply to deposit takers, the banking regime and the NBDT regime, apply different licensing or registration approaches to those entities within the respective regulatory perimeters.

Banking regime

The banking regime is 'name-based', which means that if an entity undertakes financial services and wishes to use certain restricted words in its name or advertisements (e.g. 'bank' or 'banking'), it must register with the Reserve Bank. It does not need to register as a bank just to undertake certain activities (e.g. deposit taking).

One purpose of the limitation on the word 'bank' is to prevent potential customers being misled about the status or standing of an entity as a registered bank supervised by the Reserve Bank, with the potential harm that may result from this. A key harm is that a New Zealand person may place funds or otherwise transact with an entity lacking the financial strength that could be expected of a registered and supervised bank and believing that deposits may be more secure than is really the case.

NBDT regime

In contrast to the banking regime, the NBDT regime operates on an 'activities-based' framework that is linked to securities law. An entity is defined as an NBDT if it:

- makes a 'regulated offer' of debt securities under the Financial Markets Conduct Act 2013 (in broad terms, this is an offer made to at least some retail investors), and /or
- carries on the business of borrowing and lending money, or providing financial services.

NBDTs must be licensed by the Reserve Bank. The NBDT sector is an important component of the broader financial system because it provides funding to sectors of the economy that the mainstream banks often avoid, and provides alternative investment options for individuals and organisations. If an entity meets the definition of NBDT then, unless exempted or declared out of the definition by regulations, all requirements under the NBDT Act and regulations apply to it.

Under the proposed regulatory perimeter, any entities offering deposit-taking or finance company services would need to obtain relevant licences from the Reserve Bank. It is important that the Reserve Bank's licensing power is subject to appropriate procedural requirements.

4.5.K.2 What options are available to address the problem?

We have identified, and consulted on, the following process requirements that would apply to licensing under the Deposit Takers Act (an 'enhanced status quo'). As discussed in section 4.1, we propose to create a single regulatory regime for banks and non-bank deposit takers. The status quo, for the purposes of comparing the impact of the enhanced status quo, assumes the same respective processes for banks and non-bank deposit takers as under the separate regulatory regime.

Enhanced status quo

The licensing test would be based on the Reserve Bank's assessment of whether the applicant would be able to comply with the Deposit Takers Act, applicable standards and any proposed licence conditions.

The substance of the Reserve Bank's licensing process for a deposit taker would be based on an assessment of whether the entity would be able to comply with the requirements imposed on that class of deposit taker, and in particular whether the entity would be able to comply with applicable standards. The assessment would take into account any proposed exemptions that would apply. It would also include consideration of the entity's ability to comply into the future as well as at the point of licensing. The Reserve Bank would provide the information required as part of the licensing process as well as guidance on the matters it would consider in the assessment and its approach to licensing more generally.

More detail on the matters considered in a licensing assessment will be developed as part of the drafting process for the Deposit Takers Act and tested through the exposure draft. The Deposit Takers Act may also need to specify other matters that the Reserve Bank should have regard to in licensing assessments, particularly in relation to overseas bank branches and subsidiaries (similar to sections 73A and 73B of the current Reserve Bank Act).

The Reserve Bank would need to be satisfied that the applicant's directors and senior managers are fit and proper persons to hold their positions.

As part of the licence assessment, the Reserve Bank would need to satisfy itself that the applicant's directors and senior managers were fit and proper persons to hold these positions. In general terms, a fit and proper person is someone of good character who abides by the laws of New Zealand and elsewhere, and who is likely to continue to do so while being the holder of an authorisation. A 'fit and proper' assessment can also include an assessment of an individual's capabilities in light of their qualifications and experience.

The Reserve Bank would be empowered to issue fit and proper standards in relation to directors and senior managers, including requiring procedures and policies designed to provide assurance of the ongoing fitness and propriety of these individuals, and Reserve Bank approval for the appointment of any new directors and senior managers. The Reserve Bank could remove directors and senior managers who it subsequently determined were no longer fit and proper persons.

Given the impacts of the Reserve Bank deciding that an individual does not satisfy a fit and proper person test, it is appropriate that the Deposit Takers Act provide for appropriate procedural protections both at the licensing stage (as discussed below) and as part of any subsequent fit and proper determination (which would also require reasons to be given and provide for appeal rights).

The Reserve Bank would be required to give notice before refusing to issue a licence or imposing limits or restrictions on a licence (including reasons for its decision), and to provide applicants with the opportunity to respond.

It is important from a due-process perspective that the Reserve Bank provide applicants with notice before refusing to grant or imposing restrictions on licences. This notice period would provide applicants with the opportunity to challenge the Reserve Bank's assessments of key matters and to provide further argumentation or evidence that the Reserve Bank should consider in making its final determinations.

The Reserve Bank would be able to set licence conditions for individual deposit takers. Conditions could restrict the scope of a deposit taker's licence or could relate to matters considered in the licensing process.

Licence conditions or exemptions could be used to manage the risks presented by particular entities. The scope of any conditions (which would be administrative rather than legislative instruments) would be constrained by standards having been set in relation to particular matters, as the conditions could not impose requirements that differ from those imposed by applicable standards.

Licence conditions could be set in relation to a matter that the Reserve Bank is able to make a standard, but has not done so for the applicable deposit taker class. Licence conditions could not display or vary a standard that applies to that class of deposit taker, although this could be done through the use of the Reserve Bank's exemption power.

Licence conditions would likely be more broadly used in relation to foreign branches, where the substantive requirements relate to ensuring compliance with relevant overseas regulatory regimes. In most other cases the intent is that the bulk of regulatory requirements would be established via standards, which would be subject to parliamentary oversight but, unlike licence conditions, would not be subject to appeal.

The Act would provide for appeal rights in relation to Reserve Bank licensing decisions (including decisions regarding fit and proper assessments).

The Reserve Bank Act does not provide for appeal rights on bank registration decisions, including on whether directors and senior managers are fit and proper persons. The ability to challenge these decisions is limited to judicial review. While the NBDT Act provides for appeal rights in relation to fit and proper decisions, it does not provide for appeals on other elements of the Reserve Bank's licensing decisions.

The DTA's proposed system of appeal in relation to licensing decisions is as follows (see section 4.9 for further analysis).

- Decisions subject to merits review:
- fit and proper decisions in relation to directors and senior employees, along with civil and criminal breaches
- the decision to not grant a deposit taker licence.
- Decisions subject to appeal on questions of law:
- decisions by the Reserve Bank that affect the rights and interests in relation to an initial licence (i.e. conditions of licence, approvals to carry on certain activities).

4.5.K.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have identified the following key considerations:

- **Legitimacy / Flexibility** – The objectives and functions of a regulatory system should sit in primary legislation, but arguably prudential rules should be set in delegated legislation due to their highly technical nature and need to change prudential rules relatively often.

- **Accountability / Transparency** – Operational independence and delegated decision-making for regulators should be balanced by accountability for their actions and transparency of their rules and decision-making processes.

4.5.K.4 What other options have been ruled out of scope, or not considered, and why?

The proposed procedural requirements set out above are representative of the main options considered in our analysis.

For the purposes of this analysis we have not separately examined every potential permutation of process requirements.

4.5.K.5 What do stakeholders think?

During consultation, stakeholders expressed support for a clear licensing framework for deposit takers, including the right of appeal.

4.5.K.6 Impact analysis

	Option 1: Status quo	Option 2: Enhanced status quo
Legitimacy / Flexibility	0	++ Would support the Reserve Bank to flexibly manage the risks presented by particular entities.
Accountability / Transparency	0	++ Would improve the Reserve Bank's accountability and transparency through improved due process requirements, including appeal rights.
Overall assessment	0	++

4.5.K.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 2: Enhanced status quo. As noted above, the proposed approach would support the Reserve Bank to flexibly manage the risks presented by particular entities. In addition, it would improve the Reserve Bank's accountability and transparency through improved due process requirements, including appeal rights.

The Treasury supports the proposed approach.

4.5.K.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised*	**Evidence certainty** *(High,*

		impacts; high, medium or low for non-monetised impacts	*medium or low)*

Additional costs of proposed approach compared to taking no action			
Regulated parties	Initial one-off costs associated with the implementation of new process requirements.	Low	Low
Regulators	Initial one-off costs associated with the implementation of a new framework for making prudential rules, and ongoing costs associated with the strengthened process requirements.	Low	Low
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Low

Expected benefits of proposed approach compared to taking no action			
Regulated parties	Reductions in ongoing compliance costs from a more transparent regulatory framework, providing participants with a clearer sense of the Reserve Bank's approach and focus in relation to licensing.	Low	Low
Regulators	Benefits associated with a more flexible regime (largely through licence conditions) and one that is more compliant with the Basel Committee on Banking Supervision's Core Principles. Benefits through enabling the Reserve Bank to respond to identified risks.	Medium	Low
Wider government			
Other parties	Benefits associated with improved public confidence in the Reserve Bank, through stronger transparency and accountability requirements.	Medium	Low
Total Monetised Benefit			
Non-monetised benefits		Medium	Low

4.5.K.9 What other impacts is this approach likely to have?

No other impacts have been identified.

Section 4.5: Liability and accountability

Overview of the existing liability and accountability framework

Holding individuals to account for outcomes over which they have significant influence is an important part of the prudential framework. International standards, including the Basel Committee's 2012 *Core principles for effective banking supervision* and the International Association of Insurance Supervisors' 2018 *Insurance Core Principles*, state that a regulator should have suitable sanctions available to apply to individuals such as board directors, senior managers or both, to facilitate timely corrective actions.

Directors of registered banks are currently the focal point for the individual accountability provisions in the Reserve Bank of New Zealand Act 1989.

Attestation regime

The current Reserve Bank of New Zealand Act creates a form of executive accountability for registered banks through the 'attestation regime'. Under the disclosure rules, which are a sub-set of the broader prudential rule-book that are set by Orders in Council, registered banks are required to publish a twice-yearly 'disclosure statement'. The disclosure rules also create an 'attestation regime' that applies to directors (and the New Zealand CEO of overseas incorporated banks). These individuals must 'attest' whether they believe, after due enquiry, that:

- the bank has systems in place to monitor and control adequately the banking group's material risks
- those systems are being properly applied, and
- the bank has complied with its CoRs over the period covered by the disclosure statement.

Liability

The disclosure rules (including the attestation regime) expose directors to criminal liability without proof of a fault element, unless directors can establish a defence. This year, the Reserve Bank has introduced materiality thresholds around breaches of CoRs. The lack of materiality thresholds had the ability to place directors and CEOs in a challenging position, given that they need to attest to the correctness of all information disclosed. From an operational standpoint, registered banks have indicated that the absence of materiality thresholds required a meaningful investment of time on minor breaches at both a board and senior manager level that is difficult to justify. Given the recent change, the problem is less obvious in practice.

Directors are faced with criminal liability for making false and misleading attestations in a bank's public Disclosure Statement. Conceptually this creates strong incentives for them to take their duties seriously and provide thorough oversight of their institutions. However, there are a number of drawbacks in the current approach to this 'self-discipline':

- the Reserve Bank has no guidance for banks on what constitutes 'adequate risk management'
- the point-in-time nature of the director obligation
- there is limited verification by the Reserve Bank that attestations are correct, and

- criminal liability can be disproportionate to the 'crimes'.

Improvements could be made to how deposit takers are providing assurance to both the Reserve Bank and other external stakeholders that they are prudently managing risks.

These issues (and particularly those relating to materiality thresholds) were raised by a number of stakeholders during the scoping for Phase 2.

Summary of preferred approach

Under the preferred approach set out in this chapter, directors of licensed deposit takers would have a positive and on-going duty to ensure there are adequate systems, processes and policies in place to ensure the entity complies with its obligations. There would be a pecuniary penalty for breaches of this duty by directors. There would be protections for directors in the form of a defence for a breach of this duty, if they could show they took reasonable steps to meet their obligations. In addition, directors would be able to take out personal insurance against the potential penalty for such breaches. The entity itself would not be able insure or indemnify the director. This is to ensure the incentive appropriately lies on the director personally, rather than the company.

Directors of licensed deposit takers would also be liable for a civil pecuniary penalty if false or misleading information is given to the Reserve Bank or publicly disclosed by a deposit taker.

Cabinet has also previously agreed [DEV-MIN-19-0346 refers] that a wider accountability regime be established for directors and senior executives of deposit takers and insurers, one that is integrated across the two 'peaks' of New Zealand's regulatory system (i.e. prudential and market conduct). This work will be progressed outside the Phase 2 Review. It may require future amendments to the DTA at the point that this more encompassing accountability regime is implemented.

J. Enhanced director accountability

4.5.K.1 What is the specific problem?

As noted in the *Overview* section above, holding individuals to account for outcomes over which they have significant influence is an important part of the prudential framework. Directors of registered banks are currently the focal point for the individual accountability provisions in the Reserve Bank of New Zealand Act 1989.

They are faced with criminal liability for making false and misleading attestations in a bank's Disclosure Statement. Conceptually this creates strong incentives for them to provide a thorough oversight role and to take their duties very seriously. It is designed to promote market and self-discipline.

However, there are a number of drawbacks with the regime compared to international practice: there is no guidance from the Reserve Bank to banks as to what constitutes adequate risk management, there is limited verification on the part of the Reserve Bank that attestations are correct, and criminal liability can be disproportionate. Improvements could be made to how banks are providing assurance to both the Reserve Bank and other external stakeholders that they are prudently managing risks.

4.5.K.2 What options are available to address the problem?

The Review has considered the key features that underpin a strengthened director accountability regime. These features have been selected based on a review of international practice and submissions on two rounds of public consultation. There is a range of relatively minor variations on these options that could also be considered, but which we do not think would have a substantive impact on the analysis. For the purposes of this analysis, we have not separately examined every potential combination of regime features and have instead analysed each feature compared to the status quo on its own merits before considering the combined effect of the preferred regime.

Features of a strengthened director accountability regime

	Option 1: Status quo	**Option 2: Strengthened director accountability regime**
Focus of accountability	Board directors of registered banks.	Board directors of all licensed deposit takers.
Suitability checks	Fit and proper framework implemented through secondary legislation.	Framework for fit and proper requirements outlined in primary legislation, detail provided for in a prudential standard (see section 4.2).
Obligations	Generic obligations on directors under the Companies Act 1993 Specific attestation requirements tied to signing of disclosure statements.	Reframed attestation regime, which would decouple the attestation regime from the disclosure rules, but would retain the existing focus on directors. This would be achieved by creating high-level duties via legislation that applied to the registered deposit taker, under a civil liability framework. Positive duties imposed on directors (in addition to existing duties) – see below. These duties supported by clarification/guidance from the Reserve Bank.
Sanctions	Criminal sanctions on directors for contraventions of attestation requirements.	Civil sanctions on directors who fail to meet obligations (criminal penalties in very serious cases). Removal of a director (or senior executive) by the Reserve Bank, once appointed, where they do not meet fit and proper requirements.

	Applicants for director (and senior executive) positions may be rejected on basis of fitness and propriety (note the Reserve Bank cannot remove directors on fit and proper grounds once appointed).	

The Review consulted on the following proposed duties (based largely on the Australian bank executive regime):

- take reasonable steps to ensure that the deposit taker is being run in a prudent manner
- act with honesty and integrity, and with due skill, care and diligence, and
- deal with the Reserve Bank in an open and honest manner.

The third consultation proposed that directors would be accountable through duties backed by pecuniary penalties, following an in-principle Cabinet decision in 2020. The proposed framework is not a 'deemed liability regime'. The directors will have direct (or 'positive') duties for which they will be directly accountable for breaches to the public. The justification for this duty is the high social and economic costs of imprudently run deposit taking institutions, particularly large and systemically important banks.

Following stakeholder and agency feedback on the appropriate specification of these duties the Review team has narrowed the scope of the proposed duties. This should provide additional certainty, and reduce or minimise overlap with other obligations (such as the proposed offence to not mislead the regulator). The Review team now proposes a single duty:

- to ensure there are adequate systems, processes and policies in place to ensure the deposit taker complies with its prudential requirements and obligations.

To reflect the nature of the duty, there would no longer be criminal penalties. This duty aligns with the model in the Credits Contracts and Consumer Finance Act.

4.5.K.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have identified the following assessment criteria as being critical to addressing the potential vulnerabilities with the attestation regime:

- **Proportionately responds to financial stability risks:** the accountability regime should provide for the ability for the Reserve bank to hold directors to account for governance failures, while keeping liability proportionate and subject to appropriate defences. In addition, the regime should create an incentive ex-ante to encourage favourable behaviour.
- **Provides clarity and legitimacy:** the accountability regime should provide sufficient certainty and scope for directors to act without unduly constraining their fiduciary obligations to shareholders/owners and the institutions more generally.

- Credibility**:** the accountability regime should provide public confidence in the good governance of deposit takers.

4.5.K.4 What other options have been ruled out of scope, or not considered, and why?

Role of insurance in director accountability

The Review had considered a bar on directors being able to obtain insurance for this penalty for breach of their duty. It has been taken as part of considering Option B, that directors should not be able to be indemnified or insured against personal financial loss arising from breaching the new positive duties or unsuccessful defences of criminal proceedings generally.

However, an overly onerous regime would make it difficult for small deposit takers to attract high-quality directors. Some submitters also expressed concern with the proposed approach to insurance, suggesting directors should be able to insure themselves against potential penalties for breaches of director duties. To address these concerns, directors would be able to personally insure themselves, but would not be able to be insured or indemnified by the deposit taker. This aligns with the model in the FMC Act.

'Senior managers' regime

Another option considered, and consulted on, was a 'senior managers' regime. This would represent an extension on the proposed reframed attestation regime to something closer to the executive accountability arrangements recently introduced in other countries, such as Australia, the United Kingdom and Hong Kong.

A senior managers regime would extend beyond directors (a clearly identifiable group of individuals), and capture senior managers involved within certain control functions or business lines. Introducing such a regime would require a high degree of clarity around:

- the senior managers that sit within the scope of the regime, and
- the obligations that fall on those senior managers, and the steps they need to take to discharge them.

A senior managers regime would provide the Reserve Bank with a broader toolkit for regulatory responses.[47] Introducing a regime would mean a clear shift towards a more intrusive supervisory model with a greater focus on the actions of individuals, rather than the regulated entity as a whole. Given the United Kingdom, Australian, and Hong Kong models have been enacted in the near past, there is not yet sufficient experience to derive lessons for New Zealand on their effectiveness.

47 For example, the Bank of England consider that the Senior Managers regime "provides a valuable supervisory tool where new market practices and risk emerge. In such cases, the PRA can remind firms of the need for appropriate oversight by one or more Senior Managers" (Bank of England (2018) Strengthening the link between seniority and accountability: the Senior Managers and Certification Regime – Quarterly Bulletin. Available at: https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2018/senior-managers-certification-regime)

Executive accountability regime

As outlined above, Cabinet has made an in-principle decision to strengthen the accountability framework for deposit takers' directors under the new Deposit Takers Act. This draws from option 2 (a reframed attestation regime). The key elements of this model are:

- a decoupling of key director responsibilities from disclosure requirements and the attestation process through the creation of new high-level director duties that will apply in an ongoing manner. These duties would be applied through a 'positive accountability framework' in which directors would take certain actions separate from the regulated entity, such as 'reasonable steps' to ensure the entity is run in a prudent manner, and
- a shift in the individual liability framework, away from criminal penalties as the primary redress towards civil penalties (with criminal penalties reserved for very serious cases of recklessness or intent).

This regime would apply to deposit takers and insurers, and cover both prudential and conduct matters. The policy and legislative work underpinning this 'integrated prudential conduct executive accountability regime' will take place outside the Phase 2 Review process.

4.5.K.5 What do stakeholders think?

During the second consultation, most stakeholders supported strengthening directors' accountability, with a number also supporting the introduction of an executive accountability regime (that is, extending the formal accountability requirements beyond directors to specified senior employees). However, this support was generally qualified, as most noted the importance of creating an integrated executive accountability regime for prudential and financial market conduct regulation.

The third consultation sought feedback on the design of an improved accountability framework for directors in the DTA. There was broad support for adopting a regime with pecuniary and civil, rather than criminal penalties. However, there was some concern that the director duties did not provide enough clarity and were not consistent with other obligations on directors. There was some support from submitters to shift away from the existing attestation regime. An individual submitter described it as 'unsatisfactory' with insufficient guidance. Banks raised concerns that the current regime was outdated and out of step with international regimes, significantly increasing compliance costs, and focusing on "point in time" accountability.

Some submitters also expressed concern with the proposed approach to insurance, suggesting directors should be able to insure themselves against potential penalties for breaches of director duties.

4.5.K.6 Impact analysis

	Option 1: Status quo	Option 2: Strengthened director accountability regime
Public confidence	0	++

		To enable the Reserve Bank to promote financial stability it would be empowered with a flexible suite of enforcement and supervisory tools, which could be used expeditiously and with efficacy. These changes would more clearly focus the attestation regime on the key underlying conduct (being director oversight of risk management and risk culture). Shifting the liability framework would also allow for the application of a more proportionate set of enforcement tools, such as civil pecuniary penalties for the regulated entity.
Proportionality	0	++ To reflect the nature of the duty, there would no longer be criminal penalties. This duty aligns with the model in the Credits Contracts and Consumer Finance Act. As above, would more clearly focus the attestation regime on the key underlying conduct.
Certainty		++ A narrow scope of director duty should provide additional certainty, and reduce or minimise overlap with other obligations (such as the proposed offence to not mislead the regulator). Likely to provide greater public confidence in the good governance of deposit takers than Option 1.
Overall assessment	0	++

4.5.K.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 2: Strengthened director accountability regime.

These changes will represent a strengthening in the accountability of directors, sharpening their incentives to manage risk and improving the ability of the Reserve Bank to hold directors to account. These changes would more clearly focus the attestation regime on the key underlying conduct (being director oversight of risk management and risk culture).

The Treasury supports the proposed approach.

4.5.K.8 Summary table of costs and benefits of the preferred approach

See section 4.5.L.8 for a summary table outlining the costs and benefits of all preferred liability and accountability approaches.

4.5.K.9 What other impacts is this approach likely to have?

As noted above, Cabinet has made an in-principle decision that officials are to develop an ‘executive accountability regime’ that extends the individual accountability framework beyond directors to senior employees (i.e. senior executives). This regime would apply to deposit takers and insurers, and cover both prudential and conduct matters. The policy and legislative work underpinning this ‘integrated prudential conduct executive accountability regime’ will take place outside the Phase 2 Review process.

Account needs to be taken of the potential interaction between executive accountability and other liability regimes that could impact on the prudential regulatory system. It is envisaged that this regime would ultimately be broader than just the prudential regulation of deposit takers, covering insurers too, and extending formal accountability requirements to key executive office holders, while cutting across the conduct peak of New Zealand's regulatory system. It is important that the new framework in the DTA does not unduly constrain the future development of this executive accountability regime.

K. Liability

4.5.L.1 What is the specific problem?

A prudential regulator can apply civil or criminal-type penalties to institutions as legal entities and individuals within entities. The choice of sanction reflects, among other things, an assessment of the seriousness of or social harm caused by the contravention and the extent to which there is some recklessness or intent underpinning it.

In its current form, the Reserve Bank's individual liability framework focuses on directors of registered banks and their duty to ensure the accuracy of disclosure statements. There are elements of the current rule-making regime that are arguably not proportional. The potential consequences that flow from breaches of either CoRs or the disclosure rules are significant.

The emphasis on criminal liability for rule breaches in the Reserve Bank of New Zealand Act is arguably disproportionate to the nature of the underlying conduct it seeks to address. In most cases, criminal enforcement action will not be the most fit-for-purpose regulatory response. Indeed, the Reserve Bank has not taken enforcement action against a registered bank to date.

Breaches of CoRs can arise from minor or technical issues. Currently, a breach of a CoR can serve as grounds for the Reserve Bank to take enforcement action against a registered bank under a criminal liability regime. The disclosure rules (including the attestation regime) expose directors to criminal liability without proof of a fault element, unless directors can establish a defence.

Disclosure regime

Registered banks, directors and CEOs of overseas incorporated registered banks currently face two forms of liability in relation to the disclosure regime:

- Criminal liability for false or misleading disclosure statements (for individuals, this is applicable only to those that sign the disclosure statement), and
- Civil liability for losses suffered by persons that subscribe for debt securities in reliance on a false or misleading disclosure statement.

The current disclosure rules (including the attestation regime) expose directors to criminal liability without proof of a fault element, unless directors can establish a defence. The disclosure rules until recently operated without materiality thresholds around breaches of CoRs. The lack of materiality thresholds can place directors and CEOs in a challenging position given they need to attest to the correctness of all information disclosed. From an operational standpoint, registered banks have indicated that the absence of materiality thresholds can require a meaningful investment of time on minor breaches at both a board and senior manager level that is difficult to justify.

These issues (and particularly those relating to materiality thresholds) were raised by a number of stakeholders during the scoping for Phase 2.

4.5.L.2 What options are available to address the problem?

The Review has considered the key features that underpin liability in relation to the disclosure regime and consider the two broad options to be:

- **Option 1: Status quo**, with an emphasis on criminal liability
- **Option 2: Primarily civil liability**, for material breaches of rules that do not involve knowing or reckless misconduct.

While preserving the Reserve Bank's ability to take regulatory action, it may be preferable that criminal liability is removed for breaches of prudential rules that do not involve a fault element. An alternative model would be to provide for civil liability (such as pecuniary penalties) for material breaches of rules that do not involve knowing or reckless misconduct Such a shift would be consistent with a potential move towards a broader set of tools to allow the Reserve Bank to respond to breaches, including directions not subject to ministerial consent, enforceable undertakings, warning letters, and infringement notices. Reflecting the Reserve Bank's role as a risk-based regulator, it may also be possible to justify the use of regulatory tools (including the use of rule-making itself) in cases where no breach of rules has occurred.

The ability to apply sanctions to individuals recognises that certain senior office holders in an institution should be directly accountable for decisions that result in misconduct or poor risk management – outcomes that can undermine the regulator's statutory objective, which is tied to promoting financial stability. This individual accountability reinforces any sanctions that can be applied to the entity itself.

For Option 2, there is a range of relatively minor variations on this option that could also be considered, but which we do not think would have a substantive impact on the analysis. For the purposes of this analysis, we have not separately examined every potential combination of liability for breaches of the standards and have instead analysed a shift to primarily civil liability compared to the status quo. We have taken the following as given for Option 2:

- **Criminal liability for breaches of the Act** should generally be limited to undertaking deposit-taking activity without a licence, holding out to be a deposit taker (or otherwise using restricted words), non-compliance with the Reserve Bank's supervision and resolution powers (such as failure to comply with directions), and knowing or reckless breaches of other provisions.

- **Breaches of standards** should generally give rise to civil liability, including a monetary penalty, with criminal liability generally limited to knowing or reckless breaches.
- **Maximum civil pecuniary penalty** for bodies corporate based on the highest of:
    - a specified dollar amount;
    - a percentage of the size of the institution;
    - a multiple of any gain or loss avoided.
- **Provide for lower maximum civil pecuniary penalties for individuals**, up to a specified dollar amount.
- Provide for **moderate monetary penalties** for criminal offences relating to the obstruction of more routine supervisory powers.
- Provide for more **significant monetary penalties** and for potential imprisonment for criminal offences relating to more serious breaches of the Deposit Takers Act.
- The Deposit Takers Act should require all **breaches to be reported** to the Reserve Bank. The Reserve Bank would subsequently determine the reporting frequency of different breach types, based on, among other things, materiality criteria.

We note that Cabinet has made in-principle the decision to shift the individual liability framework away from criminal penalties as the primary redress towards civil penalties (with criminal penalties reserved for very serious cases of recklessness or intent).

4.5.L.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The Review has identified the following assessment criteria in considering a liability framework:

- provide **public confidence** in the good governance of deposit-taking institutions
- provide for the ability for the Reserve bank to hold individuals and entities to account for governance failures, while keeping liability **proportionate** and subject to appropriate defences, and
- provide sufficient **certainty** and scope for directors to act without unduly constraining their fiduciary obligations to shareholders/owners and the institutions more generally.

4.5.L.4 What other options have been ruled out of scope, or not considered, and why?

The proposed options are representative of the main options considered in our analysis. A wide range of variations on these options is possible.

4.5.L.5 What do stakeholders think?

During consultation, there was broad support for adopting a regime with pecuniary and civil, rather than criminal penalties.

Submitters who commented on deemed liability for false or misleading disclosure generally supported a move towards the FMC Act regime. The Institute of Directors thought that the proposed positive duties would make deemed liability for disclosure redundant.

4.5.L.6 Impact analysis

	Option 1: Status quo	Option 2: Primarily civil liability
Public confidence	0	++
Proportionality	0	++ The shift in emphasis from criminal to civil liability for rule breaches would be more proportionate to the nature of the underlying conduct it seeks to address.
Certainty	0	++ Additional certainty, including on materiality thresholds, would enable entities and the Reserve Bank to target efforts on issues of greatest social harm.
Overall assessment	0	++

4.5.L.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 2. Shifting the liability framework would also allow for the application of a more proportionate set of enforcement tools, such as civil pecuniary penalties for the regulated entity.

The Treasury supports the proposed approach.

4.5.L.8 Summary table of costs and benefits of the preferred approaches to liability and accountability

Affected parties *(identify)*	**Comment***: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional costs to comply with attestation.	Medium	Low

Regulators	Exercising of additional enforcement tools would entail additional costs. Some implementation costs.	Low	Low
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Low

Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits associated with improved clarity of enforcement mechanisms.	Low	Low
Regulators	Benefits associated with improved clarity of role.	Medium	Low
Wider government	Avoided costs of Crown bail-out.	Medium	Low
Other parties	Benefits associated with confidence by public on entities' liability and accountability.		
Total Monetised Benefit			
Non-monetised benefits		Low	Low

4.5.L.9 What other impacts is this approach likely to have?

No other impacts have been identified.

Section 4.6: Supervision and enforcement

***Ov**erview*

Supervision and enforcement are key components of the prudential regulatory framework. Effective supervision increases the likelihood that regulatory requirements will be met and emerging risks will be identified. Effective enforcement helps to deter or punish improper behaviour by sanctioning those who violate regulatory requirements.

Supervisory model

The following section discusses the Reserve Bank's supervisory model, noting that the Reserve Bank does not have sufficient enforcement options in its toolkit. The Reserve Bank, therefore, lacks ways to take a graduated set of actions if a regulated entity does not respond appropriately to the prudential policy framework and associated requests, or supervisors' use of moral suasion.

Context

The size and complexity of financial markets and institutions mean it can be challenging to detect undesirable conduct and practices, monitor institutions' risk-taking, or identify potential systemic risks. This is compounded by "entrenched asymmetries of information and expertise that often pervade relationships between regulators and market participants. Constrained by the costs, regulators must inevitably confront difficult questions about how best to allocate their finite resources in pursuit of different regulatory objectives" (Armour et al, 2016, p. 578). This finding by Armour is particularly relevant for the Reserve Bank and its prudential function, which has traditionally been lightly resourced.

While it may not be possible to fully overcome this informational disadvantage, there are two choices for addressing it:

- The supervisory model could accept the asymmetry to a certain degree and place greater reliance and trust in regulated entities for financial system outcomes.
- The prudential authority could try to mitigate this asymmetry by increasing supervision intensity through developing a deeper knowledge of entities' business models, risk-management and internal control frameworks, and general financial condition.

The more intensive and intrusive a supervisory approach, the higher the regulatory burden on regulated entities. It is also sometimes argued that a more intrusive approach runs the risk of diluting, or undermining, any emphasis placed on the entity to manage its own risks. This situation is termed moral hazard, but is not a perspective supported by the Basel Committee on Banking Supervision's Core Principles or international practice in general, at least post-GFC.

The Reserve Bank's supervisory 'model'

In developing the terms of reference for Phase 2 of the Review, the Treasury and the Reserve Bank met with a number of stakeholders early in 2018 to hear their views on the Reserve Bank's financial system-related responsibilities, including its approach to supervision and enforcement. During these discussions, some stakeholders identified a number of issues with the current approach. They related to:

- the current resourcing level and a perceived lack of capacity and capability for specialised supervisory tasks, and
- the light-handed nature of the model, and its being out of step with international norms.

The IMF's 2016/17 FSAP also identified a number of gaps in relation to the Basel core principles for effective banking supervision (the BCPs).

The Reserve Bank's approach to supervision has traditionally been 'light touch', historically focusing more on market and self-discipline to ensure compliance with regulatory requirements. Overseas regulators have tended to shift towards a more intrusive and active model of supervision since the GFC and have relied more on independent verification.

The Reserve Bank does not routinely independently verify the information that banks provide to it. The absence of this routine independent verification is tied, in part, to the absence of a supervisory methodology involving on-site inspections – a typically resource-intensive supervisory activity which powers under the current Reserve Bank of New Zealand Act do not allow for.

However, the Reserve Bank does check banks' compliance with prudential requirements (using the information they provide) through a desk-based approach, and mandated public disclosure statements are vetted by the banks' internal auditors. Further, the Reserve Bank has in recent years undertaken thematic reviews to test compliance with requirements (e.g. the Review of Banks' Compliance with the Liquidity Policy). Most verification largely comes from different sources corroborating information provided to the Reserve Bank, and through insights gained through face-to-face meetings with banks' boards and senior management. Other than the lack of ability to undertake 'on-site' inspections, there are few legislative constraints on the Reserve Bank's ability to undertake more verification; the main constraint, in the past at least, has been the Reserve Bank's 'philosophical approach' to supervision and the way this has been historically reflected in the degree of resourcing for the supervision function.

That said, the Reserve Bank's approach has become more intensive in recent years, recognising the need to improve the capacity and capability of the supervision function, with a significantly increase in staff numbers. The Reserve Bank aspires to build and maintain relationships based on open and effective communication, insight and scrutiny.

However, as the Reserve Bank does not have sufficient enforcement options in its toolkit, the Reserve Bank lacks ways to take a graduated set of actions if a regulated entity does not respond appropriately to the prudential policy framework and associated requests, or supervisors' use of moral suasion.

Enforcement model

The Reserve Bank already has a number of supervisory and court-based enforcement tools for prompting banks to take corrective action.

Reserve Bank approach to regulating entities

The Reserve Bank is not an 'enforcement-led' regulator; if a regulated entity makes a mistake or a risk arises, it focuses as a first step on understanding why the issue has arisen, and in practice the Reserve Bank has determined that best results are usually achieved via the use of moral suasion to develop forward-looking solutions. The Reserve Bank aspires to build and maintain relationships based on open and effective communication, insight and scrutiny.

Enforcement in the broadest sense involves taking corrective action if a bank does not comply with regulatory requirements, or to address emerging risks before any formal non-compliance. As discussed above, effective enforcement helps to deter or punish improper behaviour by sanctioning those who violate regulatory requirements. At a high-level, the objectives of enforcement are to:

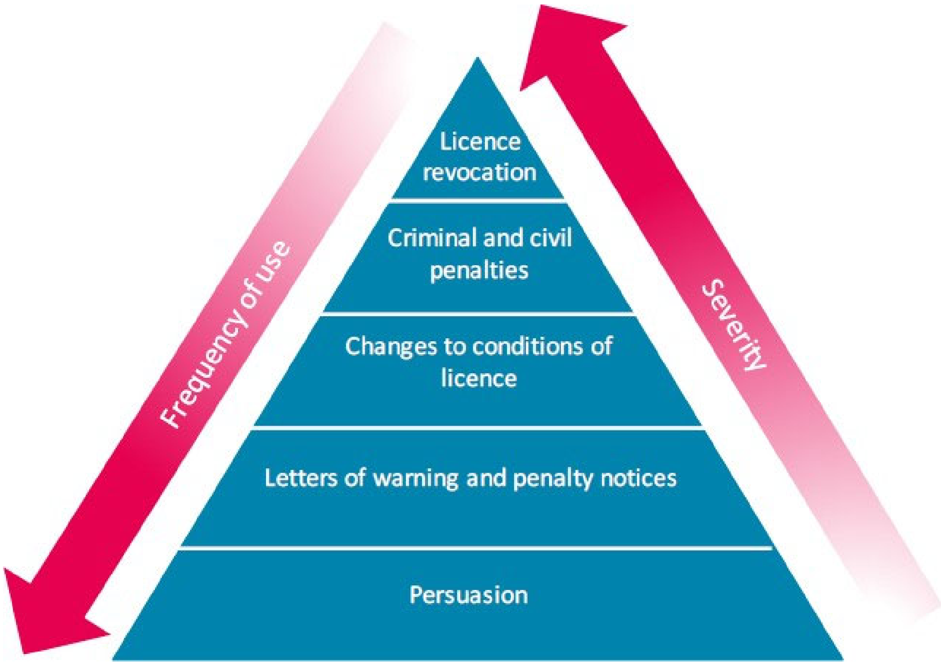
- promote effective risk management and constrain excessive risk-taking
- generate a credible deterrent, and
- punish wrongdoing, or ensure that injured parties are provided with adequate compensation (Armour et al, 2016, p. 578).

Lack of graduated set of enforcement tools

However, without a credible deterrent (an effective enforcement regime), supervisors will lack ways to take action if a regulated entity does not respond appropriately to the prudential policy framework and associated requests, or supervisors' use of moral suasion.

The Reserve Bank's enforcement tools may not be sufficiently flexible to allow the Reserve Bank to respond to non-compliance appropriately; the Reserve Bank currently relies on supervisory measures, such as moral suasion, to encourage change, and has yet to take court-based action against bank directors, which carries heavy criminal penalties. Having an enforcement model with a graduated set of enforcement tools is known as a 'responsive compliance model' of regulation, and is often illustrated as a pyramid, with a hierarchy of sanctions of increasing severity and decreasing frequency of use (see Figure 4).

Figure 4: Indicative Sanctions Pyramid



Without a credible deterrent (an effective enforcement regime), which includes a graduated set of enforcement tools with a continuum of potential actions, supervisors will lack ways to take action if a regulated entity does not respond appropriately to the prudential policy framework and associated requests, or supervisors' use of moral suasion.

Enforcement in the broadest sense involves taking corrective action if a bank does not comply with regulatory requirements, or to address emerging risks before any formal non-compliance. As discussed above, effective enforcement helps to deter or punish improper behaviour by sanctioning those who violate regulatory requirements. At a high-level, the objectives of enforcement are to:

- promote effective risk management and constrain excessive risk-taking
- generate a credible deterrent, and
- punish wrongdoing, or ensure that injured parties are provided with adequate compensation (Armour et al, 2016, p. 578).

Summary of proposed approach

- *Supervisory tools (section 4.6.L):* this section proposes more intensive supervisory powers to provide the Reserve Bank with a wider suite of tools to proactively monitor deposit takers.
- *Enforcement approach (section 4.6.M):* this section proposes that the Reserve Bank be provided with a broader set of enforcement tools, which would enable the Reserve Bank to better promote financial stability.

L. Supervisory tools

4.6.L.1 What is the specific problem?

As noted above, the Reserve Bank does not have sufficient enforcement options in its toolkit. The Reserve Bank, therefore, lacks ways to take a graduated set of action if a regulated entity does not respond appropriately to the prudential policy framework and associated requests, or supervisors' use of moral suasion.

4.6.L.2 What options are available to address the problem?

Options that may improve the New Zealand approach have both legislative and non-legislative dimensions, with the former the focus of this analysis.

For the non-legislative options to improve the New Zealand approach to supervision, the Reserve Bank would have choices in relation to the intensity of its supervisory approach, drawing on any available tools provided by legislation and subject to addressing the current constraint around funding.

We have identified, and consulted on, the following broad options to improve the enforcement options that the Reserve Bank would have in its legislative toolkit:

- **Option 1: Enhanced status quo** – no legislative change. The Reserve Bank would maintain its existing supervisory approach, which involves desk-based monitoring, thematic reviews, and participation in the Australian Prudential Regulation Authority's (APRA's) on-site visits to the four large Australian banks. However, the Reserve Bank would increase the intensity of its approach by applying more supervisory resources to undertake more thematic reviews and more off-site monitoring, particularly of larger banks.
- **Option 2: More intensive supervisory powers** – under this option, the Reserve Bank would be empowered via the DTA with additional supervisory functions, including:
    - **Spot-check inspections** – the Reserve Bank would be given a new legislative power to go 'on-site' to independently verify individual banks' compliance with prudential requirements, or to assess any emerging issues. It would do this on a targeted and discretionary basis, focusing on concerns raised through desk-based monitoring of individual banks.
    - **Regular on-site inspections** – the Reserve Bank would be given the legislative power (along with significantly more supervisory resources to enable the use of this power) to go on-site, conducting regular inspections of all banks. This is broadly the model used by APRA, the United Kingdom's Prudential Regulation Authority (PRA) and Canada's Office of the Superintendent of Financial Institutions (OSFI). There is additional optionality around the Reserve Bank's interaction with APRA, and any on-site inspection regime for the Australian-owned banks.
    - **Assurance processes** would be an important limb of the supervisory framework. Deposit takers will undertake audits in accordance with

requirements set by the Reserve Bank through standards. The Reserve Bank will also have a power to require that the licensed entity produce a report by a suitably qualified person. However, by themselves, assurance processes will not provide a sufficiently robust supervisory framework to ensure confidence in the regulation of the financial system.

Formal supervisory powers are only one part of the regulatory toolkit. It is likely that the Reserve Bank will not always need to resort to these formal powers to achieve its objectives. It can rely on moral suasion and maintaining relationships to supervise licensees and to address concerns. However, access to a flexible and empowering suite of formal tools will ensure that it has options when necessary. Perhaps more importantly, the existence of these tools will provide the credibility to ensure that cooperation is forthcoming.

4.6.L.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have considered the following assessment criteria in considering the likely impacts the options:

- **Ability to obtain information**: the regime should provide the Reserve Bank with an empowering and flexible set of tools to allow it to proactively monitor deposit takers to address risks arising from the financial system which might threaten financial stability.
- **Encourage compliance:** the Reserve Bank's supervisory approach should encourage ongoing compliance with prudential requirements.
- **Timeliness:** the Reserve Bank's supervisory approach should support the Reserve Bank to proactively monitor, identify and respond to an entity's lack of compliance with prudential requirements in a timely manner.
- **Public confidence:** the Reserve Bank's supervisory approach should support public confidence in the prudential regulation of deposit takers.

4.6.L.4 What other options have been ruled out of scope, or not considered, and why?

The Review also considered more intrusive supervisory powers, where the Reserve Bank would locate supervisors permanently in banks so that they can undertake regular and very detailed inspections. Currently used in the United States for the largest financial institutions, this is the most intrusive and resource-intensive approach.

In addition to the resourcing constraint, it is more appropriate to have a constructive but arm's-length relationship between the regulator and regulated entity. This enables a supervisor to be probing, challenging of management and the board, and able, where necessary, to escalate the supervisory and enforcement response. A cosy or 'captured' relationship with industry risks regulatory forbearance.

4.6.L.5 What do stakeholders think?

During consultation, stakeholders expressed support for widening the Reserve Bank's supervisory and enforcement toolkit, subject to appropriate safeguards.

4.6.L.6 Impact analysis

	Option 1: Enhanced status quo	Option 2: More intensive supervisory powers (proposed approach)
Ability to obtain information	+ Minor improvements compared to status quo.	++ This approach would provide the Reserve Bank with a wider suite of tools to proactively monitor deposit takers.
Encourage compliance	0 No improvements to over-reliance on regulator discretion.	++ A broad, flexible and empowering regime should encourage greater compliance with prudential requirements than the status quo.
Timeliness	+ Minor improvements compared to status quo.	++ Should support the Reserve Bank to proactively monitor, identify and respond to an entity's lack of compliance with prudential requirements in a timely manner.
Public confidence	+ Minor improvements compared to status quo.	++ A broad, flexible and empowering regime would better support public confidence in the regulation of deposit takers.
Overall assessment	+	++

4.6.L.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 2: More intensive supervisory powers.

Failures of individual deposit takers impose significant costs on customers and taxpayers. Deposit takers are complex, they do not internalise all the risks and costs, and system-wide impact due to linkages can be significant. This justifies a broad, flexible and empowering (for the regulator) regime, which must be balanced with the rights of those subject to these powers, and constitutional considerations.

Supervision and enforcement are closely related to the penalties and offences, and to the standards and licensing regime. Prudential rules will be set through standards, licence conditions, and the relevant legislation.

The Treasury supports the proposed approach.

4.6.L.8 Summary table of costs and benefits of the preferred approach

See section 4.6.M.8 for a summary table outlining the costs and benefits of preferred approaches to both supervision and enforcement.

4.6.L.9 What other impacts is this approach likely to have?

As noted above, there is additional optionality around the Reserve Bank's interaction with APRA, and any on-site inspection regime for the Australian-owned banks. There is an inherent level of cooperation and coordination between the Reserve Bank and APRA; this includes expected engagement between the two agencies for any supervisory and enforcement activity relating to a Big Four bank.

No other impacts have been identified.

M. Enforcement approach

4.6.M.1 What is the specific problem?

As noted above, while the Reserve Bank lacks a graduated set of enforcement tools and, therefore, the Reserve Bank may not be able to respond to non-compliance appropriately.

Without a credible deterrent (an effective enforcement regime), which includes a graduated set of enforcement tools with a continuum of potential actions, supervisors will lack ways to take action if a regulated entity does not respond appropriately to the prudential policy framework and associated requests, or supervisors' use of moral suasion.

4.6.M.2 What options are available to address the problem?

For the purposes of this analysis, we consider the two broad options to be:

- **Option 1: status quo**, with a limited number of court-based enforcement tools for prompting firms to take corrective action.
- **Option 2: a broader set of tools to allow the Reserve Bank to respond to breaches.** The Review has identified, consulted on, and considered a number of additional enforcement tools that could strengthen the Reserve Bank's enforcement role, including:
    i. statutory public notices – public warnings supported by legislation
    ii. enforceable undertakings – commitments from banks that are enforceable in court
    iii. infringement notices – criminal offences that carry fines but do not result in criminal convictions, and
    iv. civil penalties – non-criminal penalties that are applied under the civil standard of proof.

There is a range of relatively minor variations on these options that could also be considered, but which we do not think would have a substantive impact on the analysis. For the purposes of this analysis we have not separately examined every potential combination of enforcement tools. Instead, we analyse a shift from the status quo to a broader set of enforcement tools.

The choice of tools and the enforcement action taken are influenced by two broad approaches (although in practice enforcement actions sit along a continuum):

- **Ex ante preventive actions** – generally speaking, prudential authorities' corrective actions focus on ex ante risk prevention, based on a forward-looking approach to risk assessment.[48] This implies the authority's willingness to work with regulated entities to ensure their compliance with regulatory requirements or to address areas of emerging concern (via persuasion).[49] If this does not work to the supervisor's satisfaction, a number of other supervisory tools can be applied to achieve the desired change in behaviour. However, their use is not necessarily made public, and this can reduce the broader public 'deterrence' value of such sanctions. Non-public supervisory actions also prevent commercially sensitive information entering the public domain.
- **Ex post enforcement actions** – these actions can, in addition to 'punishing' the financial institution or individual for non-compliance, have a wider preventive purpose in deterring similar behaviour by other firms (PRA, 2016, p. 60).

Application of enforcement tools

Enforcement tools should be used in a way that is proportionate to the nature of the contravention or the desired behavioural change. There should generally be a continuum of potential actions, with each intervention along the continuum having some form of due process attached. However, having graduated actions does not mean the regulator always has to work their way through them; there may at times be a need to take immediate and significant enforcement action. Having a range of tools:

- enables a proper differentiation between minor and major violations, with the option of punishing more severely the most serious violations that create the most social harm
- enables a supervisor to tailor actions based on an entity's behaviour – for example, if it has a history of non-compliance or is cooperating and serious about taking remedial action
- allows for appropriate escalation, and
- provides incentives for firms to take remedial or corrective action if the threat of subsequent escalation and enforcement action is seen as credible (Armour et al, 2016, p. 591).

There is also an important operational dimension for enforcement action, including timeliness and cost. For example, court-based enforcement can take years, outcomes are uncertain, and costs can be very significant.

48 In contrast, in the area of financial market conduct regulation, ex post public enforcement action will typically have a greater role.

49 Moral suasion as a supervisory tool is often more effective in influencing individual institutions' behaviour than making changes at the sectoral level or across multiple institutions.

4.6.M.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have considered the following assessment criteria in considering the likely impacts the options:

- **Efficiency:** the regime should provide the Reserve Bank with an empowering and flexible set of tools to allow it to proactively monitor deposit takers, and enforce compliance to address risks arising from the financial system which might threaten financial stability.
- **Legitimacy:** an over-reliance on regulator discretion reduces the certainty of law, which provides it with legitimacy.

Properly designed, the principles of efficiency and legitimacy should reinforce each other.

4.6.M.4 What other options have been ruled out of scope, or not considered, and why?

The proposed options are representative of the main options considered in our analysis. A wide range of variations on these options is possible.

4.6.M.5 What do stakeholders think?

During consultation, stakeholders expressed support for widening the Reserve Bank's supervisory and enforcement toolkit, subject to appropriate safeguards.

4.6.M.6 Impact analysis

	Option 1: Status quo	Option 2: A broader set of tools
Efficiency	0	++ To enable the Reserve Bank to promote financial stability it would be empowered with a flexible suite of enforcement and supervisory tools, which could be used expeditiously and with efficacy.
Legitimacy	0	++ Would provide certainty and legitimacy that these powers would be no broader than necessary, and the scope and use would be clear and justified.
Overall assessment	0	++

4.6.M.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 2: a broader set of tools. A broader set of enforcement tools would enable the Reserve Bank to apply these tools in a way that is proportionate to the nature of the contravention or the desired behavioural change.

The Treasury supports the proposed approach.

4.6.M.8 Summary table of costs and benefits of the preferred approaches to supervision and enforcement

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional costs to comply with supervisory and enforcement tools.	Medium	Low
Regulator	Exercising of additional supervisory and enforcement tools would entail additional costs. Some implementation costs.	Low	Low
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Low
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits associated with improved clarity of supervisory and enforcement mechanisms.	Low	Low
Regulator	Benefits associated with improved governance and decision-making.	Medium	Low
Wider government	Avoided costs of Crown bail-out.	Medium	Low
Other parties			
Total Monetised Benefit			
Non-monetised benefits		Low	Low

4.6.M.9 What other impacts is this approach likely to have?

As noted above, there is additional optionality around the Reserve Bank's interaction with APRA, and any on-site inspection regime for the Australian-owned banks. There is an inherent level of cooperation and coordination between the Reserve Bank and APRA; this includes expected engagement between the two agencies for any supervisory and enforcement activity relating to a Big Four bank.

No other impacts have been identified.

Section 4.7: Resolution and crisis management

Overview of the existing framework for managing bank failures

This section discusses the Reserve Bank's role in managing periods of financial stress and discusses the features that New Zealand's bank resolution and crisis management regime should have. For further information, see the background paper on crisis management and resolution[50], prepared for Phase 2 of the Reserve Bank Review.

The Reserve Bank Act 1989 already includes most of the elements of crisis management that are now recognised internationally as being important for an effective resolution regime, but not all of them.

Crisis management

Crisis management refers to the use of powers and supporting arrangements to deal with events that seriously threaten a deposit taker's viability or financial stability generally. An effective crisis management regime encompasses elements that include:

- preparation and prevention
- the ability to intervene early and with a credible set of tools
- coordination between domestic authorities and, where relevant, national authorities in other countries.

'Special bank resolution' is a central element of crisis management. It covers the restructuring and/or orderly wind-down of all or part of a bank's business in a way that adequately safeguards the public interest. The 'public interest' in this context can include the continuity of the bank's critical functions (see below), containing distress at a failing bank and maintaining overall financial stability (see below), and avoiding or minimising the reliance on taxpayers for meeting the costs of resolving a failed bank. 'Special resolution' processes were developed to keep critical parts of failing banks open without using public money – they would instead seek to tap the creditors' liabilities to absorb losses and restore viability Special resolution that seeks to maintain financial stability or optimise aggregate wealth can leave individual creditors worse off than they might have been, had they been participating in an ordinary company liquidation.

A deposit taker's critical functions

- Crisis management often focuses on maintaining the immediate continuity of a bank's critical functions and services during an orderly resolution.
- Deposit takers perform functions that are critical for economic activity to take place. They provide services that are essential for day to day living, enabling participation in, and the smooth running of, the wider economy.

50 Reserve Bank Act Review (June 2019). Safeguarding the future of our financial system: Background paper on bank crisis management and resolution (June 2019). Available at https://www.treasury.govt.nz/sites/default/files/2019-06/rbnz-safeguarding-future-financial-system-background-paper-p2.pdf

- Customers include individuals, businesses, other organisations, and local and central government – and all require an ability to make and receive payments and conduct other financial transactions.
- If a deposit taker fails, the knock-on effects for the wider economy of abruptly discontinuing (or even disrupting) these financial services can be far greater than the losses incurred by the deposit taker itself.

Contagion

- Deposit takers operate on the basis of trust. If depositors and other creditors lose confidence in a bank, they may withdraw their funds quickly, which can lead to the deposit taker's failure.
- The failure of a large deposit taker may also undermine confidence in other deposit takers and create instability in the financial system as a whole.
- Through this contagion effect, difficulties facing one participant in the financial system can spread to other participants, rapidly eroding the value and viability of other deposit takers and destabilising the entire financial system.

Crisis management is part of the wider regulatory framework discussed in section 2.2 known as the 'financial safety net', which comprises elements that work together to support a strong, stable, and resilient financial system.

Crisis management framework

The Reserve Bank Act's general framework for crisis management dates back to the 1986 Reserve Bank of New Zealand Amendment Act. Since then, much has changed in the potential economic and social impacts posed by banking crises, and in the way that other jurisdictions have prepared to respond to failing or failed banks – especially in the past decade as part of post-GFC reforms.

In addition, in recent years the New Zealand public's expectations of regulators have changed significantly. One of the biggest changes has been recognition that visible and proactive regulators can be critical to the effective operation of a regulatory regime. A shift towards performance- or principles-based regulation has been matched by a shift towards the law being more specific about what is expected of both the regime and the regulator, typically in specifying objectives and functions.

Financial crises have been uncommon in New Zealand, with the country weathering the GFC better than most. The GFC provided a number of key lessons for prudential policy in New Zealand:[51]

- The contagion effects of a crisis can be heavily amplified by the contraction of liquidity in funding and asset markets.
- The credit cycle is a major driver of risk in the financial system - the seeds of financial crises are often sown in the credit booms that precede them.

51 Spencer, Grant (2012). Prudential lessons from the Global Financial Crisis - A speech delivered to Financial Institutions of New Zealand 2012 Remuneration Forum in Auckland. Accessed at: https://www.rbnz.govt.nz/research-and-publications/speeches/2012/speech2012-05-03

- Large bank failures can have devastating effects on both financial systems and government finances. Governments must find ways of protecting the financial system from bank failures without having to resort to bail-outs. New Zealand's main response to this lesson has been to enhance our existing failure management framework by including a resolution structure called 'Open Bank Resolution' (OBR).[52]
- OBR is a way of responding in the rare event of a bank failure. It provides access to depositors' funds that does not exist in a normal liquidation process, when depositors may not be able to access their accounts for extended periods. Under OBR, if a bank fails, it can be reopened the next day under statutory management. Customers have immediate access to most of their money. Under OBR, this money will be government guaranteed.

New Zealand does not operate a zero-failure banking regime. This means that a deposit taker, like any other business, can fail. However, as the GFC showed, placing a failed financial institution into ordinary insolvency can have damaging consequences for its customers, the rest of the financial system, and the wider real economy. Studies show financial crises can lead to a permanent loss of economic output equivalent to between 20 and 160 percent of annual GDP.[53]

International trends

To prevent even greater spill-overs during the GFC, many governments bailed out institutions using public funds or supported them with temporary, ad hoc guarantees. The GFC demonstrated a need for resolution regimes that enable authorities to resolve failing banks quickly without destabilising the financial system or exposing taxpayers to loss. Publicly funded bailouts and financial sector guarantees came to be viewed as too expensive and too inequitable to society, and too harmful to market discipline by encouraging excessive risk taking ('moral hazard'). Special bank resolution tools were required.

52 OBR supports the objective of avoiding significant damage to the financial system arising from a bank failure. OBR achieves this by providing the government with an option that would minimise spill-over costs to the rest of the economy and help manage fiscal risk. In the process, OBR strengthens the incentives faced by depositors, creditors and parent groups. It places the cost of a failure in the first instance on shareholders but also provides the flexibility to assign losses to creditors without causing unnecessary disruption to the payments system, thus promoting the maintenance of a sound and efficient financial system.

53 Guthrie, Susan - Reserve Bank of New Zealand. Capital Review Background Paper: An outline of the analysis supporting the risk appetite framework. (April 2019). Accessed at: https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Policy-development/Banks/Review-capital-adequacy-framework-for-registered-banks/Capital-Review-An-outline-of-the-analysis-supporting-the-risk-appetite-framework.pdf?revision=058df82e-5fc8-4e4c-9431-5f2dfff5aa4a&la=en

The past decade has seen an international focus on deep and wide-ranging regulatory reforms to address the GFC's root causes and bolster the financial system's resilience to their recurrence. In the midst of, and soon after, the GFC, several jurisdictions undertook major legislative reforms to strengthen their resolution regimes, and many other jurisdictions have since followed suit. The G20 and international bodies such as the Financial Stability Board (FSB)[54] have focused on enabling failing banks to be resolved in an orderly way without resorting to publicly funded bailouts or financial sector guarantees.

In response to post-GFC international commitments that future financial crises should not impose the costs of bank failures on taxpayers, the FSB adopted the Key Attributes of Effective Resolution Regimes for Financial Institutions (FSB, 2014). The G20 endorsed these Key Attributes as "a new international standard for resolution regimes" as part of agreeing on comprehensive measures to ensure that "no firm can be deemed 'too big to fail' and to protect taxpayers from bearing the costs of resolution" (G20, 2011, p. 3). The Key Attributes set out the core elements that the FSB considers to be necessary for an effective resolution regime and reflect important lessons learned by the international community from the GFC.

Problem definition

New Zealand's legislative framework for bank crisis management, being largely based on statutory management, has not been comprehensively reviewed since the late 1980s. Under this framework, the Reserve Bank developed the Open Bank Resolution (OBR) policy to manage the failure of a large bank. Since then, bank resolution regimes have been fundamentally overhauled internationally, particularly in the wake of the 2007-GFC. It is therefore timely to consider possible enhancements to New Zealand's framework. The Review's work has been informed by the international experience and the subsequent post-GFC global reform programme. A key theme in the stakeholder feedback – which the Review seeks to deliver – is that the regime should be aligned with international best practice and guidance.

New Zealand's crisis management framework and potential issues

This section surveys New Zealand's existing crisis management regime. With reference to the FSB Key Attributes and the IMF FSAP recommendations[55], it identifies a number of potential enhancements that could be made to the existing legislative framework. The existing framework is structured around Reserve Bank powers, statutory manager powers, and the Minister of Finance's supporting consent role.

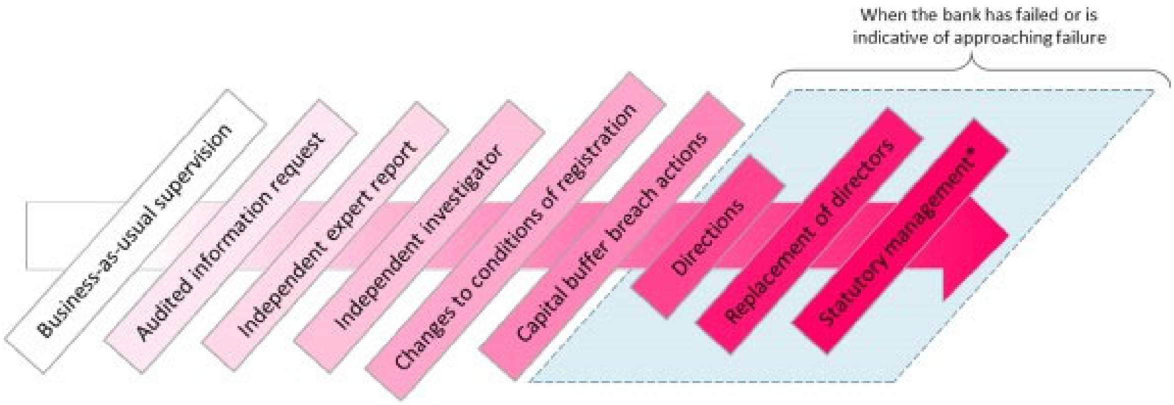
54 The FSB is an international coordination body based in Basel, Switzerland. Its members comprise the G20 plus Hong Kong SAR, Singapore, Switzerland, Spain, The Netherlands, the Bank for International Settlements (BIS), the IMF, the OECD, the World Bank, and a number of international standard-setting bodies such as the Basel Committee on Banking Supervision, the International Accounting Standards Board, and the International Organization of Securities Commissions.

55 The IMF FSAP included a separate 'Technical Note' on New Zealand's contingency planning and crisis management framework. The IMF's Technical Note included several recommendations for making New Zealand's bank crisis management regime more effective and more in line with international best practice (International Monetary Fund (May 2017). New Zealand : Financial Sector Assessment Program: Technical Note-Contingency Planning and Crisis Management Framework. Available at: https://www.imf.org/en/Publications/CR/Issues/2017/05/10/New-Zealand-Financial-Sector-

Reserve Bank Act powers in managing deposit taking sector risks

The Reserve Bank Act provides the Reserve Bank with a set of graduated intervention measures to manage deposit taking sector risks. At one end of the spectrum is business-as-usual prudential supervision; at the other sits statutory management. Early indications of deposit taker distress would normally be identified through business-as-usual supervision. If not addressed through early interventions, a deteriorating situation could be addressed through the use of more intrusive crisis management powers and, ultimately, the use of resolution powers. Figure 5 below lists the existing tools in the graduated set of interventions – crisis management falls in the last three steps.

Figure 5: The Reserve Bank's powers in managing deposit taker risks



*Open Bank Resolution (OBR) is given effect through statutory management (see Box 5D)

The Reserve Bank Act essentially provides for three channels of crisis management intervention: Reserve Bank directions, director replacement and statutory management.

Reserve Bank directions

There are a number of grounds on which the Reserve Bank can direct a registered bank (or an 'associated person'). The scope of the direction power is broad. The Act lists specific actions that can be required of the registered bank through a direction, as well as a more general requirement to "take the action that is specified in the direction to address any circumstances of financial difficulties" (section 113A(h) of the current Reserve Bank Act). The Reserve Bank must have ministerial consent to use the power of direction.

Director replacement

If the criteria for giving a direction are met, the Reserve Bank can also remove a director from, replace a director at, or appoint a director to, the bank concerned if it has reasonable grounds to believe it is necessary. As with the power of direction, the director replacement power requires ministerial consent.

Assessment-Program-Technical-Note-Contingency-Planning-and-44899). The full set of bank crisis management-related recommendations are listed in the accompanying background paper on crisis management, including commentary on how this Review has addressed those recommendations (Reserve Bank Act Review (June 2019). Safeguarding the future of our financial system: Background paper on bank crisis management and resolution (June 2019). Available at https://www.treasury.govt.nz/sites/default/files/2019-06/rbnz-safeguarding-future-financial-system-background-paper-p2.pdf)

Statutory management

If certain criteria for giving a direction are met, or if a bank has not complied with a direction, the Reserve Bank can recommend to the Minister that the bank be placed under statutory management. A statutory manager takes over the management of the bank, assuming the rights of the bank's board and shareholders and possibly replacing members of the bank's senior management, subject to advice and direction from the Reserve Bank.

Placing a bank into statutory management creates an automatic moratorium on creditor claims, including existing claims and legal action that may have already begun. However, the statutory manager can choose to waive that moratorium in whole or in part to any creditor or class of creditors. Under the Reserve Bank Act 1989, a statutory manager has powers to resolve a bank using a mix of measures, including:

- suspending deposit repayments, debt payments, or any other obligation
- cancelling obligations to provide funding to any person
- negotiating a compromise with any creditor of the bank or any creditor class
- setting up a new company to acquire the bank's business (including a foreign bank branch)
- selling or transferring viable parts of the business (whether or not subject to any existing charge or other security), or
- with the Reserve Bank's approval, applying to put the bank into liquidation (potentially imposing losses on any outstanding creditors and shareholders).

A statutory manager does not have the power to directly write-down a bank's liabilities (impose a 'haircut') or convert a bank's liabilities into equity. However, creditors can potentially bear losses to the extent that a statutory manager continues to suspend the repayment of deposits or the discharge of obligations during the course of statutory management, with the insolvent rump bank[56] then being put into liquidation. This liquidation process can take years to run its course.

The main safeguard the Act provides for the statutory manager's powers is a requirement for Reserve Bank approval before selling or otherwise disposing of a substantial part of a bank's business. In turn, the Reserve Bank must obtain ministerial consent to grant that approval.

As noted, a statutory manager is subject to direction from the Reserve Bank. The Reserve Bank may also 'advise' the statutory manager. It would be through either of these mechanisms that the Reserve Bank would use its Open Bank Resolution (OBR) policy option.

There are a number of potential enhancements that could be made to the current framework, which are discussed and addressed in the individual problem analyses below:

- resolution objectives
- clarity over the designated resolution authority

56 The 'rump' would be what remains of the original failed bank after viable parts have been sold or transferred to another entity.

- the Minister's role
- crisis management powers
- director and creditor safeguards
- resolution funding options potentially putting public funds at risk.

What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

In general, we have considered the following assessment criteria in considering the likely impacts of the proposed options:

- **Proportionately responds to financial stability risks:** The resolution regime should provide the resolution authority with the powers and tools that deliver resolution in an orderly manner without causing disruption to critical financial services or damage to financial stability
- **Clarity and legitimacy:** Resolution can be a significant and complicated intervention in the affairs of a private entity; the resolution regime should be clearly articulated and circumscribed so that there is clarity about what is enabled by the law
- **Durability and flexibility of the law**: The resolution regime should enable the resolution authority to deal most effectively with different deposit takers – which can have very different operating models, funding structures, and failure scenarios.

In particular, we have had particular regard to the FSB assertion that jurisdictions should have in place a resolution regime that provides the resolution authority with a broad range of powers and options to resolve a firm that is no longer viable and has no reasonable prospect of becoming so. Of particular relevance are the following FSB key attributes, whereby an effective resolution regime should:

- ensure continuity of systemically important financial services, and payment, clearing and settlement functions
- allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims
- provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution.

Summary of preferred package for resolution and crisis management

Drawing on international practice, we have considered a number of enhancements to New Zealand's crisis management framework. The general approach is to build on the existing framework, not replace it. This would be achieved by aligning the framework with international practice where appropriate for New Zealand. As such, the alternative options considered for many of the policy issues that follow are largely restricted to only one option, reflecting that international practice in crisis management is well-established.

The aim of the enhancements to New Zealand's crisis management is to provide more options and flexibility for authorities, and provide them with greater accountability for exercising what are significant powers to intervene and resolve failing banks. In particular, the framework could benefit from:

- clearer resolution objectives
- formally designating the resolution authority
- rebalancing the Minister's role to one with less involvement during recovery and early intervention and a more purposeful involvement during resolution
- additional tools and powers for the Reserve Bank
- making resolution tools and powers directly available to the Reserve Bank rather than only via a statutory manager
- director and creditor safeguards
- minimising the risk of taxpayer bailouts.

The new framework recognises the importance of both domestic and international cooperation and coordination, with a new statutory resolution function for the Reserve Bank of coordinating with other authorities. Given the significant Australian ownership of the deposit taking sector, this new function anticipates the importance of coordination with Australian authorities in the preparation for, and actual resolution of, an Australian-owned entity. However, the legislative framework, while enabling of coordination between New Zealand and Australia given the current home-host relationship, does not single out cooperation with Australian authorities per se in crisis management (aside from a generic trans-Tasman cooperation function that will be carried across from the current Reserve Bank Act). This recognises that the ownership structure of New Zealand's deposit taking sector could evolve overtime and that the new legislative framework will need to accommodate any future trends in this regard.

In addition to the changes below, the Review will also be considering remaining areas of crisis management reform, most of which function as a 'supporting' framework for the recommendations included in this regulatory impact statement. Ministerial consideration of these issues will be progressed outside of this set of decisions, and include:

- resolution funding
- further details on the 'no creditor worse off' creditor safeguard
- other legal safeguards and technical provisions
- transparency and accountability provisions.

The remainder of this chapter is structured as follows:

- For policy issues where there is one primary alternative option to the status quo, for example, to ensure the resolution regime aligns with international practice via FSB key attributes, these are grouped into the following impact analysis (see section 4.7.N)
- For the remainder of the policy issues, a full overview is provided, including an articulation of the problem, options, criteria and impact analysis.

Impact analysis

Impact of proposals on well-being

Financial and physical capital is a critical component of well-being. As we saw in the global financial crisis and in global shocks (such as COVID-19), well-being is impacted when physical and financial capital stocks are depleted. The global economic shock related to COVID-19 has seen financial capital depleted around the world as incomes and employment have fallen and governments and central banks have engaged in unprecedented monetary and fiscal stimulus to support their economies.

A fit for purpose crisis management regime allows the failures of financial institutions to be managed, and ensures that the financial system will be resilient to failures of financial institutions, both large and small – preventing the impact of shocks from spilling over to the broader economy and threating the economic and social well-being of New Zealanders. The proposals relating to the new crisis management regime will support the resilience of New Zealand at the national level.

	Status quo	Option 1: Preferred package for resolution and crisis management
Proportionately responds to financial stability risks	**0**	++ Would increase the range of resolution options and deliver resolution in an orderly manner without causing disruption to critical financial services or damage to financial stability. In particular, it would ensure continuity of systemically important financial services, and payment, clearing and settlement functions, and allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims.
Clarity and legitimacy	0	++ Resolution can be a significant and complicated intervention in the affairs of a private entity; the proposed approach would ensure that the resolution regime is clearly articulated and circumscribed so that there is clarity about what is enabled by the law. Would provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution. May help investors to understand the risks associated with their investments and to price those risks accordingly.
Durability and flexibility of the law	0	+ Will enable the resolution authority to deal effectively with different deposit takers. Provides a better and more coherent fit within the context of wider changes, such as changes to governance and accountability settings. Exercising resolution powers in a way that respects the hierarchy of creditors that would apply in liquidation is accepted internationally as good practice

Consultation / stakeholder feedback

There was broad support for the overall direction in crisis management in the submissions on the third consultation. For stakeholder feedback on the individual policy proposals, see the impact analyses below.

N. Grouped analysis for select resolution and crisis management issues

4.7.N.1 Impact analysis

	Problem definition	Preferred approach	Stakeholder feedback
Who should be the resolution authority?	The current framework lacks clarity over which entity is the designated resolution authority. Clarity on who exercises resolution powers (and accountability for exercising those powers) is critical to the legitimacy of the resolution regime given its scope for affecting shareholder and creditor interests and how losses are allocated across these groups. This lack of clarity on who the resolution authority is can create uncertainty about who is responsible for leading crisis management decision-making and who is accountable for the outcomes. A lack of clarity can lead to poor pre-crisis preparedness and delay in responding to a crisis. The FSB Key Attributes state that there should be a designated authority responsible and accountable for exercising resolution powers over the institutions within the regime's scope. Clarity in who exercises these resolution powers (and accountability for exercising those powers) is critical to the legitimacy of the resolution regime, given its scope for affecting shareholder and creditor interests and how losses are allocated across these groups. The IMF noted that the Reserve Bank Act (which does not explicitly designate a resolution authority) is ambiguous on who is responsible for exercising resolution powers and recommended clarifying the Reserve Bank's role as the sole resolution authority for New Zealand's banks. The main source of ambiguity arises from the Act not requiring the Reserve Bank to direct the statutory manager on how its resolution powers are to be exercised, potentially leaving the statutory manager as the effective resolution authority.	*Option 1: Designate Reserve Bank as resolution authority* We consider that the Reserve Bank is the most appropriate candidate to be the resolution authority. Additionally, the Reserve Bank already functions as, and is widely seen to be, the resolution authority despite having no formal designation as such. International guidance and practice indicate that the resolution function should rest with an authority that is operationally independent of political interference. Important synergies of knowledge and information-sharing exist between prudential supervision and resolution.[57] Resolving a bank successfully requires the resolution authority to understand the bank's structure, its business operations, the critical services it provides, and the underlying cause of the failure. For this reason, other jurisdictions commonly co-locate the resolution authority and the prudential supervisor, although keeping them functionally separate. *Other options considered* Another option would be to create a new agency to perform the resolution function. However, little benefit would be gained in creating a new agency solely for the resolution function while prudential supervision remains with, and depositor protection will soon be carried out by, the Reserve Bank.	The Review did not consult stakeholders on this issue due to the nature of the issue, and some timing and sequencing constraints.
Objectives of resolution authority	The Reserve Bank Act's current resolution framework looks to constrain the purposes for which powers may be used, while setting out a number of considerations that a statutory manager should 'have regard to' when exercising those powers. While these considerations provide guidance on the use of legal powers such as statutory management, the framework does not provide clear expectations for the resolution outcomes that the resolution authority should seek to achieve (other than the broad purpose of 'avoiding significant damage to the financial system that could result from the failure of a registered bank').[58] Better clarity can be achieved by legislation setting out the functions and objectives associated with the resolution authority's role. In addition, better clarity would support the resolution authority's resolution planning function, and its funding and prioritisation, which is critical to ensuring an effective resolution regime.	In considering possible objectives for the resolution authority, we considered the FSB Key Attributes, the objectives other jurisdictions have applied the FSB Key Attributes when drafting their resolution regime objectives and international best practice. See the second consultation document for further analysis on how the objectives under the proposed approach were developed.[59]	The second consultation asked for stakeholders' views on the most important objectives for New Zealand's resolution authority, whether they should be ranked in order of importance, and whether the suggested objectives strike the right balance between providing guidance and accountability for the Reserve

57 Further, Cabinet is being asked to agree that New Zealand's deposit insurance scheme would be the responsibility of the Reserve Bank (see section 4.8). The depositor protection function also has synergies with both prudential supervision and resolution.

58 Section 68(b) of the Reserve Bank Act, available at: https://www.legislation.govt.nz/act/public/1989/0157/latest/DLM200336.html

59 Reserve Bank Act Review (June 2019). Safeguarding the future of our financial system – The Reserve Bank's role in financial policy: tools, powers, and approach. Consultation Document 2B. Available at: https://www.treasury.govt.nz/sites/default/files/2019-06/rbnz-safeguarding-future-financial-system-2b.pdf

	At present, the considerations to which a statutory manager must have regard are only considerations, and only the statutory manager is required to take them into account under the Act. This lack of clarity hampers accountability, and only indirectly provides guidance on where the Reserve Bank should focus its efforts in a resolution. The IMF recommended the inclusion of statutory resolution objectives as well as requirements for accountability reporting against them. Resolution authorities face difficult choices in deciding how to resolve a failing financial firm. These choices include how best to impose losses and how best to limit damage to the financial system. In order to make the choice that best reflects societal interests, and to legitimise the use of delegated powers, resolution authorities need a clear set of objectives to guide their actions. Good regulatory design demands that conferring extensive powers on an unelected body be accompanied by clear statutory objectives governing the use of those powers. For New Zealand, the resolution objectives should identify the key outcomes expected of the regime and that the Reserve Bank, in implementing the regime, should seek to generate – provided that the objectives do not unhelpfully fetter the Reserve Bank's ability to deal effectively with a financial crisis. An overarching objective to 'protect and enhance the stability of New Zealand's financial system' (the Reserve Bank's financial stability objective, as would be established through the RBNZ Bill) does not provide sufficient specificity for the bank resolution function. The intrusive nature of resolution powers and their potential distributional impacts demands greater clarity on the outcomes that the resolution authority should be aiming to achieve. Moreover, resolution powers may need to be exercised in relation to banks whose failure would not have systemic implications, yet clarity on the expected outcomes would be no less important for the stakeholders concerned.	*Option 1: Proposed approach* Our preferred approach is that the Reserve Bank would have the following statutory objectives in performing the resolution function, including resolution planning: a. enable all deposit takers to be resolved in an orderly manner; b. avoid significant damage to the financial system in the event of the failure of a deposit taker, including by maintaining the continuity of systemically important financial functions and preventing contagion; c. to the extent not inconsistent with objective b above: i. minimise the cost of resolution and avoid unnecessary destruction of value and interference with property rights ii. protect public funds, including by minimising the need to apply public funds to resolve the failure of a deposit taker. The first objective reflects the resolution authority's resolution planning function which, along with appropriate funding and prioritisation, is critical to ensuring an effective resolution regime. The second objective acknowledges that resolution underpins financial stability, particularly through maintaining the continuity of systemically important functions and preventing contagion. The last objective reflects the idea that those exercising resolution powers are likely to be best placed to help manage fiscal risk to the government if public funds were ever needed to be relied upon in a resolution.	Bank and flexibility for the Reserve Bank to deal effectively with a crisis. Submitters who commented on the proposed objectives were generally supportive. The third consultation noted that the Review was still considering the merits of having 'protecting insured depositors' as an additional resolution objective. One submission opposed that idea on the grounds that the resolution authority would already have a multitude of objectives to manage and should not be aiming to be a champion of any particular creditor group.
Functions of the resolution authority	The existing Act does not explicitly designate a resolution authority function. Better clarity, including for the purposes of funding and prioritisation, can be achieved by legislation setting out the functions associated with that role.	The Review has considered the following set of functions to address the problem. The proposals have been selected based on a review of international practice, as well as submissions through the public consultation. There is a range of relatively minor variations on these proposals that could also be considered, but which we do not think would have a substantive impact on the analysis. *Option 1: Proposed approach* Taking into account international good practice guidance for resolution authorities and New Zealand's circumstances, this option would provide that the Reserve Bank's resolution functions be focussed on: • preparing and maintaining a plan to resolve each deposit taker in the event of its possible failure[60] • testing the effectiveness of those plans at regular intervals	Most stakeholders who submitted on crisis management were supportive of the proposed direction of reform to the crisis management regime.

60 Resolution plans aim to achieve an orderly resolution without systemic consequences, so they will be more detailed for large firms. For small deposit takers whose liquidation would not threaten financial stability, the plan may simply be to close and liquidate the institution (with insured depositors reimbursed by the deposit insurance scheme).

		• coordinating with other authorities, both in New Zealand and overseas, as necessary to be prepared for the possible failure of a deposit taker, and • in the event of a deposit taker failure, exercising the powers available to the Reserve Bank consistently with the objectives set out above. The function to prepare and maintain resolution plans for deposit takers includes identifying preferred resolution strategies and impediments to resolution, and working with deposit takers to remove those impediments where possible. Crucially, deposit takers – particularly the large banks – will be expected to provide substantial input into developing and maintaining resolution plans, reflecting the need for resolution plans to closely reflect the nature of their specific business, and as the main input to inform the Reserve Bank's resolution planning.	
Statutory bail-in as a resolution tool	The FSB Key Attributes recommend that resolution authorities be vested with statutory bail-in powers. The IMF, too, recommended that express bail-in powers be added to the Reserve Bank's suite of resolution options. These powers have featured widely in resolution regimes introduced in other jurisdictions since the GFC as a way of minimising the use of taxpayer funds to recapitalise a distressed bank. Experience with using bail-in is still in its infancy and has both demonstrated benefits and revealed issues. The main benefit is the ability to recapitalise a bank while minimising the need for a taxpayer bailout. The Bank of England has noted other significant benefits, including avoiding operational challenges and legal consequences that can arise when transferring some of a failed bank's business to a purchaser.	*Option 1: Introduce statutory bail-in* We propose that the Reserve Bank be given a direct power to write down or convert unsecured liabilities into equity. This new power provides a new option for imposing costs of a deposit taker failure on investors and creditors rather than taxpayers. *Alternative options* An alternative to bail-in that would also not require taxpayer support could be the use of a resolution fund paid for by industry-wide levies. However, a resolution fund could struggle to gain the size needed for a large bank failure and any resolution fund may reduce the incentives for banks to manage their business prudently (moral hazard). The Review also considered the benefits of solely contractual bail-in – where the legal basis for the bail-in is in the contractual terms of a debt instrument rather than in a resolution authority's statutory powers. Contractual bail-in, however, is prone to uncertainty as to when the relevant contractual clauses will actually be triggered. Having both contractual and statutory bail-in carries the greatest legal certainty.	Stakeholder feedback during the Review was supportive of introducing the bail-in tool, including from banks and members of the legal community who have familiarity with bank resolution issues internationally. The sector's support recognises that there are advantages to New Zealand's banking sector in having resolution tools which reflect international guidance, have become familiar internationally, and are well-understood by institutional investors.
Creditor safeguards	Respect for property rights is a fundamental principle of insolvency law that allows investors and creditors to identify the risks to which they are exposed, allowing them to be priced and managed prudently in normal business. Certain creditor safeguards in the resolution of a failed bank are considered international best practice and are a common expectation among creditors internationally. Exercising resolution powers in a way that respects the hierarchy of creditors that would apply in liquidation is accepted internationally as good practice. In cases where respecting the hierarchy of creditors is not feasible or where departure from the hierarchy can be justified on financial stability grounds, the principle that creditors should nevertheless be left no worse off than in a liquidation is still widely recognised internationally.	The Review has considered, and consulted on, the following option to address the problem. This option has been selected based on a review of international practice, as well as submissions through the public consultation. *Option 1: Credit hierarchy respected + NCWO compensation (preferred approach)* Under this option, resolutions would be required to be conducted in a manner that respects the creditor hierarchy that would normally apply in a liquidation unless departure from the hierarchy is necessary to	During consultation, most stakeholders who submitted on crisis management were supportive of the proposed direction of reform to the crisis management regime. There was support for the proposed general alignment with international best practise, and the Financial Stability Board (FSB) Key Attributes in particular. Two

	The ‘no creditor worse off than in liquidation’ (NCWO) principle is a central element in the FSB Key Attributes. It is strongly promoted by the IMF and has been adopted in one form or another by many jurisdictions. New Zealand is currently an outlier internationally for its lack of safeguards for creditor property rights in a bank resolution. New Zealand’s existing statutory management legislation allows the statutory manager, in pursuit of their statutory objectives, to depart from the creditor hierarchy that would apply in a liquidation – with no compensation to adversely affected creditors.	maintain the stability of the financial system, including maintaining critical financial functions. In addition, an after-the-event compensation mechanism would be established to compensate creditors if a resolution left some creditors worse off than they would have been in an ordinary liquidation (the ‘no creditor worse off’ principle). Recommendations in this area will be provided in a subsequent tranche of advice.	submitters commented directly on NCWO, as follows: • One submitter supported departing from the creditor hierarchy with a NCWO compensation scheme. • Another submitted supported NCWO in principle, but noted it could be complicated to apply.

4.7.N.2 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** $m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	**Evidence certainty** (High, medium or low)
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional costs associated with the implementation of the above proposals, including preparation of resolution plans and ongoing engagement with the Reserve Bank on these plans. Potential additional funding costs in relation to debt instruments that will be eligible for bail-in, offset by the low risk of bail-in being used due to the Reserve Bank's capital requirements.	Low	Medium
Regulators	Additional costs associated with implementation of the above proposals, including the assessment of resolution plans and ongoing engagement with regulated entities on these plans. Additional costs associated with operationalising a bail-in regime. On-going costs associated with engagement with Australian authorities, and other relevant international authorities, particularly with respect preparing for the failure of a trans-Tasman deposit taker.	Low-medium	Medium
Wider government	Potential for compensation to be paid if some creditors are left worse off than they would have been in a normal liquidation. Bail-in, if exercised, may override individual rights in order to ensure the continuity of essential functions, but creditors will not be worse off than they would have been in a normal liquidation.	Low-medium	Medium
Other parties			
Total Monetised Cost			
Non-monetised costs		Low-Medium	Medium
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits from alignment with international best practice as international investors	Low	Medium

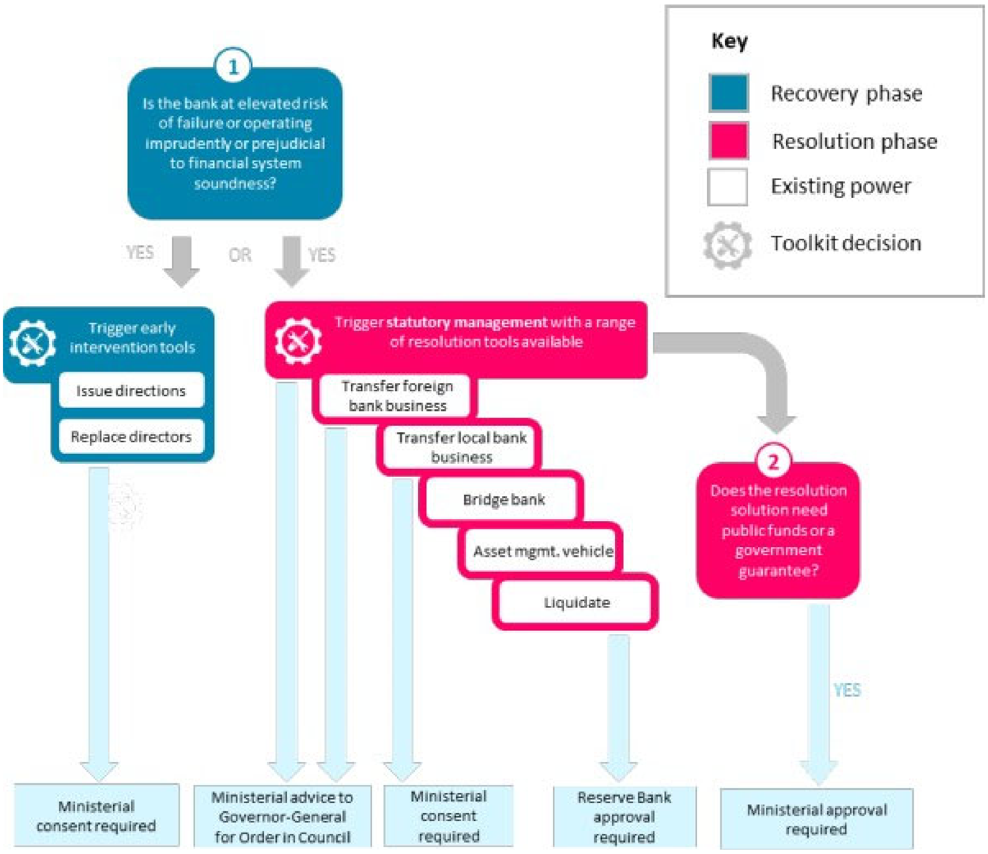
	would have clarity and certainty about the risk they face in the event of a resolution. Benefits associated with improved clarity on the Reserve Bank's role, objectives and functions as resolution authority. Benefits associated with bail-in providing the ability to turn a failed bank to a viable/solvent state		
Regulators	Benefits through international recognition and understanding of the resolution regime and greater willingness to conduct resolutions that may depart from the creditor hierarchy Benefits associated with having a high degree of clarity in the resolution authority's mandate. This will support pre-crisis preparedness and mitigate any delay in responding to a crisis. Benefits associated with a clear set of objectives and functions, which will legitimise and guide the use of the resolution authority's delegated powers while not fettering the Reserve Bank's ability to deal effectively with a financial crisis. This will support pre-crisis preparedness and mitigate any delay in responding to a crisis, including with Australian authorities with respect to a trans-Tasman deposit taker. Benefits associated with the resolution authority having a clear ability to deal effectively with some types of financial crisis if a bail-in framework is implemented by the Reserve Bank.	Low	Medium
Wider government	Benefits by way of avoided taxpayer bailouts through pre-planned orderly resolutions Benefits through greater international credibility of the resolution regime	Medium	Medium
Other parties	Benefits associated with improved public confidence in the regulation of deposit takers, reducing the likelihood and severity of bank runs and disorderly bank failures, and contributing to financial stability. Improved investment decision-making for creditors.	Medium	Medium
Total Monetised Benefit			
Non-monetised benefits		Low-Medium	Medium

O. Powers of the resolution authority

4.7.O.1 What is the specific problem?

Figure 6 below shows that the Reserve Bank Act's key powers of resolution are currently only available when a bank is under statutory management (although conditions of registration can still be used outside of statutory management to require pre-positioning for some resolution options such as Open Bank Resolution).

Figure 6: The Reserve Bank's current crisis management tools



However, placing a bank into statutory management is a significant intervention. Ideally, it should be an action of last resort, when a failing bank's management is unwilling or unable to facilitate a recovery or resolution on a going-concern basis while the bank is under private control. According to the IMF in the context of Australia's resolution tools, statutory management should be used very cautiously, as the appointment of a statutory manager could destabilise the bank by triggering or exacerbating funding runs (IMF, 2019, p. 19).[61] Resolution tools should not depend on the failing bank first going into statutory management.

61 International Monetary Fund (February 2019). Australia : Financial Sector Assessment Program-Technical Note-Bank Resolution and Crisis Management. Available at: https://www.imf.org/en/Publications/CR/Issues/2019/02/13/Australia-Financial-Sector-Assessment-Program-Technical-Note-Bank-Resolution-and-Crisis-46605. A bank may also struggle to recover once placed in statutory management given the lack of authorities' confidence in the board and management that

Statutory management can be a significant and complicated intervention in the affairs of a private entity and may not always be required to effect a resolution. Several of the existing powers that are available only under statutory management could potentially be exercised directly by the resolution authority.

A bank needs to be resolved quickly to provide certainty, avoid contagion, and allow access to transactional services. Legal impediments, such as allocating losses, may prevent a bank from being resolved in the time frames required. There are no enforceable tools available under the current Reserve Bank Act to directly allocate losses without completing a normal insolvency and liquidation process. Also, if transactions that departed from respecting the creditor hierarchy were deemed necessary in the course of the resolution, a subsequent liquidation of a rump institution poses some risk of litigation (primarily judicial review risk) if some creditors experience outcomes worse than they would have in liquidation.[62]

Nor does the Act provide for any enforceable non-taxpayer-funded recapitalisation powers. The lack of direct loss-allocation and recapitalisation tools makes it difficult for authorities to secure a sustainable solution without having to rely on taxpayer support or otherwise putting public funds at risk. This power is available in a number of other jurisdictions, though is tailored to the specific context. For example, the Australian Prudential Regulation Authority (APRA) has broad power to give directions in certain circumstances such as where the deposit taker has contravened a prudential requirement.

As discussed above, the FSB Key Attributes imply that the Reserve Bank's legislation should provide a broader range of resolution powers. These powers would include the ability to override shareholders' rights, with the creditor hierarchy respected, to enable a resolution – which could involve a merger, an acquisition, a sale of parts of the bank, recapitalisation, or a bail-in (if recapitalisation is necessary to ensure the continuity of essential functions).[63]

Under the current Act, existing resolution powers (other than directions) can only be exercised by a statutory manager. Statutory management displaces the powers of the existing board and management of an entity and vests them in a statutory manager. Existing resolution powers include incorporating a body corporate under the Companies Act 1993, transferring the whole or any part of a bank in resolution to that body, selling the whole or any part of a bank in resolution, or applying to have a bank in resolution placed into liquidation.

statutory management signifies. Statutory management is also a common trigger for the acceleration and termination of swaps and derivatives contracts and other financial and commercial agreements that feature cross default provisions. A bank may struggle to regain the confidence of key financial markets if the widespread termination of its financial contracts is triggered

62 Section 292 of the Companies Act 1993 provides that a liquidator can void an insolvent transaction that enables a person to receive more towards satisfaction of a debt owed by the company than the person would receive, or would be likely to receive, in the company's liquidation. See https://www.legislation.govt.nz/act/public/1993/0105/latest/DLM321975.html

63 See the creditor safeguards discussion above for further information. Under the proposed approach, resolutions would be required to be conducted in a manner that respects the creditor hierarchy that would normally apply in a liquidation unless departure from the hierarchy is necessary to maintain the stability of the financial system, including maintaining critical financial functions.

A range of resolution options is required to deal most effectively with different banks – which can have very different operating models, funding structures, and failure scenarios. Below are some examples where it would be desirable to have a range of resolution options available to the resolution authority.

- a small institution's failure may be most effectively dealt with through a special bank liquidation process, in conjunction with a mechanism to protect insured depositors from loss through the forthcoming deposit insurance scheme
- small and medium-sized banks that are largely deposit-funded may be more suited to resolutions known as 'purchase and assumption', where a healthy bank or group of investors purchases some or all of the failed bank's assets and takes on some or all of its obligations. The Reserve Bank Act currently provides basic powers for purchase and assumption resolutions, but only if a statutory manager has been appointed first.
- large, more complex banks may need to be kept open to maintain the continuity of essential financial services, and will require tools that return them to an appropriately capitalised and viable state. Internationally, and in response to the GFC, a bail-in regime is recommended (see section 4.7.N and section 4.7.R below).
- An alternative to bail-in that would also not require taxpayer support could be the use of a resolution fund paid for by industry-wide levies. However, a resolution fund could struggle to gain the size needed for a large bank failure and any resolution fund may reduce the incentives for banks to manage their business prudently (moral hazard).

4.7.O.2 What options are available to address the problem?

The Review has considered the following option to address the problem. The proposals within the option have been selected based on a review of international practice, as well as submissions through the public consultation. There is a range of relatively minor variations on these proposals that could also be considered, but which we do not think would have a substantive impact on the analysis.

Option 1: Stronger regulatory powers with an FSB-compliant tool kit (proposed approach)

In line with international guidance, where practicable, certain existing powers under statutory management would be available directly to the Reserve Bank as the resolution authority, without requiring that a bank be placed into statutory management. These powers could include setting up a bridge bank[64] or applying for a failed deposit taker to be put into liquidation.

A modified form of statutory management under the Reserve Bank's control would, however, still be available as an option to address situations where taking full control of a failed deposit taker is necessary to implement the chosen resolution option. The existing process for placing a deposit taker 'under statutory management' and the appointment of a statutory manager would be ***replaced*** with placing an entity 'into resolution' (provided the statutory resolution criteria have been met (see sections 4.7.Q below)).

64 A bridge bank is a temporary entity set up by the resolution authority and into which key parts of a failed bank's business are transferred.

Once an entity has been placed into resolution, the Reserve Bank as resolution authority would have access to the full range of resolution powers. These powers would include the ability to appoint one or more 'resolution managers' (either from within the Reserve Bank or an external person) to take control of the entity (as a statutory manager would under the current Reserve Bank Act1989). The resolution manager would be able to exercise resolution powers on behalf of the Reserve Bank, and the Reserve Bank would be responsible for the resolution manager's performance. This empowerment of the resolution authority aligns with international guidance and addresses industry's request that the existing statutory management model be modified in a manner guided by the FSB Key Attributes.

In line with international guidance and global post-GFC reforms, the Reserve Bank would be provided with an FSB-compliant resolution toolkit that increases the range of resolution options, namely bail-in along with other powers currently invested in the statutory manager.[65] An effective resolution regime also needs to be able to resolve a range of institution types, size, and complexity in a range of failure scenarios. Broadly speaking, the regime needs to be able to deliver three types of resolution in an orderly manner without causing disruption to critical financial services or damage to financial stability. The three types are:

I. **Orderly closure and liquidation** at the point of non-viability without endangering the financial system as a whole. This type of resolution lends itself to small deposit takers. A prompt payout of insured deposits is critical to its credibility.

II. **A transfer of key deposit accounts and other critical liabilities to another entity** – either a temporary bridge bank or directly to an acquiring entity – together with either good assets from the failed entity or other financial resources. Assets and liabilities not transferred would remain in the failed entity and would be wound down. This type of resolution is generally called a 'partial transfer' or a 'purchase and assumption' when applied to smaller entities, where at a minimum, insured deposits would be transferred to the going concern entity.

III. **Open resolution**, where the failing entity is stabilised and resolved (at least temporarily) in a manner that keeps the doors of the failing entity itself open and services operational. Access to deposit accounts is uninterrupted. Stabilisation generally requires the entity to be recapitalised or have a government guarantee (as is the case with Open Bank Resolution (OBR)). Recapitalisation can happen via 'bailing in' suitable prepositioned and subordinated liabilities, including those of a parent institution in the case of a subsidiary such as one of New Zealand's big four banks. This type of resolution is in practice generally reserved for large or systemically important institutions that provide services critical to the financial system.

Resolution types (i) and (ii) could be catered for by transferring existing statutory management powers to the Reserve Bank as the resolution authority and through implementation of the deposit insurance scheme. The tools available for doing this would include the appointment of a resolution manager in the stead of the existing statutory manager. Resolution type (iii) would be supported by a new statutory 'bail-in' power (discussed in section 4.7.N and section 4.7.R).

65 As noted below, officials are still considering other technical details of a number of existing statutory management powers to ensure that what is transferred is fit-for-purpose.

Prior to resolution, the first line of defence is equity capital, the amount of which will increase over the coming years as part of the Reserve Bank's Capital Review decisions. As equity capital weakens, the early intervention powers discussed above are important.

4.7.O.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have considered the following assessment criteria in considering the likely impacts of the proposed option:

- **Proportionately responds to financial stability risks:** The resolution regime should provide the resolution authority access to a resolution toolkit that increases the range of resolution options and delivers resolution in an orderly manner without causing disruption to critical financial services or damage to financial stability
- **Clarity and legitimacy:** Resolution can be a significant and complicated intervention in the affairs of a private entity; the resolution authority's powers should be clearly articulated and conscribed so that there is clarity about what is enabled by the law
- **Durability and flexibility of the law**: A range of resolution options enables the resolution authority to deal most effectively with different deposit takers – which can have very different operating models, funding structures, and failure scenarios.

In particular, in considering the scope of the resolution authority's powers, we have had particular regard to the FSB assertion that jurisdictions should have in place a resolution regime that provides the resolution authority with a broad range of powers and options to resolve a firm that is no longer viable and has no reasonable prospect of becoming so. Of particular relevance are the following FSB key attributes, whereby an effective resolution regime should:

- ensure continuity of systemically important financial services, and payment, clearing and settlement functions
- allocate losses to firm owners (shareholders), and unsecured and uninsured creditors in a manner that respects the hierarchy of claims
- provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution.

4.7.O.4 What other options have been ruled out of scope, or not considered, and why?

The proposals under the proposed approach are representative of the main options considered in our analysis. Officials are still considering other technical details of a number of existing statutory management powers to ensure that what is transferred is fit-for-purpose. Recommendations on this matter will be provided in a subsequent tranche of advice.

4.7.O.5 What do stakeholders think?

Submissions from the banking sector support the view that the appointment of a statutory manager may constitute an unnecessary additional step if the resolution function is situated in an adequately resourced division of the Reserve Bank with the appropriate knowledge and skills.

Further, stakeholder feedback, particularly from the banking and the legal sector, had pointed to concerns – both within New Zealand and from international banks – with New Zealand's version of statutory management as an intervention tool for banks[66]. These concerns apply both to statutory management under the Reserve Bank Act and statutory management under the Corporations (Investigation and Management) Act 1989 (CIMA). Both have similarly broad powers with few of the safeguards recommended in international guidance. The industry's concerns echo those raised in 2001 by the Law Commission in relation to statutory management under CIMA.[67]

4.7.O.6 Impact analysis

	Status quo	Option 1: Stronger regulatory powers with an FSB-compliant tool kit (proposed approach)
Proportionately responds to financial stability risks	0	++ Would increase the range of resolution options and deliver resolution in an orderly manner without causing disruption to critical financial services or damage to financial stability. In particular, it would ensure continuity of systemically important financial services, and payment, clearing and settlement functions, and allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims.
Clarity and legitimacy	0	++ Would improve clarity and legitimacy by clearly articulating and circumscribing the resolution authority's powers. Would provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution. May help to communicate the regulatory intensity levels for resolution interventions
Durability and flexibility of the law	0	++ Will enable the resolution authority to deal most effectively with different deposit takers
Overall assessment	0	++

66 For example, the New Zealand Bankers' Association (NZBA) noted in the second consultation that although statutory management is intended to be a control and management tool that preserves the business and provides "breathing space" to enhance orderly resolution, it has a number of significant drawbacks in the context of bank resolution and recovery.

67 Law Commission (2001) Insolvency Law Reform: Promoting Trust and Confidence. Available at: https://www.lawcom.govt.nz/sites/default/files/projectAvailableFormats/NZLC%20SP11.pdf

4.7.O.7 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank agreed with Option 1: Stronger regulatory powers with an FSB-compliant tool kit. As noted above, this option would increase the range of resolution options and deliver resolution in an orderly manner without causing disruption to critical financial services or damage to financial stability.

The Treasury supports the proposed approach.

4.7.O.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** $m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	**Evidence certainty** (High, medium or low)
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional costs associated with engagement on any exercise of resolution powers.	Low	Medium
Regulators	Additional costs associated with exercise of resolution powers. Additional implementation costs more broadly.	Medium	Medium
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low-Medium	Medium
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits associated with improved clarity on the Reserve Bank's powers.	Low	Medium
Regulators	Benefits associated with the resolution authority having a clear ability to deal effectively with a financial crisis. This will support pre-crisis preparedness and mitigate delay in responding to a crisis.	Medium	Medium
Wider government	Benefits by way reducing likelihood and costs associated with the use of public funds.	Medium	Medium
Other parties	Improved public confidence in the regulation of deposit takers, reducing the likelihood and severity of bank runs and	Low	Medium

	disorderly bank failures, and contributing to financial stability.		
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.7.O.9 What other impacts is this approach likely to have?

No other impacts have been identified.

P. Direction powers

4.7.P.1 What is the specific problem?

The Reserve Bank currently has the power to direct registered banks, with the consent of the Minister of Finance, in situations where certain statutory triggers have been met (essentially where the Reserve Bank has reasonable concerns about the soundness of the registered bank and the risks it may pose to the financial system). These powers can also be used in an enforcement setting to effect corrective action and ensure compliance with prudential requirements. The existing legislative framework does not draw a clear line between using powers to address matters of prudential concern without a threat to viability on one hand, and the point at which the exercise of resolution powers becomes warranted for viability reasons on the other.

Cabinet has made an in-principle decision (DEV-19-MIN-0346 refers) to remove the current requirement for the Reserve Bank to seek the Minister of Finance's consent to using direction powers. This decision is part of a broader set of changes aimed at modernising the governance and accountability settings of the Reserve Bank. Cabinet made this decision subject to there being appropriate thresholds developed for the use of direction powers. The powers have also needed to be redeveloped to make them fit coherently with the wider set of changes.

4.7.P.2 What options are available to address the problem?

The Review has considered the option of distinguishing directions and other early interventions from resolution to address the problem, which is outlined below. Other options were also considered, but not taken forward (also discussed later in this section). The proposed statutory triggers have been selected based on a review of international practice, as well as submissions through the public consultation. There is a range of relatively minor variations on these proposals that could also be considered, but which we do not think would have a substantive impact on the analysis.

***Option 1: Distinguish directions and other early interventions from resolution (propo**sed approach)*

The proposed statutory triggers for direction powers are where the Reserve Bank has reasonable grounds to believe that:

- there is a contravention, or a likely contravention, by a licensed entity of its prudential requirements or obligations (including, without limitation, if the licensed entity is insolvent or likely to become insolvent, or is about to suspend payment or is unable to meet its obligations as they fall due); or
- the business of the licenced entity is not being conducted in a "prudent manner"; or
- the circumstances of the licensed entity are such as to be prejudicial to the soundness of the licenced entity or the financial system.

The proposed terms of the directions are whatever the Reserve Bank believes is necessary to remedy the situation that has given rise to the grounds for the direction ('the event'), avoid or mitigate the harm or potential harm arising out of the event, potential event, or risks to the ongoing viability of the entity. The scope of the direction powers would also include all of the existing direction powers contained within the Reserve Bank Act 1989, as well as the following additional new powers, to give the Reserve Bank the ability to direct a licensed entity to:

- implement a recovery plan, or
- issue additional shares.

It is also proposed that direction powers be available for use by the Reserve Bank in the context of associated persons. Although associated persons as unlicensed entities are out of the scope of prudential regulation, they can create wider risks and costs to society through their impact on licensed entities. Risks to the soundness of a deposit taker can be generated by the activities of related entities, such as a deposit taker's holding company or its subsidiaries. It is therefore important that the Reserve Bank have sufficient tools to monitor and manage these risks.

It is also proposed that the Reserve Bank have the ability to remove, replace or appoint directors of a licensed entity. This ability currently exists in the Reserve Bank Act 1989, and should be included in the DTA.

The Review also considered, but did not progress, a range of other options:

Option considered	**Reasons for not progressing this approach**
Two-tier system of triggers, with more intrusive powers reserved for higher-risk behaviours	A need for operational flexibility. The Reserve Bank should have access to a full range of tools in order to respond to unique situations. Distinctions between enforcement through to early intervention can be arbitrary and unnecessarily bureaucratic.
Setting out the triggers for intervention in specific and detailed terms	A broad power is more keeping with the existing framing of section 113 of the current Reserve Bank Act, which sets out and enables the Reserve Bank's direction-making power. It allows for an appropriate degree of flexibility to the regulator, which is justified given the complexity of the industry and the potential for wide-ranging harm to financial stability. The in-built check of "reasonable concern" acts as a practical limit on the application of triggers, as the regulator will still need to provide evidence and build a case for intervention.

Not including a prudent conduct trigger	As above, there are compelling policy reasons for giving the regulator flexibility to respond to situations where there is a reasonable concern regarding financial stability.
Setting out the scope of directions in very specific and detailed terms	A broad power is more keeping with the existing framing of section 113A of the current Reserve Bank Act, which sets out the scope of the Reserve Bank's direction-making power. As above, there are compelling policy reasons for allowing the regulator flexibility, given the complexity and evolution of the sector, and the potential for widespread harm to financial stability.
Not including a "cease and desist" power *This is a new direction power, not currently incorporated in section 113 of the current Reserve Bank Act.*	This power is intended to work as an ability for the regulator to require a temporary stop on actions or proceedings, for example, in the case of a new or novel product or offering where the RBNZ might need more time to investigate. Given the complexity of the sector, and its ability to change and evolve, there are compelling policy reasons for giving the regulator an ability to require a temporary hold on proceedings. Although it is an infringement on an entity's ability to do business, it has the potential to mitigate further harm, and allows the RBNZ to effectively and proactively manage risk.
A "brightline" distinction between supervision and enforcement, and early intervention	In reality, banking stress and crises might not necessarily move neatly through phases. In a given situation, it might not be especially clear where a situation is going beyond BAU supervision and enforcement and into something that is more serious. The regulator should have a full set of tools appropriate to the situation. Consideration has been given to the possibility of perverse incentives. Therefore, a framework with a set of triggers and direction powers with some reasonable boundaries is preferred.
No distinction between supervision and enforcement, and early intervention	As some of the early intervention powers involve bigger restrictions on the entity's ability to do business, and infringements on property rights, it seemed necessary to build in some reasonable boundaries and restrictions for using the more "interventionist" powers.
Introduce requirement for regulator to show the intervention action is proportional to the harm being averted	Adding in proportionality would make the balancing factors too complex. It wouldn't necessarily add more safeguards than the link to harm, but would add complexity. It might also restrict the regulator's ability to take the necessary action to avert the harm.
Subject offences and process elements to a more first-principles policy review	No compelling evidence that there is anything wrong with the current law.
Section 113B could be incorporated into the broader direction powers	This was considered but not pursued. The existing law in section 113B of the current Reserve Bank Act, which sets out the Reserve Bank's power to remove, replace or appoint directors, has a different framing and test to the general direction powers which makes it difficult to incorporate. In the absence of compelling evidence or policy reasons for change, it should be re-written for the DTA with no policy change. In addition, this is a more intrusive power than the other general direction powers, so it is unlikely to fit well within the general direction powers.

4.7.P.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have considered the following assessment criteria in determining the likely impacts of the proposed option:

- **Proportionately responds to financial stability risks:** The proposed statutory triggers should provide the resolution authority access to a resolution toolkit that increases the range of resolution options.
- **Clarity, legitimacy and appropriate safeguards:** There should be as clear a delineation as possible between lesser interventions to address matters of prudential concern and the point at which the use of resolution powers becomes warranted. There should also be appropriate bounds on the use of direction powers and resolution powers, so as to ensure they are properly constrained.
- **Durability and flexibility of the law:** A range of direction options enables the resolution authority to deal effectively with different types and structures of deposit takers – which can have very different operating models, funding structures, and failure scenarios.

4.7.P.4 What other options have been ruled out of scope, or not considered, and why?

The features of the proposed option are representative of the main options considered in our analysis. As noted above, there is a range of relatively minor variations on these proposals that could also be considered, but which we do not think would have a substantive impact on the analysis.

4.7.P.5 What do stakeholders think?

Although there was broad support for the overall direction in crisis management in the submissions on the third consultation, the consultation did not set out a comprehensive set of proposals on direction powers. Therefore, a full set of stakeholder views has not yet been received on this proposal.

However, one submitter did make the point that it is essential to have a clear delineation between early intervention tools such as direction powers, compared with more intrusive actions, such as resolution. The proposed approach makes this delineation.

4.7.P.6 Impact analysis

	Status quo	Option 1: Proposed approach
Proportionately responds to financial stability risks	0	++ Would enable a range of resolution options and provide options for proactively responding to situations of financial stress in licensed deposit takers therefore potentially avoiding larger and more harmful crises.
Clarity, legitimacy and appropriate safeguards	0	++ Would improve clarity and legitimacy by clearly articulating and circumscribing the resolution authority's powers. A clear set of statutory triggers provides specific grounds for regulatory intervention and should provide certainty for industry and protection from over-reach. May help investors to understand the risks associated with their investments and to price those risks accordingly.
Durability and flexibility of the law	0	++ Will enable the resolution authority to deal effectively with different deposit takers. Provides a better and more coherent fit within the context of wider changes, such as changes to governance and accountability settings.
Overall assessment	0	++

4.7.P.7 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank agrees with Option 1: the proposed approach. As noted above, this approach would enable a range of resolution options and provide options for proactively responding to situations of financial stress in licensed deposit takers therefore potentially avoiding larger and more harmful crises.

The Treasury supports the proposed approach.

4.7.P.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** $m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	**Evidence certainty** (High, medium or low)
Additional costs of proposed approach compared to taking no action			
Regulated parties	Additional costs associated with compliance with direction (the terms of directions will vary according to the circumstances, but could include things	Medium	Medium

	such as a direction to issue shares to increase capital).		
Regulators	Additional costs associated with exercise of additional or amended direction powers.	Low	Medium
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low-Medium	Medium

Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits associated with improved clarity on the resolution authority's triggers for directions, and stability of the wider financial sector.	Low-medium	Medium
Regulators	Benefits associated with the resolution authority having a clear ability to issue directions and deal effectively with a financial crisis (or emerging financial crisis). This will support pre-crisis preparedness and mitigate delay in responding to a crisis.	Medium	Medium
Wider government	Benefits by way of potentially averting the failure of a regulated entity and reducing the likelihood and costs associated with the use of public funds.	Medium	Medium
Other parties	Improved public confidence in the regulation of deposit takers, reducing the likelihood of disorderly bank failures, and contributing to financial stability. Increased trust and confidence in the financial system, and therefore benefits across a range of well-being domains (e.g. income and consumption, jobs and earnings).	Medium	Medium
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.7.P.9 What other impacts is this approach likely to have?

No other impacts have been identified.

Q. Triggers for resolution

4.7.Q.1 What is the specific problem?

Resolution involves the use of statutory powers that may interfere with normal shareholder and creditor rights, subject to the 'no creditor worse off than in liquidation' (NCWO) principle.[68] Such interference is generally seen as justified because of the wider risks and costs to society and potentially the financial system and the economy that could otherwise eventuate from the disorderly failure of a deposit taker. However, there should be a balance between the power of the regulator, and shareholder and creditor interests.

The current Reserve Bank Act provides for three channels of crisis management intervention: Reserve Bank directions, director replacement, and statutory management. There are six possible triggers for recommending the appointment of a statutory manager. The first five are the same first five triggers for giving a direction – that is, the Reserve Bank must have reasonable grounds to believe that any one of the following applies:

a. The bank or the associated person is insolvent or is likely to become insolvent.

b. The bank or the associated person is about to suspend payment or is unable to meet its obligations as and when they fall due.

c. The bank or the associated person is conducting its affairs in a way that is prejudicial to the soundness of the financial system.

d. The bank's or the associated person's circumstances are prejudicial to the soundness of the financial system.

e. The bank has not been, or is not, conducting its business in a prudent manner.

The sixth possible trigger is that the bank or the associated person has failed to comply with a direction from the Reserve Bank.

The FSB Key Attributes set out a narrower set of conditions for resolution (noted above) than those that enable a bank to be placed into statutory management under the Reserve Bank Act. In particular, the meaning of 'prejudicial to the soundness of the financial system' or not 'in a prudent manner' may need refining. The existing legislative framework could be better tailored to provide a set of clear statutory triggers for placing a licensed entity into resolution (statutory management under the current legislation), enabling the Reserve Bank to act proactively when licenced entities are failing.

68 See the creditor safeguards discussion above for further information. Under the proposed approach, resolutions would be required to be conducted in a manner that respects the creditor hierarchy that would normally apply in a liquidation unless departure from the hierarchy is necessary to maintain the stability of the financial system, including maintaining critical financial functions.

4.7.Q.2 What options are available to address the problem?

The Review has considered the following option to address the problem. The proposed statutory triggers have been selected based on a review of international practice, as well as submissions through the public consultation. There is a range of relatively minor variations on these proposals that could also be considered, but which we do not think would have a substantive impact on the analysis.

Option 1: New triggers based on international practice (proposed approach)

The use of resolution powers should be reserved for when no other options are available – or other options have been exhausted – to avert the failure of a deposit taker, to manage it in an orderly way or to address a material threat to financial stability.

Given the special nature and purpose of resolution powers, there should be as clear a delineation as possible between lesser interventions to address matters of prudential concern and the point at which the use of resolution powers becomes warranted. Clarity in the triggers for exercising resolution powers also helps investors to understand the risks associated with their investments and to price those risks accordingly.

It is proposed that there is a set of clear statutory triggers that will enable the Reserve Bank to act proactively before a licensed entity actually reaches the point of failure. In order to place a deposit taker into resolution, the Reserve Bank would need to be satisfied on reasonable grounds that both a non-viability test and a necessity test have been met. The non-viability test should be satisfied when one or more of the following applies to a licensed entity:

- The value of the deposit taker's assets is or is likely soon to be less than the value of its liabilities.
- The deposit taker is unable or likely to become unable to pay its debts as they fall due.
- The deposit taker has persistently or seriously failed to comply with any direction, condition or other requirement that it must comply with to be a licensed deposit-taker.
- The deposit taker is failing or has failed to maintain a minimum amount (or ratio) of capital as required under an applicable standard or licence condition.

The necessity test, which would be applied after the non-viability test has been met, is an assessment of whether there is no reasonable prospect – based on the opinion of the supervisory and resolution authority – of the non-viable deposit taker being remedied outside resolution to the satisfaction of the resolution authority.

Both the non-viability test and the necessity test would need to be satisfied for a resolution to be initiated.

These tests have been based on the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions, to ensure that the Reserve Bank is able to initiate timely entry into resolution before a firm is balance sheet insolvent.

4.7.Q.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have considered the following assessment criteria in considering the likely impacts of the proposed option:

- **Proportionately responds to financial stability risks:** The proposed statutory triggers should provide the resolution authority with timely access to a resolution toolkit that increases the range of resolution options and delivers resolution in an orderly manner without causing disruption to critical financial services or damage to financial stability.
- **Clarity, legitimacy and appropriate safeguards:** There should be as clear a delineation as possible between lesser interventions to address matters of prudential concern and the point at which the use of resolution powers becomes warranted. The triggers themselves should provide clarity to licensed entities and their investors and creditors as to when they can expect an entity to be placed into resolution by authorities.

4.7.Q.4 What other options have been ruled out of scope, or not considered, and why?

The proposed approach is representative of the main options considered in our analysis. In order to facilitate cross-border resolutions, officials are considering an additional resolution trigger to deal with the situation where an overseas authority has taken, or is taking, resolution action against the deposit taker or a member of the deposit taker's group. Ministerial consideration of the additional resolution triggers will be progressed outside of this set of decisions.

One option that was considered was to require the publication of guidance on the operation of resolution triggers. We concluded that such a requirement did not need to be put into legislation (although the Reserve Bank may still do it of its own accord) as specific thresholds such as minimum capital requirements for licensed entities will be set out by the Reserve Bank in standards or license conditions.

4.7.Q.5 What do stakeholders think?

There was broad support for the proposed approach to defining the conditions for placing a deposit taker into resolution. Several submitters agreed that greater specification would be required. The consultation document noted that greater specification could be required through the Reserve Bank being required to publish a 'statement of approach' that specified conditions to a greater extent.

Two submitters acknowledged the role that such guidance could play in mitigating their concerns. Two submissions favoured purely financial indicator triggers (e.g. capital levels) for the objectivity and transparency that they offered. One submitter was concerned that a failure to meet a nonfinancial licensing requirement was too broad a trigger and that licensing issues should be addressed with non-resolution tools.

Elements of the non-viability test have been amended following the third consultation, in part due to concerns raised in submissions. Several of the submitters expressed their concern that elements of the test (in particular, limb C, which in the proposal in consultation was linked to de-licensing) would operate as too low of a bar for putting an entity into resolution. The reasons for this centred on the fact that a licenced entity might still be financially viable, despite meeting this element of the test. There was also concern that this test might operate as a "hair trigger", when it should instead be reserved for the most serious contraventions.

Limb C has been re-framed to focus this part of the test on persistent and serious contraventions, consistent with the test in the IPSA. Triggers for resolution should provide a balance between clear and well-defined scenarios for a serious regulatory action, as against an empowered resolution authority that is able to act proactively in emerging financial crises, before the point where an entity is balance sheet insolvent. In addition, the elements of the non-viability test would not justify putting an entity into resolution in of themselves, as the necessity test must also be met. This means that the Reserve Bank would also need to show that resolution is the only reasonable option at that time, in addition to showing that non-viability test has been met.

4.7.Q.6 Impact analysis

	Status quo	Option 1: Proposed approach
Proportionately responds to financial stability risks	0	++ Would enable the resolution authority to intervene before a licensed entity is balance sheet insolvent and thereby resolve a failing entity in an orderly manner without causing disruption to critical financial services or damage to financial stability
Clarity and legitimacy	0	++ Would improve clarity and legitimacy by clearly articulating the conditions that must be met before resolution powers can be exercised. May help investors to understand the risks associated with their investments and to price those risks accordingly.
Durability and flexibility of the law	0	++ Will enable the resolution authority to deal most effectively with different deposit takers in a range of failure scenarios
Overall assessment	0	++

4.7.Q.7 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers the proposed approach. As noted above, this approach would enable the resolution authority to intervene before a licensed entity is balance sheet insolvent and thereby resolve a failing entity in an orderly manner without causing disruption to critical financial services or damage to financial stability.

The Treasury supports the proposed approach.

4.7.Q.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** $m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	**Evidence certainty** (High, medium or low)
Additional costs of proposed approach compared to taking no action			
Regulated parties	There is a potential cost of institutions having to comply with directions at earlier stages prior to resolution?	Low	Medium
Regulators	No additional costs.		
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Medium
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits associated with improved clarity on the resolution authority's triggers for resolution.	Low	Medium
Regulators	Benefits associated with intervening at earlier stages to reduce the risk of institutions reaching the point of non-viability		
Wider government			
Other parties	Improved public confidence in the regulation of deposit takers, reducing the likelihood and severity of bank runs and disorderly bank failures, and contributing to financial stability. Increased clarity for investors and creditors, better enabling them to price risk into their decision-making.	Medium	Medium
Total Monetised Benefit			
Non-monetised benefits		Low-Medium	Medium

4.7.Q.9 What other impacts is this approach likely to have?

No other impacts have been identified.

R. Liabilities that would be subject to statutory bail-in

4.7.R.1 What is the specific problem?

For bail-in to be a credible and orderly resolution option it is essential that there is *ex ante* transparency on the scope of eligible bail-in instruments (i.e. liabilities subject to write-down or conversion). This enables investors and creditors to assess the risks associated with, and the pricing of, liabilities potentially subject to bail-in. The FSB's Principles on Bail-in Execution[69] recommend that resolution regimes clearly define the scope of instruments and liabilities to which statutory bail-in could be applied.

4.7.R.2 What options are available to address the problem?

Internationally, jurisdictions have different approaches to specifying the scope of statutory bail-in powers. Two contrasting examples from modern resolution regimes are those of the United Kingdom and Canada. The United Kingdom takes what might be called a broad, 'negative list' approach, where all liabilities are included except those on a negative list.[70]

In contrast, Canada's approach is to specify a more targeted, relatively short positive list of liabilities subject to statutory bail-in.[71] The bail-in framework in Canada applies only to the six domestic systemically important banks.

69 Financial Stability Board (June 2018). Principles on Bail-in Execution. Available at: https://www.fsb.org/wp-content/uploads/P210618-1.pdf

70 The United Kingdom's negative list can be summarised as:

- insured deposits
- secured liabilities (e.g. covered bonds)
- liabilities arising from holding client assets (that is, where the property is not that of the failed entity)
- liabilities with an original maturity of less than seven days owed to a credit institution or investment firm (i.e. short-term inter-bank liabilities)
- liabilities arising from participation in designated settlement systems
- liabilities owed to employees or pension schemes
- liabilities relating to the provision of critical services to the deposit taker
- derivatives.

71 Canada's list comprises:

- debt that is:
  - unsecured (or, if partly secured, only the unsecured portion)
  - tradable
  - transferable, and
  - for an initial term of at least 400 days; and
- any share or subordinated debt that is neither a common share nor 'non-viability contingent capital' (instruments that are convertible to common shares by their terms at the point of non-viability of the entity).

We have considered, and consulted on, the following approaches to which liabilities would be subject to bail-in. In considering the available options, we are mindful that bail-in as a resolution strategy would not generally be expected to be used in the failure of a smaller, largely deposit-funded institution where liquidation and an insurance payout of insured deposits may be more suitable.

Option 1: Broad approach

In general, by focussing on exclusions, the broader approach is likely to result in a wider pool of liabilities being potentially available for a bail-in.

However, it may pose challenges for the resolution authority in identifying a logistically practical set of liabilities and liability holders to bail in without departing from the *pari passu* rules of treating creditors of the same class on an equal footing.

Option 2: Targeted approach

By contrast, a more targeted approach, perhaps focused on long-term debt instruments, would make it easier to bail in a smaller number of those liability holders who would be best suited for it – wholesale institutional investors. The targeted approach (such as Canada's) enables deposits – whether insured or not – to be unambiguously excluded from the scope of statutory bail-in.

Option 3: Broad approach with specified minimum requirements (preferred approach)

The Review is proposing that liabilities eligible for bail-in be closely aligned with international practice (particularly the United Kingdom and EU, which a number of other jurisdictions have also followed). A proposed list of exclusions[72] would leave eligibility for bail-in essentially limited to subordinated capital and debt instruments (including structurally subordinated debt issued to a holding company or a parent institution), uninsured deposits, and unsecured wholesale debt.

While the scope of bail-in may be relatively broad, further refinement is required and pre-positioning would be required to support an 'open resolution' because:

- the availability of certain otherwise eligible liabilities (short-term debt and uninsured deposits) cannot be relied upon for planning purposes and
- some bail-inable liabilities will need to be subordinated to other liabilities that otherwise rank equally in the creditor hierarchy.

72 The following liabilities would be excluded from the scope of statutory bail-in: secured liabilities, including those related to covered bonds; client assets held by a deposit taker in trust or in a custodial capacity; liabilities owed to an employee or former employee; tax liabilities and liabilities owed to retirement savings schemes – e.g., KiwiSaver; liabilities owed to creditors arising from the provision to the deposit taker of goods or services (other than financial services) that are critical to the daily functioning of the deposit taker's operations; liabilities owed to the deposit insurance scheme; derivatives and debt instruments with derivative-linked features, including liabilities under netting agreements that are subject to New Zealand's netting legislation (but this exclusion does not apply to unsecured net amounts due to a counterparty after the application of the netting provisions).

The Review considered two approaches for setting out which liabilities would be eligible for minimum requirements for planning an open resolution with bail-in. The preferred approach is for the Reserve Bank to define eligibility for minimum requirements in standards. The alternative approach is to set eligibility through Regulations made by Order in Council.

While the Regulations approach provides greater certainty, the preferred approach is consistent with how the Reserve Bank will set minimum capital requirements (also via standards), which allows minimum bail-in requirements to be seen as an extension of going concern capital requirements. It also allows for alignment between Reserve Bank communications on bail-in planning and communications on the implementation of its capital review decisions.

4.7.R.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have considered the following assessment criteria in considering the likely impacts the options:

- **Proportionately responds to financial stability risks:** The key to making bail-in a credible resolution tool is to ensure that only liabilities that can readily and credibly be bailed in are included within bail-in's scope.
- **Clarity and legitimacy**: Clarity on the liabilities that can be readily and credibly bailed in supports resolution planning and investment planning.

4.7.R.4 What other options have been ruled out of scope, or not considered, and why?

The options noted above are representative of the main options considered in our analysis.

4.7.R.5 What do stakeholders think?

During the consultation process, almost all submissions that commented on crisis management favoured taking the broader, negative list approach to the scope of statutory bail-in. Only one preferred the narrower, positive list approach. Simplicity was a key factor in views expressed, although there were opposing views as to which approach was simpler. For some submitters, what mattered more was having clarity in the result rather than how one got there. Banks (including the NZBA) desired that the approach to bail-in should align with international practice.

There were opposing views on whether uninsured deposits should be included within the scope of bail-in. Two submissions thought deposits should be excluded from bail-in. Two submitters thought that deposits should be included in bail-in provided that deposits were made higher in the creditor hierarchy (e.g. via deposit preference). Only one submitter thought deposits should be included in bail-in without qualification.

Almost all submissions that commented on crisis management opposed statutory bail-in being applicable to pre-existing liabilities (e.g. bonds already issued at the time the powers are legislated for). A key concern was that investors should be able to price the risk of bail-in into their decision-making at the time of making their investments.

4.7.R.6 Impact analysis

	Option 1: Broad approach *Treated as status quo*	**Option 2: Targeted approach**	**Option 3: Broad approach with specific minimum requirements (preferred)**
Proportionately responds to financial stability risks	0	- Would reduce the pool of liabilities being potentially available for a bail-in.	++ This approach would ensure bail-in is a credible resolution tool, providing the resolution authority with a tool to resolve failing banks quickly, without destabilising the financial system or exposing taxpayers to loss
Clarity and legitimacy	0	+ Is unambiguous on the scope of liabilities excluded from statutory bail-in.	++ Would provide clarity on the liabilities that can be readily and credibly bailed in. Would support investment planning.
Overall assessment	0	0	++

4.7.R.7 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 3: a broad approach with specific minimum requirements. As noted above, this approach would ensure bail-in is a credible resolution tool, providing the resolution authority with a tool to resolve failing banks quickly, without destabilising the financial system or exposing taxpayers to loss.

The Treasury supports the proposed approach.

4.7.R.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** $m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	**Evidence certainty** (High, medium or low)
Additional costs of proposed approach compared to taking no action			
Regulated parties	Potential additional funding costs in relation to debt instruments that will be eligible for bail-in, offset by the low risk of bail-in being used due to the Reserve Bank's capital requirements.	Low	Medium

Regulators	Additional costs associated with operationalising a bail-in regime	Medium	Medium
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low-Medium	Medium

Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits associated with clarity on liabilities subject to bail-in	Low	Medium
Regulators	Benefits associated with clarity on liabilities subject to bail-in	Medium	Medium
Wider government	Benefits by way of avoided taxpayer bailouts	Medium	Medium
Other parties	Improved investment decision-making. Improved public confidence in the regulation of deposit takers, reducing the likelihood and severity of bank runs and disorderly bank failures, and contributing to financial stability	Medium	Medium
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.7.R.9 What other impacts is this approach likely to have?

No other impacts have been identified.

S. Role of the Minister during resolution planning

4.7.S.1 What is the specific problem?

The Minister of Finance has a strong and legitimate interest in ensuring that bank resolution policies appropriately manage the broader fiscal and macroeconomic risks associated with banking failures. A Minister of Finance has key responsibilities on behalf of the government in a deposit taker failure. These include:

- understanding and managing the economic and social impact risks associated with deposit taker failure and the management of such failures
- the wider international (especially trans-Tasman) relationship dimensions of the management of the failure of any of New Zealand's foreign-owned banks
- managing expectations that public funds will be put at risk to manage a deposit taker failure, and

- managing fiscal risk to the government in the event that public funds are put at risk to manage a deposit taker failure.

However, the 1989 Reserve Bank Act does not set out a clear role for the Minister that reflects this interest. There are a number of shortcomings:

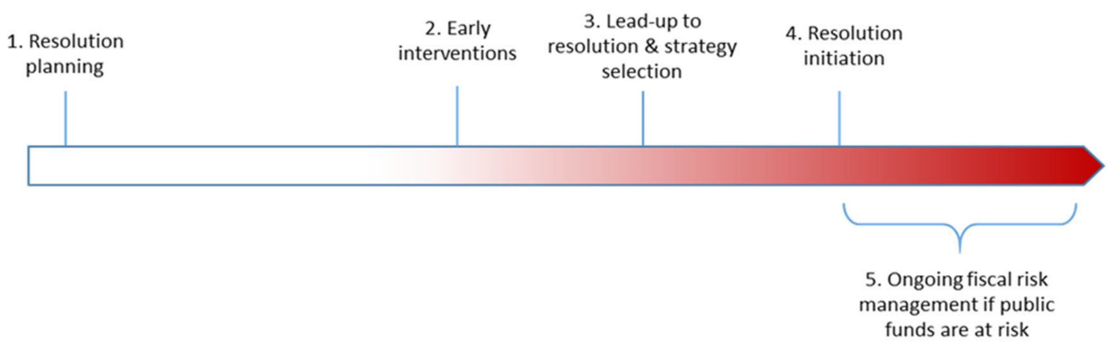
- While the Act requires the Minister's consent or approval in several areas, the Minister's role is entirely reactive. At all points the Reserve Bank has to make a recommendation to the Minister – with the implied expectation that the Minister would agree or not agree.
- There is no explicit provision for the Minister to direct the Reserve Bank, even if public funds were, or were likely to be, required.
- The 1989 Reserve Bank Act does not require early consultation with the Minister (or other agencies) on emerging financial crises.
- The Minister's consent is required for all types of direction – including, for example, something as simple as a direction requiring a bank to consult the Reserve Bank.

While Ministers normally set expectations, monitor performance, and have a role influencing policy, the current framework involves the Minister in decisions that the Review considers to be operational in nature (e.g. consent to enforcement directions). The IMF expressed concern that the requirement for ministerial consent for all directions was not in line with best-practice supervisory independence and would reduce the timeliness of supervisory enforcement actions. The IMF recommended that ministerial consent be required only for resolutions with fiscal or systemic implications.

The current arrangements threaten to slow down the Reserve Bank's ability to respond quickly when timeliness will likely be of the essence. They also do not provide the Minister with any formal tools to direct events when appropriate – for example, when public funds may be at risk or if wider economic issues (e.g. economic relations with Australia) need to be considered.

Figure 7 below shows the five key points of ministerial interest in crisis management.

Figure 7: Key points of ministerial interest in crisis management



4.7.S.2 What options are available to address the problem?

The Review has considered the following option to address the problem.

Option 1: Requirement to consult the Minister of Finance in the preparation of the statement of approach

During normal times, the Reserve Bank would be required to develop resolution plans for deposit takers (advanced planning being critical to smooth and orderly resolutions). Resolution plans should set expectations as to how a deposit taker would be resolved in the event of triggering the conditions for resolution. The Minister of Finance would not be involved in the development of resolution plans.

It is proposed that, alongside the development of these resolution plans, the Reserve Bank will be required to consult the Minister of Finance in the preparation of a general 'statement of approach to resolution' and to have regard to the Minister's view's before finalising the statement. The statement of approach will be required to be published and should include:

- the expected resolution strategy or strategies for different types of deposit taker[73]
- the approach to collaborating with other agencies (e.g. the Treasury) in resolution planning
- how the Reserve Bank will inform and engage with the Minister of Finance and other agencies on the use of crisis management and resolution powers (including the use of early intervention powers such as directions and removing/appointing directors and on consultation prior to an entity being put into resolution).

4.7.S.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

Broadly, the crisis management framework needs to strike a balance between an appropriate level of operational independence for the Reserve Bank in performing the resolution authority function on one hand and appropriate opportunities and levers for the Minister of Finance to manage the government's interest in crisis management on the other.

The resulting statutory framework needs to strike a workable balance between what can at times be both competing and complementary policy objectives:

- **Proportionately responds to financial stability risks**: the desirability of the resolution authority being able to act swiftly and independently to protect financial stability interests and having power to set regulatory requirements and plan for resolution ahead of time
- **Accountability:** the ability for a Minister of Finance to execute the Minister's responsibility on behalf of the government for managing the potential wider economic, social, international, and fiscal impacts and risks of a deposit taker failure and its resolution

73 Publication of such a statement will be an important basis for setting expectations of investors and other creditors and enabling them to appropriately price risk into their investment decisions.

- **Credibility:** the desirability of presenting to the deposit taking sector, investors, creditors, and the general public a credible alternative to taxpayer bailouts of deposit takers, especially of large deposit takers where immediate closure upon failure would be damaging to financial stability and the wider economy.

4.7.S.4 What other options have been ruled out of scope, or not considered, and why?

The preferred option is representative of the main options considered in our analysis. Officials also considered a requirement to *inform* (rather than consult) the Minister of Finance in the preparation of the statement of approach but considered that a greater role for the Minister is necessary given the government's interest in crisis management. Officials also considered whether the statement of approach to resolution should be subject to the Minister's approval or agreement, but concluded that the statement is better if fully owned by the Reserve Bank.

4.7.S.5 What do stakeholders think?

The Review did not consult stakeholders on this issue due to the nature of the issue, and some timing and sequencing constraints. As this issue concerns the relationship between the Minister of Finance and the regulator, any impact of the proposed approach on external stakeholders is marginal.

4.7.S.6 Impact analysis

	Status quo	Option 1: proposed approach
Proportionately responds to financial stability risks	0	+ Would support the Reserve Bank's ability to act swiftly and independently to protect financial stability interests in the event of a banking crisis without reliance on public funds
Accountability	0	++ Would provide the Minister of Finance with an opportunity to ensure that the potential wider economic, social, international, and fiscal impacts and risks of a deposit taker failure and its resolution are taken into account in the early stages of planning
Credibility	0	+ Consultation with the Minister of Finance would support the credibility of the resolution framework to the deposit taking sector, investors, creditors, and the general public
Overall assessment	0	+

4.7.S.7 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 1. Under our preferred option, the Reserve Bank would be required to consult the Minister of Finance in the preparation of the statement of approach. Consultation is intended to provide an opportunity for the Minister to be comfortable with the Reserve Bank's approach to resolution planning and preferred resolution strategies, especially on the costs and benefits of different resolution strategies and – importantly – to manage expectations of reliance on public funds

The Treasury supports the proposed approach.

4.7.S.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** $m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	**Evidence certainty** (High, medium or low)
Additional costs of proposed approach compared to taking no action			
Regulated parties			
Regulators	Additional costs associated with implementation	Low-medium	Medium
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low-Medium	Medium
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits through clarity on the Reserve Bank's ability to act swiftly and independently to protect financial stability interests in the event of a banking crisis without reliance on public funds	Low	Medium
Regulators	Benefits through providing an appropriate level of operational independence of the Reserve Bank	Low	Medium
Wider government	Benefits through engagement of the Minister of Finance at key points	Medium	Medium
Other parties	Improved public confidence in the regulation of deposit takers and the resolution framework, reducing the likelihood and severity of bank runs and	Medium	Medium

	disorderly bank failures, and contributing to financial stability.		
Total Monetised Benefit			
Non-monetised benefits		Low-Medium	Medium

4.7.S.9 What other impacts is this approach likely to have?

No other impacts have been identified.

T. Responsibilities for triggering resolution

4.7.T.1 What is the specific problem?

Placing a deposit taker into resolution is a significant intervention for authorities to take. It overrides ordinary shareholder rights without the kind of court oversight that exists in a normal liquidation. Entering resolution unlocks significant powers of intervention for the resolution authority. The key policy question is whether the act of placing a deposit taker into resolution should be exercised independently by an appropriately empowered regulator or whether there is an appropriate role for an elected official given the gravity of the decision and its possible impacts.

Reasonable cases can be made both for the decision being made by an independent regulator or for the decision being made at the ministerial level. International practice varies.

4.7.T.2 What options are available to address the problem?

The Review has considered the following options to address the problem.

Option 1: Resolution authority to take decision

The first approach is that Parliament empowers the Reserve Bank as resolution authority to take the decision. This approach recognises that assessing a deposit taker's situation against the statutory criteria for resolution requires a substantial degree of technical expertise or expert judgement of complex issues. There are judgements to be made, but these are judgements that an independent regulator, rather than a Minister, may be best placed to make. It also helps to avoid risks of politicising the decision (particularly the risk of Ministers being pressured to opt for taxpayer bailouts instead). Providing that the Minister had been consulted on, and is comfortable with, the resolution strategy and that wider economic, social, and international impacts have been appropriately considered and addressed, the final decision could be taken by the resolution authority acting in accordance with its statutory objectives.

Option 2: Minister of Finance to take decision

The second approach is that the decision be taken by the Minister of Finance – on the recommendation of the Reserve Bank. This approach recognises that, in some cases at least, the potential impacts of the approach to resolution could be seen as warranting the explicit endorsement of the government of the day and the additional 'legitimacy' that a formal government approval imparts. The risks are that politicising the decision could result in sub-optimal approaches to resolving the failed entity.

International practice is mixed. The United Kingdom and Australia, for example, fully empower their resolution authorities to put an entity into resolution. Canada, on the other hand, requires an order of the 'Governor in Council'.

Option 3: A tiered approach (preferred)

The third, and preferred, approach is a combination of the two approaches outlined above.

Under this approach, an open resolution based on bailing in prepositioned wholesale funding or a parent entity's funding would be able to be executed by the resolution authority without formal involvement of the Minister of Finance. Such resolutions aim for a rapid recapitalisation using the internal resources of the failed entity resulting in uninterrupted operations including continued access to accounts and critical financial services.

In all other cases, formal ministerial agreement would be required. These are resolutions where:

- losses are envisaged to be imposed on a broader set of creditors that are not prepositioned for it, as part of minimum requirements for bail-in planning
- the deposit taker would be wound down after transferring deposits and matching assets to another entity
- the deposit taker may be closed and a deposit insurance payout made.

Irrespective of whether the Reserve Bank is empowered to put a deposit taker into resolution or whether it requires a decision from the Minister of Finance, further work is required on the options for the 'legal instrument' that the DTA would require to be transmitted. Recommendations on the legal instrument will be provided in a subsequent tranche of advice.

4.7.T.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

Broadly, the crisis management framework needs to strike a balance between an appropriate level of operational independence of the Reserve Bank in performing the resolution authority function on one hand and appropriate opportunities and levers for the Minister of Finance to manage the government's interest in crisis management on the other.

The resulting statutory framework needs to strike a workable balance between what can at times be both competing and complementary policy objectives:

- **Proportionately responds to financial stability risks**: the desirability of the resolution authority being able to act swiftly and independently to protect financial stability interests and having power to set regulatory requirements and plan for resolution ahead of time
- **Accountability:** the ability for a Minister of Finance to execute the Minister's responsibility on behalf of the government for managing the potential wider economic, social, international, and fiscal impacts and risks of a deposit taker failure and its resolution
- **Credibility:** the desirability of presenting to the deposit taking sector, investors, creditors, and the general public a credible alternative to taxpayer bailouts of deposit takers, especially of large deposit takers where immediate closure upon failure would be damaging to financial stability and the wider economy.

4.7.T.4 What other options have been ruled out of scope, or not considered, and why?

The options are representative of the main options considered in our analysis.

4.7.T.5 What do stakeholders think?

The Review did not consult stakeholders on this issue due to the nature of the issue, and some timing and sequencing constraints. As this issue concerns the relationship between the Minister of Finance and the regulator, any impact of the proposed approach on external stakeholders is marginal.

4.7.T.6 Impact analysis

	Option 1: Resolution authority to take decision	**Option 2: Minister of Finance to take decision** *This option is treated as status quo*	**Option 3: A tiered approach (preferred)**
Proportionately responds to financial stability risks	+ Resolution authority is able to react with speed	- Political involvement could result in undesirable delays or sub-optimal decisions	++ Would support the Reserve Bank's ability to act swiftly and independently in open resolutions of large banks and in concert with the Minister in other cases
Accountability	++ Resolution authority is empowered and accountable for the decision	- Can blur accountability given that a Minister is likely to be unable to disagree with the resolution authority's assessment	+ Would tailor the Minister of Finance's involvement with resolution, in particular, to target involvement in resolutions that entail greater impacts and risks

Credibility	0 Supports ‘credible commitment’ but may run up against the Minister’s role in ensuring wider economic and social impacts are managed	- Would add some level of complexity given the potential introduction of political considerations, but offset by ensuring a role for the Minister to manage wider economic and social impacts	+ A tiered level of involvement by the Minister of Finance would support the credibility of the resolution framework to the deposit taking sector, investors, creditors, and the general public
Overall assessment	0	-	+

4.7.T.7 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 3: A tiered approach. As noted above, this approach would support the Reserve Bank’s ability to act swiftly and independently in open resolutions of large banks and in concert with the Minister in other cases.

The Treasury supports the proposed approach.

4.7.T.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** $m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	**Evidence certainty** (High, medium or low)
Additional costs of proposed approach compared to taking no action			
Regulated parties			
Regulators	Additional costs associated with implementation	Low-medium	Medium
Wider government	Additional costs associated with implementation	Low-medium	Medium
Other parties			
Total Monetised Cost			
Non-monetised costs		Low-Medium	Medium
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits through clarity on the Reserve Bank’s ability to act swiftly and independently to protect financial stability interests in the event of a banking crisis without reliance on public funds	Low	Medium

Regulators	Benefits through providing an appropriate level of operational independence of the Reserve Bank	Low	Medium
Wider government	Benefits through government involvement for resolutions that entail potential for wider economic, social, international, and fiscal impacts, and risks of a deposit taker failure and its resolution	Medium	Medium
Other parties	Improved public confidence in the regulation of deposit takers and the resolution framework, reducing the likelihood and severity of bank runs and disorderly bank failures, and contributing to financial stability.	Medium	Medium
Total Monetised Benefit			
Non-monetised benefits		Low-Medium	Medium

4.7.T.9 What other impacts is this approach likely to have?

No other impacts have been identified.

U. Managing risks to the financial position and interests of the Crown in a resolution

4.7.U.1 What is the specific problem?

If a resolution involved risks to the financial position and interests of the Crown, for example, through a government guarantee or equity injection, only the Minister of Finance, as authorised by Parliament, has the ability to commit or put at risk public funds in a resolution. An important question is whether the Minister should have statutory powers to direct the Reserve Bank in order to manage any risks to the financial position and interests of the Crown.

The Reserve Bank will have a resolution objective to protect public funds. Nevertheless, there is inherent uncertainty in crises and the crisis management framework should provide sufficient levers for the Minister of Finance to demonstrate an ability to prudently manage fiscal risks facing the government in line with the principles of responsible fiscal management set out in section 26G of the Public Finance Act 1989. A residual ministerial lever to manage fiscal risk is particularly important if the Minister of Finance weights the need to protect the financial position and interests of the Crown differently than the Reserve Bank does in balancing its multiple resolution objectives (of which protecting public funds is just one).

Ministerial oversight of, and accountability to Parliament for, decisions involving the actual or contingent expenditure of public funds is embedded in New Zealand's public finance management framework and the democratic traditions underpinning that framework.

4.7.U.2 What options are available to address the problem?

The Review has considered the following option to address the problem.

Option 1: The Minister of Finance is able to direct the Reserve Bank to manage the risks to the financial position and interests of the Crown in a resolution (preferred)

Under this option, Parliament, via the DTA, would provide the Minister with the ability to direct the Reserve Bank to manage the risks to the financial position and interests of the Crown in a resolution. The intention would be that the direction power is a residual lever only in order to enable the Minister to protect the financial position and interests of the Crown and not used for day-to-day intervention in a resolution.

Procedures for issuing a direction should be consistent for directions issued under other legislation such as the Crown Entities Act subject to any commercial confidentiality requirements. The DTA will need to make appropriate provision for prioritising a direction over the Reserve Bank's other statutory resolution objectives if there were to be a conflict.

For the purposes of this direction power, 'risk to the financial position and interests of the Crown' is proposed to cover the Crown's financial interest in making commitments such as government guarantees, loans, indemnities, share purchases and underwriting, and equity injections. It would exclude the Reserve Bank's use of its own funds or use of the deposit insurance scheme funds or the government fiscal backstop for the deposit insurance scheme (conditions for which would be governed under separate provisions).

4.7.U.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

Broadly, the crisis management framework needs to strike a balance between an appropriate level of operational independence of the Reserve Bank in performing the resolution authority function on one hand and appropriate opportunities and levers for the Minister of Finance to manage the government's interest in crisis management on the other.

The resulting statutory framework needs to strike a workable balance between what can at times be both competing and complementary policy objectives:

- **Proportionately responds to financial stability risks:** the desirability of the resolution authority being able to act swiftly and independently to protect financial stability interests and having power to set regulatory requirements and plan for resolution ahead of time
- **Accountability:** the ability for a Minister of Finance to execute the Minister's responsibility on behalf of the government for managing the potential wider economic, social, international, and fiscal impacts and risks of a deposit taker failure and its resolution
- **Credibility:** the desirability of presenting to the deposit taking sector, investors, creditors, and the general public a credible alternative to taxpayer bailouts of deposit takers, especially of large deposit takers where immediate closure upon failure would be damaging to financial stability and the wider economy.

4.7.U.4 What other options have been ruled out of scope, or not considered, and why?

The option above is representative of the main option considered in our analysis.

4.7.U.5 What do stakeholders think?

The Review did not consult stakeholders on this issue due to the nature of the issue, and some timing and sequencing constraints. As this issue concerns the relationship between the Minister of Finance and the regulator, any impact of the proposed approach on external stakeholders is marginal.

4.7.U.6 Impact analysis

	Status quo	Option 1: proposed approach
Proportionately responds to financial stability risks	0	+ Provides a residual lever for the Minister to act if necessary.
Accountability	0	++ Legislation will clarify that the RBNZ is not accountable for achieving resolution objectives to the extent that doing so is impacted by the need to give effect to the Minister's direction.
Credibility	0	+ Provides a clear lever for the Minister to manage fiscal risks, which in turn provides credibility to any plan that involves risks to the financial position and interests of the Crown.
Overall assessment	0	+

4.7.U.7 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 1. As noted above, this approach would provide a clear lever for the Minister to manage fiscal risks, which in turn provides credibility to any plan that involves risks to the financial position and interests of the Crown.

The Treasury supports the proposed approach.

4.7.U.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** $m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	**Evidence certainty** (High, medium or low)

Additional costs of proposed approach compared to taking no action			
Regulated parties			
Regulators	Additional costs associated with giving effect to a direction	Low	Medium
Wider government			
Other parties	Residual risk that the Minister may put Crown interests ahead of the interests of other stakeholders	Low	Medium
Total Monetised Cost			
Non-monetised costs		Low	Medium

Expected benefits of proposed approach compared to taking no action			
Regulated parties			
Regulators			
Wider government	Benefits through having a residual lever to manage fiscal risks facing the government	Medium	Medium
Other parties			
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.7.U.9 What other impacts is this approach likely to have?

No other impacts have been identified.

V. Incurring expenditure without appropriation in a financial crisis

4.7.V.1 What is the specific problem?

The use of public funds in resolving a failed financial institution carries significant risks, particularly in terms of moral hazard and raising expectations that the government will bail out failed financial institutions. Nevertheless, having the ability to deploy a public funds solution has a place in a comprehensive financial crisis management and resolution framework – as a last resort option in certain circumstances.

These circumstances would generally be when other options – including those developed in this Review – are not able to ensure an orderly resolution that avoids damage to the wider financial system, whether it be by avoiding contagion or ensuring the continuation of financial services critical to the wider economy. These circumstances would generally not include bailing out a small deposit taker, where closure supported by deposit insurance should provide a credible alternative to government bailouts.

A potentially critical gap in New Zealand's current legislative framework is the ability of the government to use public funds in a financial crisis where:

- funding needs to be provided quickly to protect financial system stability, avoid further damage to the financial system, and maintain critical financial services, and
- the funds required exceed Imprest Supply or an existing available appropriation or there is no appropriation.

This gap applies not just in relation to deposit takers, but also in relation to insurers and other critical parts of the financial system such as financial market infrastructure. The Review has considered how to address this gap in relation to all of these types of financial entities – as long as they are regulated by the Reserve Bank.

A key enabler for governments to respond to emergencies quickly and effectively is authority to incur expenditure without an existing appropriation to meet the needs of the emergency. Section 25 of the Public Finance Act 1989 provides for unappropriated expenditure when either a state of emergency is declared under the Civil Defence Emergency Management Act 2002 or a situation occurs that affects the public health or safety of New Zealand or any part of New Zealand that the government declares to be an emergency. Neither of these scenarios would support unappropriated expenditure in support of a failing financial institution.

Imprest Supply could be used to provide financial support to an entity, but it is not possible to know in advance the size of a financial failure or how much contingency will exist in Imprest Supply at the time to meet a financial support package. Imprest Supply cannot therefore be relied upon in a financial crisis, particularly if the failing entity were a large one or if multiple entities required support.

Parliament can be asked to pass specific spending authority through an Appropriation Act or additional Imprest Supply. However, a government cannot always rely on the availability of Parliament to do so in the time required. Resolution of a financial entity must be able to be executed in a timely manner and, at least initially, often out of the public eye; speed is usually of the essence if damage to the wider financial system and economy is to be avoided.

4.7.V.2 What options are available to address the problem?

The Review has considered the following option to address the problem.

Option 1: Public Finance Act amendment providing authority to incur expenditure without an appropriation in a financial crisis

The Review proposes a new section in the Public Finance Act similar to existing section 25 but focussed on and tailored to the requirements of a financial crisis (whether in banking or insurance, such as the post-Canterbury earthquake AMI Insurance crisis in 2011).

A standing authority to spend without an appropriation in a financial crisis should be available only in extraordinary circumstances. Like the existing section 25, this power would by-pass the usual processes for obtaining spending approval from Parliament or agreement from Cabinet to use Imprest Supply. It is therefore important that the circumstances in which this power can be exercised are limited and are only where it is impracticable to use other options, such as through Parliamentary authorising specific spending, to resolve the situation.

Such statutory conditions on the use of the power can also help guard against the risk of creating an expectation of government bailouts which, in turn, could have unwanted moral hazard implications.

We therefore propose that a power for the Minister of Finance to approve expenditure in a financial crisis without an appropriation should apply only to financial entities regulated by the Reserve Bank and can only be exercised where the following conditions are met:

i. The Reserve Bank has advised the Minister of Finance that the financial entity is insolvent or would soon be insolvent or otherwise considered to be failing financially

ii. The Minister is satisfied that the expenditure is:

  a. necessary or expedient in the public interest, and

  b. necessary to maintain the stability of the financial system and the continuity of critical financial services

iii. the Minister is satisfied that all other options consistent with the public interest to resolve the entity without using public funds had either been exhausted, were unlikely to succeed on their own, or were not in the public interest under the circumstances, and

iv. the Minister is satisfied that adequate arrangements will be in place to prudently manage fiscal risks to the government arising from the expenditure.

The proposed amendment would be intended to enable financial support packages to be approved only for deposit takers, insurers, and payments systems when financial stability was at risk or that provide financial services critical to the functioning of the wider economy, and only as a last resort, where it is infeasible or inappropriate for Parliament to pass specific spending authority through an Appropriation Act or additional Imprest Supply.

4.7.V.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The Review has identified the following assessment criteria in considering whether to introduce a Public Finance Act amendment providing authority to incur expenditure without an appropriation in a financial crisis.

- Proportionately responds to financial stability risks
- Legitimacy / accountability

4.7.V.4 What other options have been ruled out of scope, or not considered, and why?

The proposed option is the main option considered in our analysis.

4.7.V.5 What do stakeholders think?

The Review did not consult stakeholders on this issue due to the nature of the issue, and some timing and sequencing constraints.

4.7.V.6 Impact analysis

	Status quo	Option 1: proposed approach
Proportionately responds to financial stability risks	0	++ Would enable the Reserve Bank to act swiftly to protect financial stability interests
Legitimacy / accountability	0	+ Would enable the Minister of Finance to execute the Minister's responsibility on behalf of the government for managing the potential wider economic, social, international, and fiscal impacts and risks of a deposit taker failure and its resolution. On the other hand, it would constrain the ability of Parliament to authorise expenditure of public money.
Overall assessment	0	+

4.7.V.7 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank is neutral on this recommendation, which is proposed by the Treasury. The subject matter is outside the scope of the Reserve Bank's mandate or expertise.

The Treasury supports the proposed approach.

4.7.V.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** $m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	**Evidence certainty** (High, medium or low)
Additional costs of proposed approach compared to taking no action			
Regulated parties			
Regulators			

Wider government	Costs in reduced ability of Parliament to authorise expenditure of public money.	Low	Medium
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Medium

Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits through clarity on the Reserve Bank's ability to act swiftly to protect financial stability interests in the event of a banking crisis without reliance on public funds	Low	Medium
Regulators			
Wider government			
Other parties			
Total Monetised Benefit			
Non-monetised benefits		Low	Medium

4.7.V.9 What other impacts is this approach likely to have?

No other impacts have been identified.

Section 4.8: Depositor protection

Depositor protection regimes provide depositors with certain and prompt access to protected funds in the event that their deposit taker fails. By protecting depositors, these regimes are expected to mitigate hardship in the event of a deposit taker's failure, enhance trust in the financial system, and improve the stability of the funding base for deposit takers by reducing incentives for protected depositors to join bank runs. Depositor protection regimes also support resolution frameworks in making it more likely that failed deposit takers will be resolved without taxpayer bailouts.

Overview and problem definition

Deposit takers play a critical role in the financial system and in the economy. The fundamental business of deposit takers is intermediating between borrowers and lenders by issuing liquid, short-term liabilities (e.g. deposits) to fund relatively long-term, illiquid assets (e.g. loans). Deposit takers play an important role in supporting economic growth, providing a liquid savings vehicle for small and large depositors alike, diversifying risk, and providing critical payment systems that enable customers to conduct their daily affairs (e.g. receive wages and pay bills).

Given the special roles played by deposit takers, safety net arrangements are provided by governments to protect and promote financial stability. The financial safety net typically includes business-as-usual prudential supervision and enforcement to promote the ongoing health of the financial system, and lender of last resort functions to provide emergency lending to solvent deposit takers. In the event of failures occurring, a specialised bank resolution framework and deposit insurance work together to limit the impact on the financial system and economy.

New Zealand's regulatory framework currently lacks a deposit insurance scheme. This is consistent with the emphasis that the prudential regime has placed to date on self and market discipline. The introduction of deposit insurance was viewed as increasing incentives for risk-taking among depositors and deposit takers and was not seen as compatible with the low intensity supervisory model adopted by the Reserve Bank.[74]

The absence of depositor protection may, however, result in significant hardship for depositors in the event of a failure and increase the amount of deposits that are withdrawn from a deposit taker under stress (and thus contribute to the institution's difficulties). In addition, with no formal protection for depositors, deposit takers and their creditors may not see it as credible that the government would not move to protect depositors in the event of a deposit taker failure. Therefore, there may be a gap between the underlying social licence granted to deposit takers and the institutional arrangements in place. This gap in expectations is otherwise known as an 'implicit guarantee'.

74 See O'Connor-Close and Austin (2016) "The importance of market discipline in the Reserve Bank's prudential regime", Reserve Bank Bulletin. Available at: https://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2016/rbb2016-79-02

The proposals in the Resolution and crisis management section of this regulatory impact analysis seek to modernise New Zealand's resolution framework and align it with international practice. The objectives of the resolution and crisis management framework include enabling all deposit takers to be resolved in an orderly manner and avoiding significant damage to the financial system in the event of the failure of a deposit taker, including maintaining the continuity of systemically important financial functions and preventing contagion. However, even with these proposed reforms, all depositors would still be potentially exposed to loss, which gives rise to the issues raised above.

A common and long-standing approach used overseas is to establish a deposit insurance scheme that protects eligible depositors up to a pre-set maximum or 'coverage limit' if their deposit taker failed. Currently 35 of 37 OECD member countries have a formal deposit insurance/protection scheme, with Israel and New Zealand having no formal protection scheme. Many countries expanded the scope of their depositor protection regimes as a measure to support public confidence in the financial system following the Global Financial Crisis, and some other countries introduced deposit guarantees for the first time.[75] In New Zealand, a temporary Crown Retail Deposit Guarantee scheme was introduced with a cap of $1 million for this purpose.

Criteria used to assess options

The Review used the following high-level criteria when assessing the overall package of depositor protection reforms:

- *Mitigating hardship*. Loss of access to protected funds could create substantial hardship where deposits are used to fund everyday spending, and is not consistent with the limited capacity of ordinary depositors to monitor the risk-taking of their bank.
- *Supports public confidence in the financial system*. Public confidence underpins the effective functioning of the role deposit taker play in the economy. The importance of this role is reflected in the proposed purpose of the Deposit Takers Act 'to promote public confidence in the financial system'.
- *Enhancing credibility of resolution tools*. By protecting depositors in the event of failure and clearly signalling the boundary of protection, depositor protection should increase the Government's willingness to allow the resolution authority to resolve deposit takers using its resolution tools, rather than resorting to publicly funded bail-outs.
- *Efficient allocation of the costs of failure*: any depositor protection arrangements should aim to minimise costs of implementation and allocate its costs to deposit takers.

Summary of preferred package of options

The Reserve Bank recommends the adoption of a deposit insurance scheme (DIS) with a limit of $50,000 per eligible depositor, per licensed deposit taker. The DIS would have an objective of "protecting depositors to the extent they are covered by the scheme, and thereby contributing to financial stability". To support the DIS in achieving that objective there would be several design features:

75 For example, Australia introduced a deposit guarantee in response to the Global Financial Crisis and now has a permanent scheme in place.

- *Insured depositor preference:* The Reserve Bank recommends that the introduction of the DIS be supported by a preference for insured depositors ('insured depositor preference). Insured depositor preference would provide priority to the claims of deposits up to the insurance limit on the assets of a failed deposit taker. Insured depositor preference is, in effect, a preference for the DIS. This is because the preferential treatment of insured deposits is passed on to the DIS when it 'stands in the shoes of' (subrogates) insured depositors after they have been compensated. Such a preference would support integrating deposit insurance into the Reserve Bank's resolution framework.
- *Institutional location and governance:* The Reserve Bank recommends the responsibility for deposit insurance be assigned to the Reserve Bank.
- *Product boundary and design:* The Reserve Bank recommends that products eligible for deposit insurance would include transactional, savings and term deposits currently offered by registered banks (and the equivalent products offered by non-bank deposit takers). Financial institutions, related parties of DIS members, large non-financial corporates and government bodies would be ineligible for DIS coverage.
- *Funding framework:* The Reserve bank recommends that the DIS is fully funded by levies on DIS members. The DIS would also be supported by a Crown funding backstop. The Minister of Finance would set the funding approach through a funding strategy, taking into account several principles. Levies would be paid into a deposit insurance fund administered by the DIS that would be the first port of call for deposit insurance payouts.

The Reserve Bank notes that the Minister of Finance is recommending to Cabinet that the deposit insurance limit be set at $100,000 and that insured depositor preference is not introduced. All other recommendations from the Minister of Finance are consistent with the proposals in this section of the regulatory impact analysis.

Summary of benefits and costs

The proposed package of depositor protection reforms would help to mitigate hardship that depositors would experience if they faced losses on their deposits and lost access to their deposits in the event that their deposit taker failed. The reforms would also enhance public confidence in the financial system, mitigating the likelihood of a destabilising 'bank run'. Deposit takers will also benefit from a more stable funding base, and the government will benefit from a shift from an uncertain implicit guarantee, to a managed, limited, and user-pays explicit guarantee. A DIS will also support the proposed package of resolution and crisis management reforms, increasing the likelihood that future governments will allow deposit takers to fail without recourse to public funds.

There will be costs to deposit insurance scheme members in the form of levies to cover the costs of the DIS, and costs to upgrade their systems to implement the scheme (e.g. a single customer view and prompt payout). To the extent that funding costs would be passed on to customers, borrowers would bear (some of) the costs via higher rates on loans. The introduction of insured deposit preference would allocate a relatively larger proportion of losses on to other creditors (uninsured depositors and wholesale creditors). This change in the distribution of losses may be reflected in lower returns on deposits protected by the DIS, and a higher cost of other unsecured funding sources.

There are several variables within the proposed package of reforms that affect the overall costs of the DIS. The variables with the most significant impact are the deposit insurance coverage limit and depositor preference. The greater the value of deposits covered by the DIS, the greater the cost that deposit takers and depositors will face and, as noted above, depositor preference would allocate a relatively larger portion of losses on to other creditors. The scope of eligible depositors and products covered will also affect the overall costs.

Impact of proposals on well-being

Financial stability is a critical precondition for the maintenance and growth of New Zealand's financial and physical capital stocks. Financial stability also contributes to, and is supported by, New Zealand's social capital – in particular, trust and public confidence in the financial system. The public need to be confident that deposit takers can and will continue to provide key services, such as avenues for saving, credit to fund consumption and investment and payment systems to facilitate local and international transactions. The continued and reliable provision of these services is a pre-condition for ensuring that the financial system makes its maximum contribution to the prosperity and well-being of New Zealanders.

International agencies such as the World Bank, the World Health Organization, and the United Nations have investigated the economic and social impacts of financial crises. They report that banking crises almost always lead to a general downturn in the economy, associated with rising unemployment and lost output, with consequential societal effects.[76] These impacts go beyond the financial realm as they affect the health and quality of life, often of people who had little involvement in creating the crisis. The Global Financial Crisis of 2008/2009 was a prime example, as this crisis led to a widespread global downturn and higher rates of unemployment. While many countries have since fully recovered from this crisis, or are on the path to recovery, some countries are still trying to find their footing.

The proposals in this regulatory impact assessment to implement deposit insurance scheme would ultimately support the financial safety of New Zealanders, and would provide security and confidence from risk of financial harm. This supports the resilience of New Zealanders and helps to maintain public trust in the financial system.

Likely risks and unintended impacts

The introduction of deposit insurance has the potential to cause an unintended increase in risk-taking by deposit takers. Deposit takers that offer higher returns may attract large inflows of deposits following the implementation of the scheme and subsequently engage in higher-risk lending, which could undermine financial stability. The framework provides for the mitigation of this risk through prudential supervision of all deposit takers by the Reserve Bank (see section 4.3), the ability to charge levies that are differentiated according to the risk of deposit takers, and by placing limits on the amount of insurance provided (see section 4.8.W).

76 Otker-Robe I, and Podpiera A M (2013). The social impact of financial crises; Evidence from the Global Financial Crisis, Policy Research Working paper, No. WPS 6703, World Bank. Available at: https://openknowledge.worldbank.org/handle/10986/16912

Evidence certainty

The costs and benefits of introducing depositor protection are uncertain. Depositors may split their deposits across multiple deposit takers, which would increase the size of the scheme's exposure and may have implications for the competitive landscape of the deposit taking sector. Moreover, many aspects of the DIS will be set through secondary legislation or through operational decisions of the Reserve Bank. This includes the strategy for funding the DIS, and the implementation of infrastructure at deposit takers required to support rapid payout.

Consultation and stakeholder feedback

The Review has consulted multiple times on the introduction of a deposit insurance scheme and its appropriate design. During the first round of consultation, the majority of stakeholders supported strengthening the depositor protection framework in New Zealand. The Review received substantial feedback through the second and third rounds of consultation that the coverage limit for the scheme should be higher than the $30,000-50,000 range that was consulted on. Stakeholders generally supported the other proposed design features of the scheme consulted on in the third round of consultation, although there were mixed views about whether to introduce a preference for insured depositors (and the deposit insurance scheme through subrogation) and the need for levies to be differentiated according to the risks posed by deposit takers.

W. Deposit insurance and the insurance limit

4.8.W.1 What is the specific problem?

New Zealand's regulatory framework currently lacks one of the five safety net functions – it does not protect depositors from loss through deposit insurance. This is consistent with the emphasis that the prudential regime has placed to date on self and market discipline. The introduction of deposit insurance was viewed as increasing incentives for risk-taking among depositors and deposit takers, and was not seen as compatible with the low intensity supervisory model adopted by the Reserve Bank.[77]

The absence of deposit insurance may, however, result in significant hardship for depositors in the event of a failure and increase the amount of deposits that are withdrawn from a deposit taker under stress (and thus contribute to the institution's difficulties). In addition, there currently being no formal protection for depositors, deposit takers and their creditors may not see it credible that the government would not move to protect depositors in the event of a deposit taker failure. Therefore, there may be a gap between the underlying social licence granted to deposit takers and the institutional arrangements in place. This gap in expectations is otherwise known as an 'implicit guarantee'.

77 O'Connor-Close and Austin (2016) "The importance of market discipline in the Reserve Bank's prudential regime", Reserve Bank Bulletin. Available at: https://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2016/rbb2016-79-02

The proposals in the Resolution and crisis management section of this regulatory impact statement seek to modernise New Zealand's resolution framework and align it with international practice. The objectives of the crisis management framework include enabling all deposit takers to be resolved in an orderly manner and avoiding significant damage to the financial system in the event of the failure of a deposit taker, including maintaining the continuity of systemically important financial functions and preventing contagion. However, even with these reforms, all depositors would still be potentially exposed to loss, which gives rise to the previous issues raised above.

A common and long-standing approach used overseas is to establish a deposit insurance scheme that protects eligible depositors up to a pre-set maximum or 'coverage limit' if their deposit taker failed. Currently 35 of 37 OECD member countries have a formal deposit insurance/protection scheme, with Israel and New Zealand having no formal protection scheme. Many countries expanded the scope of their depositor protection regimes as a measure to support public confidence in the financial system following the Global Financial Crisis, and some other countries introduced deposit guarantees for the first time.[78] In New Zealand, a temporary Crown Retail Deposit Guarantee scheme was introduced with a cap of $1 million for this purpose.

4.8.W.2 What options are available to address the problem?

Option 1: Status quo

Currently there are no formal or permanent protections for depositors at failed New Zealand banks. Depositors are 'general creditors' and, after shareholders and junior creditors, stand to lose money if their banks fail. This encourages people who deposit money in banks to do so responsibly, since neither the banks nor the government is promising to protect them from the consequences of their decisions.

In the unlikely event of a bank failure, there are certain resolution options with attached functions that could be used to protect depositors from loss (and protect their access to banking services). The resolution approach used, and the protections applied, would depend on the circumstances of the failing bank and prevailing market conditions.

The status quo model means that depositors bear responsibility for monitoring the risk of their deposit taker. Currently protecting depositors from loss is embedded in the Open Bank Resolution (OBR) policy through the 'de minimis', which envisages a carve out for an unspecified amount (e.g. around $500-$1,000 per account) of prepositioned depositors from the OBR's general freeze of creditor claims. This carve out would be achieved through statutory powers to depart from the usual ranking of creditors for financial stability purposes, shifting losses from 'de minimis' deposits onto other general claims.

78 For example, Australia introduced a deposit guarantee in response to the Global Financial Crisis and now has a permanent scheme in place.

Option 2: Enhanced status quo

For the purposes of this options analysis, we have assumed that an enhanced status quo would involve legislating the OBR *de minimis* to be $10,000. For depositors whose banks are not prepositioned for OBR, we have assumed that resolution approaches would be designed to protect depositors up to $10,000.[79] Under this option, depositors would be protected up to $10,000 and this would be achieved by allocating greater losses onto other creditors. Currently around 90% of accounts would be fully protected if these resolution approaches were used.

Option 3: Deposit insurance

This option would see a deposit insurance scheme (DIS) set up with an objective to protect depositors to the extent they are covered by the deposit insurance scheme, and thereby contribute to financial stability. The DIS would pay eligible depositors up to the maximum coverage limit on a per depositor, per deposit taker basis, if their deposit taker failed.

Deposit insurance would be available to any eligible depositor who was exposed to loss, no matter which resolution method was used for their deposit taker. Depositors whose deposits were not eligible for insurance, or whose deposits exceeded the coverage limit could still be exposed to potential losses. Membership in the deposit insurance scheme would be compulsory for all deposit takers within the single deposit taker regime.

Most retail depositors would be insured by the DIS, so losses imposed on them would largely fall on the DIS. As outlined below, the DIS would be funded by levies charged to member deposit takers over time, with the scheme backstopped by the Crown (i.e., should the DIS have insufficient resources to make a payout(s), it would borrow the required amount from the Crown, which would be repaid by the DIS to the Crown, with interest, over time). These levies may vary across deposit takers according to the level of risk posed to the deposit insurance scheme.

The Review assessed three options for the deposit insurance scheme that differ in the maximum amount of cover available to depositors on a per depositor, per institution basis:

- **3a: Coverage capped at $50,000**, which would fully cover 89% of total depositors across all deposit takers and cover 28% of the value of deposits across the system covered.
- **3b: Coverage capped at $100,000**, which would fully cover 93% of total depositors across all deposit takers and cover 38% of the value of deposits across the system covered.
- **3c: Coverage capped at $250,000**, which would fully cover 97% of total depositors across all deposit takers and cover 54% of the value of deposits across the system covered.

The objective of the DIS under options 3a and 3b would be to protect depositors to the extent that they are covered by the deposit insurance scheme and thereby contribute to financial stability. The justification for a DIS with a $250,000 limit would be based heavily on supporting confidence in the financial system during periods of stress.

79 There are currently ten banks (the ten largest) in New Zealand that are pre-positioned for OBR.

4.8.W.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The Review considered the following criteria in considering the introduction of deposit insurance and the insurance limit:

Protecting depositors from loss

This criterion recognises that it may be unrealistic to expect retail depositors to be able to identify and assess the risk of their deposit taker, and unreasonable to hold them to account by exposing them to loss if those risks eventuate. Ordinary retail depositors may be less aware of the risks of their deposits than more sophisticated depositors such as large businesses and corporations. Under current regulations, bank deposits are exempt from some customer disclosure requirements that apply to other financial investments. While public tools such as the Reserve Bank's Bank Financial Strength Dashboard are helpful, there is limited evidence to suggest that ordinary New Zealanders have the financial literacy necessary to interpret bank risk metrics, assess the safety of their deposits, or manage exposure.

In addition, some deposits play critical economic functions. Everyday (transactional) accounts, in particular, are an important part of modern life, helping people in daily activities such as shopping, paying bills and receiving wages. No other financial product offers these functions, and transactional services in New Zealand are largely accessed through banks. Transactional bank deposits may be seen more as a 'public utility', helping New Zealanders to participate in the financial system, rather than as an investment choice. Many people – for example, retirees – also use the low risk returns from savings and term deposit products to fund regular spending.

Supporting confidence in the financial system

The way that bank customers are, and expect to be, treated can profoundly affect their trust and confidence in banks. Public confidence is crucial in a stable and efficient financial system. The Global Financial Crisis showed that distress at one bank can rapidly spread through the system as 'contagion', triggering widespread financial distress and dislocation, and threaten to lead to sustained adverse effects on businesses, employment, public trust, and financial inclusion.

Deposit insurance helps to address the risk of a run by depositors. While depositors are normally slow to respond to emerging bank risks, many deposit account types can be accessed at any time and money freely withdrawn. This means that when depositors do react to risks – generally only after wholesale investors and supervisors have become aware of the problems and the bank is nearing the point of failure – they can do so quickly, running to withdraw all the money they deposited and triggering a sudden loss of liquidity at the bank. While the Reserve Bank can offer emergency funds to illiquid banks as part of its lender of last resort role, a severe run would likely lead to a disorderly bank failure – particularly in an environment of distressed markets and falling asset prices.

Moral hazard

Depositor protection in the form of deposit insurance, like any insurance arrangement, can distort the incentives and the behaviour of those who benefit from it. Reducing depositors' incentives to run may also reduce their incentives to monitor and manage risks properly. At the same time, banks that are better protected from depositor runs may have less incentive to act prudently. This is known as 'moral hazard' and can give rise to excessive risk-taking by protected depositors (who may invest in less financially sound banks than otherwise) and their deposit taker (which may engage is higher risk activities).

The extent to which depositor protection gives rise to moral hazard should be balanced in light of the limited evidence that retail depositors currently monitor their deposit taker.[80] A particular risk – illustrated by the experience with the Crown Retail Deposit Guarantee Scheme introduced during the Global Financial Crisis – is that depositors may shift funding to less resilient deposit takers after implementation. This would result in an overall increase in the level of risk in the system, and potentially a weakening of lending standards among the deposit takers that pose the highest risk to a depositor protection scheme.

Distribution of costs and losses

Depositor protection can alter the magnitude, distribution, and timing of the risks and costs of failure. The distribution of costs and losses to the extent possible should fall on those who benefit, such as shareholders and uninsured creditors. Box A (below) provides indicative costs of deposit insurance under options 3a and 3b.

With deposit insurance, to the extent that an implicit guarantee exists for deposits in the financial system, such a scheme would ensure that costs of protecting depositors from loss are borne by the beneficiaries of the scheme (deposit takers and depositors) rather than taxpayers.

Reducing implicit guarantees

The Global Financial Crisis demonstrated that governments are reluctant to impose losses on depositors and may tend towards taxpayer-funded bail-out solutions when either deposit protection or other resolution options do not exist. An example of this was New Zealand's Crown Deposit Guarantee Scheme, which was an emergency taxpayer-funded measure put in place to support New Zealand's financial sector in response to the Global Financial Crisis.

80 IADI guidance notes that "*most depositors—retail and corporate alike—are generally less able to exercise effective market disciple. Typically, only a small number of large-scale depositors are able to do so. Thus, moral hazard is best mitigated by the behaviour of the small number of largescale depositors and by the incentives affecting bank management and directors, shareholders and unsecured creditors.*" IADI further highlights that moral hazard should not be aggravated if depositor protection "*cover[s] fully most, but not all, depositors and ensuring that depositors are informed on the limitations of coverage (that is, the level and scope of coverage); and ensur[es] that a significant portion of the value of deposits are not fully covered*".

International Association of Deposit Insurers (March 2013). Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage. Available at: https://www.iadi.org/en/assets/File/Papers/Approved%20Guidance%20Papers/IADI_Coverage_Enhanced_Guidance_Paper.pdf

By protecting most depositors from loss in a resolution, a formal depositor protection scheme would support the credibility of resolution tools and reduce implicit guarantees in the financial system. The level of cover provided by such a scheme should enable current and future Governments to credibly commit to using resolution tools – including imposing losses on wholesale investors and uninsured depositors.

4.8.W.4 What other options have been ruled out of scope, or not considered, and why?

Stand-alone depositor preference (see section 4.8.X below)

Under this model, depositors would be moved up in the queue of creditors in an insolvency or wind up, maximising recoveries and mitigating the possibility of loss. There would be no accompanying insurance scheme. This option was note considered as it would not give depositors at failed deposit takers access to their money with speed or certainty. Instead, it could be considered as an option to support the introduction of a deposit insurance scheme.

4.8.W.5 What do stakeholders think?

The majority of stakeholder submissions supported strengthening the depositor protection framework in New Zealand. The feedback received from written submissions roughly accords with a survey of 1,000 New Zealanders commissioned as part of the Review team's engagement process. Submitters that supported strengthening depositor protection favoured the introduction of an explicit deposit insurance scheme that could promptly reimburse depositors over a regime that would instead provide depositors with preferred access to amounts recovered from the assets of failed deposit takers (depositor preference).

The majority of stakeholders that commented on the coverage limit preferred a significantly higher coverage limit than the $30,000 to $50,000 range that was consulted on. In making the case for a higher limit, many stakeholders referred to international norms and noted that a higher limit would provide greater support for public confidence in the financial system. The majority of OECD countries have a coverage limit of approximately NZD $150,000, and Australia has a limit of $250,000. Deposit takers also supported a higher coverage limit. Small banks, credit unions and building societies, and finance companies were concerned that deposit splitting resulting from the $50,000 limit would undermine their ability to provide lending to support the economy, and threaten their stability.

Box A: Indicative costs of deposit insurance

The package of depositor protection reforms proposed in this regulatory impact statement would see a DIS established that would be fully funded by levies on DIS members. The approach to funding set out in section 4.8.AA *Funding Framework* would see the establishment of a flexible funding framework that would ensure that the deposit insurer has access to sufficient funds to promptly reimburse depositors' claims.

A key component of the funding framework is the funding strategy document. This document will set out the risks to the DIS (e.g. projected costs of the scheme), and how these risks will be managed through levies and the government fiscal backstop for the scheme. The document will also set out guidance for the appropriate levy rates to charge on member deposit takers. While the legislative reforms proposed in this RIS would provide the framework for funding and levies, levy rates and the funding strategy are not expected to be set until closer to the implementation of the Deposit Takers Act and the DIS.

Given the flexibility of the proposed funding framework, there will be many approaches to funding that could be adopted. Many governments and deposit insurers in other jurisdictions have taken an 'ex ante fund' based approach to DIS funding. Under this approach, a target fund size (usually as a per cent of total insured deposits) and a target timeframe to achieve that fund is set. Another approach would be to charge a stable levy based on the long-term expected costs of the DIS (e.g. over 50-100 years), placing less emphasis on the size of the target fund at any point in time. This approach would recognise that the benefits of the DIS span over a long time horizon and would avoid frontloading costs on a particular cohort of deposit takers and depositors.

To provide an illustrative example of what levies could look like under the proposed DIS, the analysis below sets out levies based on the international approach of a target fund and time taken to achieve that target. The tables show a range of options for these variables based on international experience.[81] These costs are presented for both a $50,000 coverage limit and a $100,000 coverage limit. The levy estimates assume a uniform levy across deposit takers. However, the funding framework empowers the setting of differentially priced levies (e.g. levies differentiated based on the risk deposit takers pose to the DIS).

Table A: Annual basis point levy on insured deposits

Fund size (per cent of insured deposits)	**Years to build fund**		
	10	**15**	**20**
1	12	9	7
2	24	17	14
3	35	26	21
4	47	34	28
5	59	43	35

The levy rate does not change with the coverage limit, however the base on which levies are charged (i.e. insured deposits) would. It is likely that the levy would partially impact depositors and partly industry. For example, if costs were entirely absorbed by industry, a 3% of insured deposit target fund built over 20 years could reduce industry profits by as much as 2.8% ($210 million) per year under a $50,000 coverage limit and by as much as 4.0% ($300 million) under a $100,000 coverage limit (see Tables B and C). If costs were entirely passed on to depositors, then depositors may see the returns on their insured deposits fall by up to 21 basis points (Table A).

Table B: Indicative costs of deposit insurance by fund size and time to build ($50,000 coverage limit)

Fund size (per cent of insured deposits)	**Annual share of industry profits**			**Annual industry levies ($ millions)**		
	Years to build fund					
	10	**15**	**20**	**10**	**15**	**20**
1	1.6%	1.1%	0.9%	120	90	70
2	3.1%	2.3%	1.9%	240	180	140
3	4.7%	3.4%	2.8%	360	260	210
4	6.3%	4.6%	3.7%	480	350	290
5	7.9%	5.7%	4.7%	600	440	360

Table C: Indicative costs of deposit insurance by fund size and time to build ($100,000 coverage limit)

Fund size (per cent of insured deposits)	**Annual share of industry profits**			**Annual industry levies ($ millions)**		
	Years to build fund					
	10	**15**	**20**	**10**	**15**	**20**
1	2.2%	1.6%	1.5%	170	120	100
2	4.5%	3.2%	2.6%	340	250	200
3	6.7%	4.9%	4.0%	510	370	300
4	8.9%	6.5%	5.3%	680	500	400
5	11.1%	8.1%	6.6%	850	620	510

Note: Contributions are assumed to start from 2023 (when the Deposit Takers Act is expected to come into effect). Deposits are assumed to grow at 6.1% per annum (pre-COVID-19 3-year average). Industry profits are estimated assuming a 1.1% annual return on assets and 5.7% annual asset growth (pre-COVID-19 5-year averages). The value of deposits covered is assumed to be stable at 27% of total deposits at a $50,000 limit and 38% of total deposits at a $100,000 limit. However, depositors may adjust their affairs to maximise insurance coverage across deposit takers (known as deposit splitting), which would see the share of the value of deposits covered increase. This would increase the cost as a share of industry profits but not change the annual basis point levy (depending on when the deposit splitting occurred). Deposit insurance levies are assumed to be invested in safe, liquid assets. The annual rate of return on these investments is assumed to be 2.2% (the 5-year average of yields on 10-year New Zealand Government bonds). The estimate of annual share of industry profits and annual industry levies ($ millions) uses the projected cost in 2023. The dollar amount of industry levies would be expected to increase over time in line with the growth rate of insured deposits. There will be ongoing operational and capital costs for the DIS (e.g. staffing costs, development and maintenance of payout infrastructure). These costs are not included in these estimates. Levies on DIS members will ultimately also include these costs, which would be in addition to those required to build any deposit insurance fund.

81 Recommendations on any target fund size are expected to be informed by modelling of the funding obligations of the DIS in severe but plausible stress scenarios. Based on initial modelling, a target fund of one per cent of total insured deposits would be sufficient to cover the expected losses of the scheme, although a larger target fund may be desirable to further mitigate the need for the Crown to borrow to fund upfront payouts.

4.8.W.6 Impact analysis

	Option 1: Status quo	Option 2: Enhanced status quo (e.g., legislated '*de minimis*')	Option 3a: Deposit insurance ($50,000)	Option 3b: Deposit insurance ($100,000)	Option 3b: Deposit insurance ($250,000)
Protecting depositors from loss	0	+ Protecting depositors up to $10,000 would fully cover the majority of depositors from loss. However, outcomes for depositors would be uncertain and unpredictable and may vary across large and small deposit takers.	++ Protecting depositors up to $50,000 would see 89% of depositors fully protected from loss. Commitment to protect depositors applies to all deposit takers and resolution tools.	++ Protecting depositors up to $100,000 would see 93% of depositors fully protected from loss. Commitment to protect depositors applies to all deposit takers and resolution tools.	++ Protecting depositors up to $250,000 would see 97% of depositors fully protected from loss. Commitment to protect depositors applies to all deposit takers and resolution tools.
Supporting confidence in the financial system	0	+ The lack of clarity about the level of protection provided (depending on the resolution tool used) is likely to undermine confidence and trust.	++ Deposit insurance can reduce incentives for protected depositors to join bank runs by ensuring timely access to funds up to a known limit. At a $50,000 limit, 27% of the value of deposits would be covered.	++ Deposit insurance can reduce incentives for protected depositors to join bank runs by ensuring timely access to funds up to a known limit. At a $100,000 limit, 38% of the value of deposits would be covered	+++ Deposit insurance can reduce incentives for protected depositors to join bank runs by ensuring timely access to funds up to a known limit. At a $250,000 limit, 54% of the value of deposits would be covered

Moral hazard	0	0 Low level of coverage and uncertainty about whether protection will be provided would strengthen incentives for discipline, although discipline applied by retail depositors is likely limited.	- Reduces incentives for covered depositors to exercise discipline and might lead to greater risk-taking at covered deposit takers. Would leave 70% of the value of deposits uncovered, and place reliance on supervision and differential levies.	-- Reduces incentives for covered depositors to exercise discipline and might lead to greater risk-taking at covered deposit takers. Would leave 60% of the value of deposits uncovered and place more reliance on supervision and differential levies.	--- Deposit insurance substantially reduces incentives for covered depositors to exercise discipline and might lead to greater risk-taking at covered deposit takers. Would leave 45% of the value of deposits uncovered, and place substantially more reliance on supervision and differential levies.
Distribution of costs and losses	0	- The costs of protecting depositors from loss would fall on other creditors of the deposit taker. Given the impending increase in capital requirements for deposit takers and the small coverage amount, the cost impact is likely to be small.	+ Shifting to an explicit guarantee allows Crown to manage risk and shift costs to deposit takers. May benefit small deposit takers by making it easier to attract low value deposits.	+ Shifting to an explicit guarantee allows Crown to manage risk and shift costs to deposit takers. Higher exposure increases costs for deposit takers and amount of funds Crown may need to lend to the DIS. Makes it easier for small deposit takers to attract low value deposits and retain deposits between $50,000 and $100,000.	- Shifting to an explicit guarantee allows Crown to manage risk and shift costs to deposit takers. Higher exposure substantially increases costs for deposit takers and amount of funds Crown may need to lend to the DIS. Makes it easier for small deposit takers to attract low value deposits and retain deposits between $100,000 and $250,000.

Implicit guarantee	0	0 The uncertainty involved with and limited amount of the level of protection may result in decision makers preferring to 'bail-out' a bank or guarantee its depositors rather than exposing them to loss.	+ Provides sufficient credibility to resolution tools that avoid using taxpayer support by imposing losses on the owners and uninsured depositors and creditors of the failed institution.	+ Provides sufficient credibility to resolution tools that avoid using taxpayer support by imposing losses on the owners, uninsured depositors and creditors of the failed institutions. May increase willingness to use resolutions other than bail-out by fully covering less sophisticated depositors that have balances between $50,000 and $100,000.	0 The substantial value covered may make the scheme too costly for industry in a failure, requiring the government to step in, thereby undermining the benefits of deposit insurance in enhancing the credibility of resolution tools.
Overall assessment	0	+	+++	++	+

Key

+++ substantially better than doing nothing/the status quo
++ much better than doing nothing/the status quo
+ better than doing nothing/the status quo
0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- - much worse than doing nothing/the status quo
- - - substantially worse than doing nothing/the status quo

4.8.W.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank's preferred approach

The Reserve Bank prefers Option 3a: Deposit Insurance with a $50,000 limit to address the issues in relation to enhancing New Zealand's financial safety net. A well designed DIS can protect depositors from risks beyond their control, mitigate the potential hardship that depositors would face from loss of access to, and loss on, their transactional accounts. This in turn can raise public confidence, reduce the likelihood and severity of bank runs and disorderly bank failures, and contribute to financial stability. A well calibrated insurance scheme also provides credibility to resolution tools that avoid using taxpayer support by imposing losses on the owners and non-insured creditors of failed firms. Also, by providing a mechanism to promptly repay customers and recover costs from industry, insurance could support the orderly closure of small deposit takers in a way that protects customers without needing Crown intervention.

The Reserve Bank considers that this option would sufficiently protect depositors from loss by mitigating any hardship depositors would face through lack of access to and loss faced on amounts up to $50,000. The Reserve Bank places substantial weight on the moral hazard risks that arise from protecting depositors from loss at higher coverage limits, and the greater reliance on costly and imperfect mitigation tools that this creates. At higher coverage limits under Options 3b and 3c there would be material moral hazard risks for little marginal benefit in terms of additional depositors fully covered.

The Reserve Bank notes that Cabinet has made an in-principle decision to have a $50,000 limit for the DIS, in line with the Reserve Bank's preferred approach. Following stakeholder feedback supporting a higher limit and further advice from the Review, the Minister has decided to recommend to Cabinet that the limit be increased to $100,000.

The Treasury's preferred approach

The Treasury prefers Option 3b: Deposit Insurance with a $100,000 limit to address the issues raised in this section. The Treasury sees that there is significant uncertainty about the appropriate coverage limit.

A $100,000 limit would cover a substantial number of depositors who are otherwise not necessarily well placed to monitor their deposit taker, such a first-home buyers and retirees. The Treasury notes that there is substantial variation in the number of deposit takers fully covered at each institution under the coverage limit options. At a $100,000 limit, the vast majority of depositors would be fully covered at the vast majority of deposit takers, while leaving a significant amount of the value of deposits unprotected. A $100,000 limit would support future Governments willingness use resolution tools that impose losses on depositors, knowing that the vast majority of depositors are fully covered.

A $100,000 limit would also support confidence in the financial system, without materially blunting incentive of more sophisticated depositors to monitor risks. While the Treasury sees moral hazard as a key consideration for depositor protection, the increase in risk-taking and the Crown's contingent liability would need to be managed using the enhanced monitoring, supervisory, and regulatory powers being provided to the Reserve Bank under the Deposit Takers Act and through levies differentiated according to the level of risk. It is also unclear whether depositors up to $100,000 are currently engaging in risk monitoring.[82]

The Treasury notes that smaller deposit takers raised in public consultation that under a $50,000 limit their depositors may shift to the perceived safety of the major banks due to many depositors currently being under the impression that their funds are fully protected by the government. The Treasury sees that depositor behaviour under the DIS is uncertain and a $50,000 limit could see deposits flow out of small deposit takers but may also see deposits flow into smaller deposit takers due to the safety provided from deposit insurance. The Treasury notes that this concern is particularly relevant as Cabinets in-principle decision was predicated on the likelihood of there being substantial deposit splitting in order to increase coverage levels over time, without consideration for the potentially disruptive impacts of splitting on small deposit takers.

The Treasury notes that several stakeholders raised, in public consultation undertaken by the Review, support for a significantly higher limit than what the Treasury recommends, for example a $250,000 limit. The Treasury notes that such higher limits would have questionable impacts on New Zealand's long-run financial stability given the more substantial moral hazard impact that would be expected.

4.8.W.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Deposit insurance scheme members	Additional costs to bring their systems in line with a deposit insurance scheme (e.g. a single customer view). Levies to cover the costs of a deposit insurance scheme.	Medium	Medium
Depositors	To the extent that costs of the insurance scheme would be passed on to depositors, depositors could receive lower returns on their deposits.	Medium	Medium

82 This was highlighted in 2019 survey undertaken by the Review, which found that of the 1000 people surveyed, only a quarter were aware that they stood to lose money in a bank failure. See: Reserve Bank Act Review (June 2019). Safeguarding the future of our financial system – In-principle decisions and follow-up questions on: The role of the Reserve Bank and how it should be governed. Consultation Document 2A. Available at: https://www.treasury.govt.nz/sites/default/files/2019-06/rbnz-safeguarding-future-financial-system-2a.pdf

Wider government	Potential liquidity and debt risk associated with providing a backstop to the scheme.	Low	Medium
Other parties			
Total Monetised Cost		Medium	Medium
Non-monetised costs		Low	Low

Expected benefits of proposed approach compared to taking no action			
Deposit insurance scheme members	A more stable deposit funding base. Easier for smaller deposit takers to compete with larger deposit takers in attracting deposits.	Medium	Medium
Depositors	Hardship mitigated in the event of a bank failure. Enhances trust in the financial system.	High	Medium
Wider government	Shifts from an uncertain implicit guarantee, to managed, limited, and user-pays explicit guarantee	High	Medium
Other parties			
Total Monetised Benefit			
Non-monetised benefits		High	Medium

4.8.W.9 What other impacts is this approach likely to have?

No other impacts have been identified.

X. Depositor preference

4.8.X.1 What is the specific problem?

Deposits – including those deposits covered by the DIS – under the current creditor hierarchy[83] rank *pari passu* (have equal rank) with other senior unsecured creditors. That means that depositors and other unsecured creditors absorb losses equally in proportion to their claim. This raises three potential issues:

83 The creditor hierarchy dictates how losses are allocated amongst creditors, including depositors. A typical creditors' hierarchy would consist of the following, in order of priority: secured creditors; administration and liquidation expenses; other preferred creditors (wages, taxes); general unsecured creditors (e.g. deposits); unsecured subordinated debts; and shareholders' equity. See N. Grouped analysis for select resolution and crisis management issues for further discussion on creditor safeguards.

- The deposit insurer would become one of the largest creditors of the failed institution when it subrogates ('stands in the shoes of') insured depositors.[84] Substantial calls on the deposit insurer's resources (for a deposit insurance payout) may require the DIS to charge large *ex post* levies on deposit takers, which could further weaken economic activity in the wake of a crisis. In addition, if the call on the DIS is sufficiently large and the Crown backstop is called upon, the Crown's loan to the DIS may remain outstanding for a longer period of time under the existing *pari passu* creditor hierarchy.
- The resolution authority would need to give effect to resolutions that protect the interests of insured depositors regardless of the resolution tool used. In many instances, resolving a deposit taker by means of liquidation (and subsequent payout of insured depositors) may not be the preferred option from a financial stability perspective. Certain resolution options (e.g. a purchase and assumption transaction of insured deposits with matching assets from the failed deposit taker) could be subject to legal challenge under the status quo (no depositor preference) if it were to treat equal ranking creditors differently, particularly given the introduction of the no creditor worse off (NCWO) principle discussed in section 4.7.N. However, the risk of legal challenge could be mitigated through the DIS providing upfront funding for the resolution subject to safeguards (see section 4.8.AA *Funding Framework*).
- Based on international experience, some governments have been unwilling to impose losses on creditors, including uninsured depositors, and therefore resort to public funded bailouts. A formal deposit insurance scheme would help to address this issue, by fully protecting the vast majority of depositors. The existence of some forms of depositor preference (such as a general depositor preference – see Option 3 below) may further increase the willingness of governments to imposes losses on creditors, as for example, uninsured depositors would have priority over other unsecured creditors (e.g. wholesale investors) in liquidation.

A preference for depositors, or a portion of a depositor's claim, could help address these issues. Such a preference would move depositors, or a portion of a depositor's claim, nearer to the front of the queue to be repaid in a deposit taker failure, giving depositors a better chance of recovering their money. It would therefore allocate a relatively larger portion of losses to other non-preferred creditors. However, with deposit insurance, eligible depositors will be promptly reimbursed up to the coverage limit, regardless of any preference arrangements.

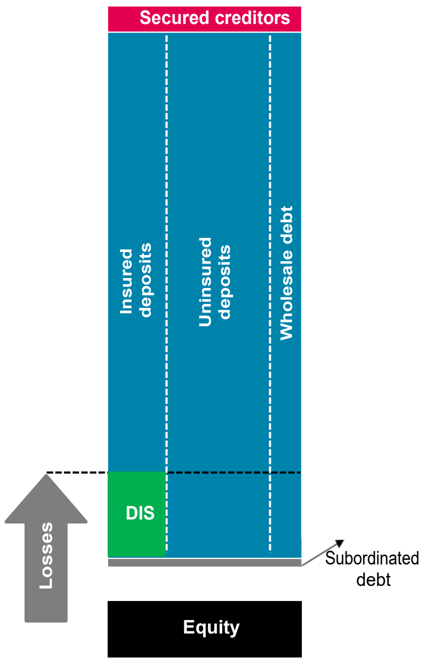
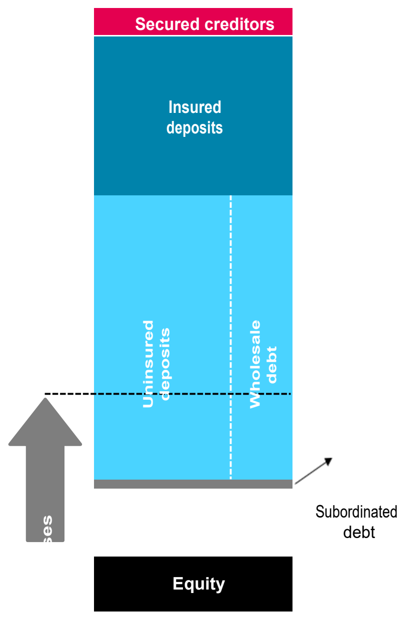
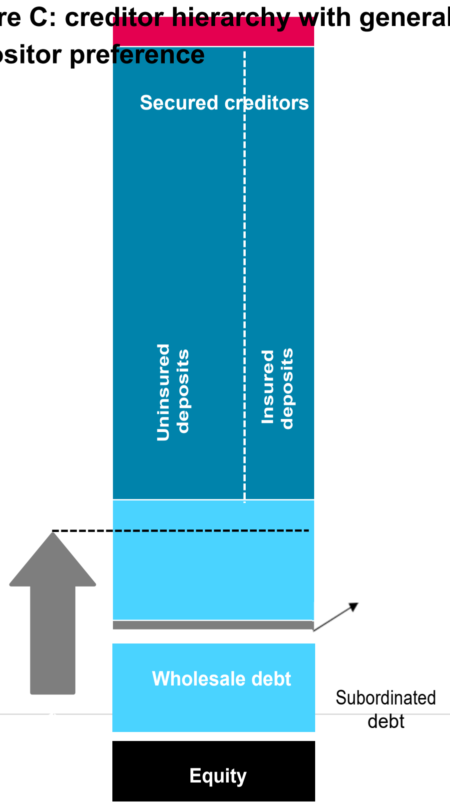
Depositor preference (in some form) has become increasingly common in other jurisdictions. A recent survey conducted by International Association of Deposit Insurers found that, of the 73 respondents, 71 percent had some form of depositor preference.[85]

84 When considering the creditor hierarchy and what 'insured' depositor and 'uninsured depositor' means, it is useful to consider an example. Suppose Person A has $150,000 of deposits at Bank ABC. Under a $50,000 limit, the first $50,000 is insured and $100,000 is uninsured. If Bank ABC fails, Person A would in effect have two claims. Their first claim as an 'insured depositor' means they would be eligible to be reimbursed by the DIS for their first $50,000. Their second claim is as an 'uninsured depositor' on their remaining $100,000. For their claim as an uninsured depositor, they would have to stand in the queue with other equal ranking creditors to receive payment on their claim, after applying any losses.

85 International Association of Deposit Insurers. (2020). "Depositor Preference and Implications for Deposit Insurance". Available at: https://www.iadi.org/en/news/iadi-brief-on-depositor-preference-and-implications-for-deposit-insurance/

4.8.X.2 What options are available to address the problem?

The following options have been identified and were consulted on as part of the second and third rounds of public consultation. Each option assumes that deposit insurance will be introduced in New Zealand.

Option	Figure	Implications
Option 1: Enhanced status quo *(pari passu regime)* For the purposes of this options analysis we assumed that the enhanced status quo is where deposit insurance is introduced without any change to the creditor hierarchy. Following a liquidation and payout, the DIS would subrogate ("stand in the shoes of") for the claim of insured depositors against the assets of the failed deposit taker alongside other unsecured creditors. As noted below, the funds of the scheme would be available for use in resolutions (outside of liquidation and payout) that protect insured depositors.	**Figure A: status quo creditor hierarchy** 	Figure A provides an example of what the status quo creditor hierarchy looks like for a typical large deposit taker. In this example the deposit taker has failed with 20% losses on its assets. These losses are shared in line with the creditor hierarchy. Shareholders are first to absorb losses, followed by subordinated debt. The remaining losses are shared equally across wholesale debt, uninsured deposits and insured deposits. The losses faced by insured depositors are notional and are better characterised as losses to the DIS (see green highlighted section in Figure A). This is because the DIS would step in to ensure that insured depositors are made whole and receive prompt access to their funds. There are many approaches to achieve this, depending on what resolution tool is used. For example, under a 'liquidation and payout' the DIS would payout all insured deposits (i.e. the green shaded area and the blue area above it), and then 'stand in the shoes' of insured depositors and make recoveries from the asses of the failed deposit taker. For other resolution approaches, the deposit insurer may only need to 'top up' insured depositors' claims (i.e. the green shaded area).
Option 2: Insured depositor preference *(preference for the deposit insurance scheme)* This option would provide preferential treatment to deposit amounts up to the insurance limit. In practice this would mean that the DIS would have preferred access to the failed deposit taker's assets as it would subrogate for the claims of insured depositors after they have been compensated. Deposit amounts over above the insurance limit (i.e. uninsured deposits) would rank *pari passu* with other general unsecured creditors.	**Figure B: creditor hierarchy with insured depositor preference** 	Figure B provides an example of what the creditor hierarchy would look like at a typical large deposit taker if insured depositor preference (preference for the deposit insurance scheme) were implemented. In this example the deposit taker has failed with 20% losses on its assets. As was the case under the status quo, shareholders and subordinated debt are first in line to absorb losses. The remaining losses are then shared equally between uninsured depositors and wholesale creditors. In most resolutions, the DIS would face no losses. All else equal, the losses wholesale creditors and uninsured depositors face would be larger than under the enhanced status quo. A preference for the DIS reduces that likelihood that the DIS would face losses to near-zero at the vast majority of deposit takers. Reduced losses also extend to other resolution tools with the introduction of the no creditor worse off principle. Outside of the credit union sector, other deposit takers receive more than half of their funding from creditors that would rank below the DIS, this means that losses would have to reach exceptionally high levels based on international experience before the DIS makes a loss. In terms of insurance pricing, this means that the expected costs of providing insurance would be near-zero.
Option 3: General depositor preference This option would involve granting preferential treatment to all deposits eligible for coverage under the DIS, including uninsured deposits (amounts above the maximum coverage limit), over general unsecured creditors. The DIS would rank *pari passu* with uninsured depositors in liquidation, but ahead of general unsecured creditors.	**Figure C: creditor hierarchy with general depositor preference** 	Figure C provides an example of what the creditor hierarchy would look like at a typical large deposit taker if uninsured depositor preference were implemented. In this example the deposit taker has failed with 20% losses on its assets. As was the case under the status quo and insured depositor preference, shareholders and subordinated debt are first in line to absorb losses. The remaining losses are then absorbed by wholesale debt. Insured deposits, and therefore the DIS, face no losses. Uninsured depositors also face no losses (given that the example deposit taker has a substantial amount of wholesale debt), however if losses were larger, they would be next in line to absorb losses. All else equal, the losses wholesale creditors face would be larger than under the enhanced status quo and insured depositor preference.

4.8.X.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The Review has adopted the following criteria in considering this issue:

Distribution of costs of depositor protection and resolution losses

Regardless of the creditor hierarchy, and as set out in the *Funding Framework* and *Implementation of Deposit Insurance and Deposit Insurance Limit* sections, member deposit takers will pay levies to fully fund the DIS (i.e. deposit takers who benefits from the DIS, pay for the DIS). To the extent that costs are passed on to depositors, then depositors who also benefit from the DIS will pay.

Shifting one group of creditors higher up in the creditor hierarchy (i.e. giving them a better chance of recovering their money), comes at the cost of giving other creditors a worse chance of recovering their money. With an insured depositor preference, for example, losses would be borne in the first instance by shareholders and junior creditors, and then uninsured depositors and other unsecured creditors of the failing deposit taker (see Figure B in the table above). If there were sufficient lower ranking creditors, then the DIS would not face any losses. The change to the creditor hierarchy would be clear ahead of failures, and to some extent non-preferred creditors may be able to shift the costs back to deposit takers by seeking compensation through higher returns.

On the other hand, under the status quo, losses would be shared equally and proportionately (*pari passu*) with the DIS and other unsecured creditors. Should equity and subordinated debt instruments be insufficient to absorb losses, then the DIS would face losses along with other equal ranking creditors.

Credibility and effectiveness of resolution tools

It is critical that all components of the financial safety net work together to support financial stability. Resolution tools will need to be compatible with the new deposit insurance scheme and vice versa in order to protect depositors from loss. A preference for the DIS would better facilitate the integration of deposit insurance with certain resolution tools, such as purchase and assumption transactions[86] or existing resolution tools such as OBR. Although resolution tools can be facilitated to protect depositors with no change to the creditor hierarchy, a preference for the DIS would enable the Reserve Bank to execute resolutions in a way that protects depositors with the greatest possible speed and certainty, and reduces the risk of possible legal challenge from other creditors.

86 A purchase and assumption transaction is a resolution method in which a healthy deposit taker or group of investors assume some or all of the failed deposit taker’s obligations (e.g. deposits), and purchase some or all of the assets of the failed deposit taker.

Exposure of the deposit insurance scheme

With deposit insurance, the deposit insurer will become one of the largest creditors of a failed deposit taker when it subrogates ('stands in the shoes of') insured depositors. A preference for depositors will increase the insurance scheme's recoveries, and thereby increase the rate at which any loan from the Crown to the DIS is repaid. As a result, it would be less likely that any Crown loan to the DIS would be in place for an extended period of time.

From the Crown's perspective, 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. Should the DIS's assets be insufficient to cover the cost of a payout, then the Crown will be required to provide funds through the backstop. The DIS (and the Crown) would recover the costs of any failure over time through industry levies.

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 large deposit taker failed). Given the proposed design of the DIS, the risk that the Crown will suffer losses is remote, and a preference for the DIS would provide more certainty around this outcome. There is a larger risk that there will be a liquidity impact on the Crown arising from the need to fund an upfront payout, and this would apply regardless of whether a preference for the deposit insurance scheme.

Funding costs

Depositor preference would increase the losses faced by non-preferred creditors, who may seek compensation (in the form higher returns) to reflect their greater exposure to loss – particularly in the case of wholesale investors that are more likely to actively monitoring their level of risk. A preference for insured deposits would substantially reduce the DIS's exposure, reducing the likelihood that large levies are charged after a failure.

In terms of insurance pricing, an insured depositor preference reduces the expected cost of providing insurance to near-zero, which theoretically could reduce levies charged to members (and the size of the fund could therefore be lower than otherwise). However, an *ex ante* fund may still play an important role as a funding source for immediate payout to insured depositors, in which case the reduced cost for the DIS (from depositor preference) would have a more limited impact on levies.

Competition and dynamism

Giving preference to one class of creditors (i.e. a better chance of recovering their money), comes at the cost of other creditors (i.e. they have a worse chance of recovering their money). A deposit preference may result in smaller deposit takers facing greater challenges attracting and retaining uninsured deposits or wholesale funding, potentially undermining competition and diversity in the financial system.

The disproportionate impact reflects that these deposit takers will be more reliant on funding insured by the DIS and deposit funding more generally. A preference for the deposit insurance scheme would disproportionately increase the losses faced by their uninsured depositors in the event of failure relative to the major banks. However, ordinary depositors are likely to treat deposits as a safe investment regardless of the creditor hierarchy.

A general preference would also reduce the relative safety of deposits at small deposit takers compared to deposits at major banks, which could encourage deposit outflows from smaller deposit takers in favour of major banks.

Any risks to competition need to be assessed in light of the introduction of deposit insurance, which will likely see smaller deposit takers more easily able to attract funding up to the coverage limit.

4.8.X.4 What other options have been ruled out of scope, or not considered, and why?

A further option is a tiered depositor preference, which would prefer insured deposits to uninsured deposits, and uninsured deposits to other general unsecured creditors. The Review has not considered this option, as it would impose the costs of both insured and general depositor preference, without commensurate benefits.

4.8.X.5 What do stakeholders think?

Banks do not support the introduction of a preference as it would increase their funding costs, create complexities in the resolution framework, and potentially significantly alter the funding profiles of some deposit-taking entities. On the other hand, several submissions from individuals strongly supported the introduction of a depositor preference. These submissions advocated for introducing a preference for all deposits on the basis that this would support confidence in the safety of deposits, enhance the credibility of the resolution regime, and enhance market discipline.

4.8.X.6 Impact analysis

	Option 1: Enhanced status quo (*pari passu* regime with deposit insurance)	Option 2: Insured depositor preference (preference for the deposit insurance scheme)	Option 3: General depositor preference
Distribution of costs of depositor protection and resolution losses	0 Deposit takers and (to the extent passed on) depositors that benefit from the DIS pay for the costs of the DIS through levies. Losses in the event of failure are distributed equally across the DIS (subrogated for insured depositors), uninsured depositors, and other general unsecured creditors	- DIS losses are shifted to uninsured depositors and other general unsecured creditors (including wholesale creditors), shifting the incidence of the costs of the DIS away from those who benefit from the scheme. Reallocation of losses may result in a small increase in market discipline (by exposing relatively more sophisticated creditors to loss).	0 Costs of failure concentrated on general unsecured creditors (including wholesale creditors). Uninsured depositors receive additional protection at major banks with wholesale funding. Reallocation of losses may result in an increase in market discipline (by exposing relatively more sophisticated creditors to loss).
Credibility and effectiveness of resolution tools	0 Resolution tools can be integrated with deposit insurance but with some complexity.	+ Reduced complexity in using resolution tools that protect insured depositors such as OBR, purchase and assumption.	+ Facilitates the transfer of entire deposit book (i.e. both insured and uninsured depositors) and reduces likelihood of the DIS (subrogated for insured depositors) and uninsured depositors face losses in resolutions of major banks (given losses would first be absorbed by wholesale creditors).
Exposure of the deposit insurance scheme	0 Reliance on Crown backstop can be materially reduced, and the DIS's exposure can be managed, through building reserves in the deposit insurance fund.	0/+ DIS's exposure substantially reduced at the vast majority of deposit takers. Improved speed and amount of recovery for backstop funds for all resolutions. Very low likelihood the Crown needs to fund losses to the DIS for an extended period.	0 Reliance on Crown backstop can be materially reduced through building reserves in the deposit insurance fund. Recoveries from resolutions of major banks increased, but not for smaller entities. DIS's exposure for major banks reduced.
Funding costs*	0 Deposit takers pay for the costs of the DIS through levies.	0 Small increase in funding costs for wholesale funding, offset by potential lower cost of deposits.	- Moderate increase in the cost of wholesale funding, may be offset by decline in cost of deposits for major banks.

Competition and dynamism*	0 Smaller deposit takers likely to pay higher levy rates than larger deposit takers reflecting their higher risks to the DIS. However, the introduction of deposit insurance will likely improve the ability of smaller deposit takers to attract deposits up to the insurance limit.	0 Smaller deposit takers would likely pay lower levies (than under the status quo) due to reduced risk to DIS. This may be somewhat offset by challenges of attracting and retaining uninsured deposits or wholesale funding due to the increased exposure these creditors would have to loss. However, ordinary depositors are likely to treat deposits as a safe investment regardless of the creditor hierarchy.	- Smaller deposit takers would pay higher levies (than under status quo) reflecting risk to the DIS. Smaller deposit takers could find it more difficult to attract and retain deposits or access wholesale markets under a general preference. Although the amount of losses faced by depositors at smaller deposit takers would be unaffected, their relative safety would decline as a result of general preference (i.e. uninsured depositors at large banks likely to bear smaller losses relative to uninsured depositors at smaller deposit takers. In addition, smaller deposit takers would face a higher cost of wholesale funding if they were to make greater use of these markets in the future, which may limit their ability to grow.
Overall assessment	0	+	-

* A preference for the DIS (insured depositor preference) does not alter the size of the payout that needs to be funded at the point of failure, but will increase the speed of the recovery. Under the proposals in the *Funding Framework* (section AA) below, the Minister of Finance would have flexibility to continue to charge the same levies with a preference for the DIS, if he or she placed a high weight on reducing reliance on the Crown for upfront funding of payout. In this case, a preference for the DIS would have a larger negative impact on competition and the funding costs of deposit takers.

Key

++ much better than doing nothing/the status quo
 + better than doing nothing/the status quo
0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- - much worse than doing nothing/the status quo

4.8.X.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank's preferred approach

The Reserve Bank, on balance, favours Option 2: Insured Depositor Preference (preference for the deposit insurance scheme through subrogation) over the status quo. Option 2 would provide material benefits to the operational effectiveness of resolution tools. Furthermore, the costs identified with a preference for the deposit insurance scheme, and any associated impacts on competition, will be partially mitigated by the increased capital requirements recently announced as part of the Reserve Bank's Capital Review,[87] and the forthcoming enhancements to early intervention and resolution powers (see section 4.7). In addition, preference for the deposit insurance scheme would also increase the amount and speed of recoveries of the deposit insurance scheme in liquidation.

The Reserve Bank notes that the Minister of Finance is proposing to Cabinet that the status quo (i.e. no preference) is maintained.

The Treasury's preferred approach

The Treasury, on balance, favours Option 1: enhanced status quo (*pari passu* regime with deposit insurance). The Treasury's view is that the preference decision is a difficult on-balance judgement weighing up implications for market structure, ease of resolution options, and the burden of costs in a resolution. On balance, the Treasury favours no preference due to the adverse effects on smaller deposit takers of the other options. The Treasury's concern with insured depositor preference for the deposit scheme is that losses are concentrated on uninsured depositors, which may create political economy difficulties in allowing the losses to fall in this way, unless a government was fully committed to imposing losses on uninsured depositors. The Treasury accepts that preference for the deposit scheme would make some resolution options easier, however such resolution options can be facilitated without preference for the deposit insurance scheme.

The Treasury notes that preference for the deposit insurance scheme weakens the link between who bears the immediate costs of the DIS and its beneficiaries. Losses would be borne in the first instance by the uninsured depositors and other unsecured creditors of the failing deposit taker, rather than the insured depositors and deposit takers more generally. The change to the creditor hierarchy would be clear ahead of failures, and to some extent non-preferred creditors may be able to shift the cost bank to deposit takers by seeking compensation through higher returns.

[87] See https://www.rbnz.govt.nz/regulation-and-supervision/banks/consultations-and-policy-initiatives/active-policy-development/review-of-the-capital-adequacy-framework-registered-banks for further details.

Preference for the deposit insurance scheme reduces the likelihood that the DIS would face losses in a liquidation to near-zero at the vast majority of deposit takers.[88] In terms of insurance pricing, this means that the expected cost of providing insurance would be near-zero, which would be likely to reduce the levies collected under the DIS (and the size of the fund would likely be lower than otherwise). However, an *ex ante* fund may still play a role in providing an additional funding source for immediate payout to insured depositors.

The benefits to smaller deposit takers of lower levies may be offset by challenges to attracting and retaining uninsured deposits of wholesale funding as a result of insured depositor preference.[89] The Treasury notes that ordinary depositors are likely to treat deposits as a safe investment regardless of the creditor hierarchy.

Agency views on general deposit preference

A general or tiered preference that includes all depositors may better facilitate the transfer of an entire deposit book to an acquiring entity or bridge bank, without requiring significant public funding, and reduce the likelihood of depositors facing losses in resolutions of major banks. However, the Reserve Bank and Treasury do not recommend a general or tiered preference, as it would pose risks to the ability of small deposit takers (that are primarily funded from deposits) to attract and retain uninsured deposits and issue wholesale funding. Smaller deposit takers predominantly fund themselves through deposits and equity, with deposits comprising the vast majority of their funding base. Under a general preference, the ranking of their existing creditors would be largely unchanged. However, should smaller deposit takers wish to access wholesale markets in the future, then their new wholesale funding would be first in line to absorb losses. This may deter investors if the amount of wholesale funding is small (which is likely to be the case).[90]

[88] Reduced losses also extend to other resolution tools with the introduction of the no creditor worse off principle. Outside of the credit union sector, other deposit takers receive more than half of their funding from creditors that would rank below the DIS, This means that losses would have to reach exceptionally high levels based on international experience before the DIS makes a loss.

[89] The base of creditors that stands first in line to absorb losses (after capital) in the event that these small deposit takers fail would shrink, therefore concentrating losses. For example, consider a small deposit taker with $100 in assets is funded with $10 capital, $45 uninsured deposits and $45 insured deposits. If the deposit taker fails with losses of $30, an uninsured depositor with $150,000 receive approximately $125,000 under a preference for the DIS vs almost $140,000 without.

[90] For example, consider a small deposit taker with $100 million assets funded by $10m equity, $80m deposits and $10m wholesale debt. If the deposit taker fails with $15m losses and there is general depositor preference, the wholesale creditors would lose 50 cents for every dollar of their claim ($5 million across all wholesale creditors). Without general depositor preference (i.e. the status quo) they would lose around 6 cents for every dollar of their claim ($0.6 million across all

wholesale creditors).

4.8.X.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Deposit insurance scheme members	Funding costs for wholesale debt may increase as a result of insured depositor preference. However, this may be somewhat offset by lower deposit funding costs and higher capital requirements resulting from the Reserve Bank's Capital Review.	Medium	Low
Smaller deposit takers	Smaller deposit takers may find it more difficult to issue wholesale funding, due to the higher cost of such funding, than under the status quo. However, a greater constraint on their ability to access wholesale funding markets may be due to their small size.	Medium	Low
Total Monetised Cost		Medium	Low
Non-monetised costs		Medium	Low
Expected benefits of proposed approach compared to taking no action			
Deposit insurance scheme	The deposit insurance scheme is more likely to recover the costs of a payout in the event of a deposit taker failure	Medium	Medium
Resolution authority	Reduces the operational complexity of integrating depositor protection with resolution tools	Medium	Medium
Crown	Any loan from the Crown to the DIS (provided through the Crown's role as backstop) would likely be repaid more quickly by the DIS.	Low	Medium
Total Monetised Benefit		Medium	Medium
Non-monetised benefits		Medium	Medium

4.8.X.9 What other impacts is this approach likely to have?

The changes to the creditor hierarchy would increase the potential exposure to loss of unsecured creditors, including uninsured depositors, by ranking insured depositors (and the DIS) higher in the creditor hierarchy.

As increases in the maximum coverage limit would likely increase the total amount of insured deposits of a deposit taker, unsecured creditors and uninsured depositors would have a greater potential exposure to loss in a failure scenario.

Y. Institutional location and governance

4.8.Y.1 What is the specific problem?

The governance and institutional arrangements of the DIS are critical to ensure the DIS can fulfil its roles in the financial safety net. Under the proposed framework in this regulatory impact statement, the Reserve Bank will house four of the five financial safety net functions: prudential regulation and supervision, lender of last resort and the resolution authority function.

The International Association of Deposit Insurers (IADI) sets out in Principle 3 – Governance of its *Core Principles for Effective Deposit Insurance Systems* that a deposit insurer should be operationally independent, well-governed, transparent, accountable, and insulated from external interference.[91] IADI further states in its guidance for governance arrangements that "*the sound governance of agencies comprising the financial safety net strengthens the financial system's architecture and contributes directly to system stability.*"

The establishment of a new deposit insurer will require decisions on where the deposit insurance function should sit and how the deposit insurer should be governed.

4.8.Y.2 What options are available to address the problem?

In the third consultation, the Review team identified and consulted on three institutional design options for deposit insurance:

[91] International Association of Deposit Insurers. (2014). "The Revised Core Principles for Effective Deposit Insurance Systems". Available at: https://www.iadi.org/en/assets/File/Core%20Principles/cprevised2014nov.pdf

Option 1: Standalone entity

This option would see the establishment of an operationally independent deposit insurer set up as an Independent Crown Entity under the Crown Entities Act 2004. The entity would have its own decision-making body, powers, functions, and transparency and reporting requirements. The entity would need to have powers to set standards in relation to deposit insurance, collect and manage levies, reimburse depositors, promote public awareness of the scheme, monitor risks to the scheme, and coordinate with other safety net participants, and release funds outside of liquidation to the Reserve Bank (as resolution authority). The entity would subrogate for depositors' claims in liquidation. The entity would also have a purpose to promptly reimburse eligible depositors in a liquidation, reflecting that non-liquidation resolutions would be undertaken by the Reserve Bank as resolution authority.[92]

Option 2: The Treasury

This option would see the Treasury tasked with carrying out the functions of deposit insurance including reimbursing depositors, promoting public awareness of the scheme, collecting and managing levies, monitoring risks to the scheme, and coordinating with other safety net participants, and releasing funds outside of liquidation to the Reserve Bank (as resolution authority). Rules relating to the scheme would be set in legislation and regulation, in consultation with other safety net participants. The Treasury would subrogate for depositors' claims in liquidation. The Treasury was the administrator for the Crown Retail Deposit Guarantee Scheme introduced after the Global Financial Crisis. The scheme would also have a purpose to promptly reimburse eligible depositors in a liquidation, reflecting that non-liquidation resolutions would be undertaken by the Reserve Bank as resolution authority.

Option 3: The Reserve Bank

This option would see the Reserve Bank Board being responsible for the achieving the objectives of and carrying out the function of deposit insurance. Duties under this function would include reimbursing depositors, promoting public awareness of the scheme, and collecting and managing levies. Rules relating to the DIS would set through the proposed standard-setting power in section 4.4.E and section 4.4.F. The Reserve Bank would be able to establish a legally separate entity in order to maintain an appropriate separation between its deposit insurance and central banking functions, and release funds outside of liquidation to the Reserve Bank (as resolution authority). The Reserve Bank, or a subsidiary of the Reserve Bank, would have the power to subrogate for depositors' claims in liquidation. The scheme would also have a purpose to promptly reimburse eligible depositors in a liquidation, reflecting that non-liquidation resolutions would be undertaken by the Reserve Bank as resolution authority.

Under all models, certain aspects of the scheme would be set in legislation by Parliament, such as the coverage limit and product boundary. In addition, the Minister of Finance would have the authority to set levies on scheme members given the potential implications for the Crown balance sheet in its role as backstop for the scheme (see 4.8.AA *Funding Framework* section).

[92] See Section O: Powers of the resolution authority, for a full description of the resolution options that are proposed to be available to the Reserve Bank as resolution authority.

4.8.Y.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The Review consulted on four general evaluative criteria as part of the first consultation process:

- **Operational independence from government:** Operational independence means that the deposit insurer is able to fulfil its mandate without interference from external parties.
- **Co-operation with the safety net:** It is important that safety net players share information and cooperate, particularly in times of crisis. Arrangements need to be designed to promote collaboration, given that the participants have different powers and tools to achieve their mandates.
- **Start-up costs and ongoing efficiencies:** The insurer should be able to execute its functions while minimising its cost for scheme members.
- **Accountability and transparency:** The deposit insurer should be operationally equipped and ready to perform its role in resolution. Accountability mechanisms, such as a Board (or other governing structure) overseeing the DIS's functions can enhance the likelihood that the insurer is adequately resourced and performs its functions effectively. Transparency mechanisms such as performance and financial reporting requirements ensure that the DIS can be held to account for the performance of the scheme.

4.8.Y.4 What other options have been ruled out of scope, or not considered, and why?

The Review's analysis of options for institution location are based on the premise that the deposit insurer would be set up as part of government. This reflects common international practice, and the need for the deposit insurer to be integrated into the existing financial safety net, which comprises entirely government bodies.

We have not considered other Crown entity options, such as a Crown agent or autonomous Crown entity (ACE) in detail. We see that for the purposes of this analysis, a Crown agent would be substantively similar to the option of the DIS being located in the Treasury. To the extent that an ACE model can be adapted for a DIS, it would not look substantively different to the independent Crown entity model proposed in Option 1, and would not as effectively signal operational independence.

4.8.Y.5 What do stakeholders think?

Seven submissions were received on this topic. Submitters supported proposals that the deposit insurer should not replicate the supervision and resolution functions of the Reserve Bank, should be located within the Reserve Bank, and should be allowed to contribute to the cost of resolutions. Some submitters suggested that a stand-alone entity should be considered if the scheme becomes more complex, and that the deposit insurer's mandate should have a greater focus on pricing the insurance correctly. Banks emphasised the importance of deposit insurance and resolution functions being co-ordinated.

4.8.Y.5 Impact analysis

	Option 1: Standalone entity (treated as the status quo)	Option 2: The Treasury	Option 3: The Reserve Bank
Operational independence	0 A standalone entity would be afforded all the operational independence protections afforded to Independent Crown Entities under the Crown Entities Act 2004.	- Unlike other options the Treasury is not at arm's length from the Crown. However, the Secretary to the Treasury (and other departmental heads) can and are granted statutory powers to act independently of Minister's. In addition, any ministerial directions must be lawful and consistent with the objectives and purposes of the Act.	0 Establishing the DIS as part of the Reserve Bank would provide deposit insurer the same high degree of operational independence currently afforded to the Reserve Bank
Co-operation with the safety net	0 A standalone entity would have to enter into information sharing agreements with the Reserve Bank and establish a co-ordinating body to enable deposit insurance and resolution functions to coordinate in a crisis.	0 The Treasury would have to ability to enter into information sharing agreements with the Reserve Bank and establish a co-ordinating body to enable deposit insurance and resolution functions to coordinate in a crisis.	+ The Reserve Bank is the designated prudential regulator and supervisor, and is proposed to be the resolution authority. The DIS would be able to rely on the Bank's powers to achieve its functions and there would be close coordination between all parts of the financial safety net.

Start-up costs and ongoing efficiencies	0 The standalone entity may establish some duplicate supervisory functions with those of the Reserve Bank	+ The Treasury would need establish supervisory and enforcement functions to manage and monitor the risks to the DIS, while these could be contracted out to the Reserve Bank there is risk from a split model for accountability and operationalisation. But the insurer could draw on the Treasury's existing governance structure and support functions.	++ The Reserve Bank would be able to draw on existing resources and expertise from supervisory, statistical and enforcement functions to efficiently undertake the functions of the DIS.
Accountability and transparency	0 A limited set of functions and powers with a dedicated oversight Board would ensure that all functions of deposit insurance are resourced and given sufficient focus.	- Reporting on the Scheme would be provided through the Treasury's reporting obligations under the Public Finance Act 1989 and accountability under the Public Sector Act 2020	- The DIS function of the Reserve Bank would draw on the existing transparency and accountability requirements under the Reserve Bank Bill. The establishment of a subsidiary would allow for the DIS's financial statements to be separate from the Reserve Bank.
Overall assessment	0	-	+

Key
++ much better than doing nothing/the status quo
+ better than doing nothing/the status quo
0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- - much worse than doing nothing/the status quo

4.8.Y.6 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 3: The Reserve Bank. There are several advantages to housing the scheme within the Reserve Bank:

- There are synergies with vital technical design, such as ensuring that banks have the necessary systems in place to protect depositors (e.g. developing a single customer view).
- Given the proposed narrow function, there are limited conflicts of interest with the other responsibilities of the Board.
- The Reserve Bank is already the regulator, supervisor, and lender of last resort, and is proposed to be designated as the resolution authority. The addition of the depositor protection function would better utilise the synergies from these various functions. Relative to the alternative options, Option 3 would reduce the potential duplication of supervisory functions already undertaken by the Reserve Bank.
- Relative to alternative options, ongoing efficiencies would be higher and start-up costs would be lower as the Reserve Bank to an extent can draw on existing resources and expertise.

Under this model, the Reserve Bank Board would be responsible for the organisational design and implementation of the deposit insurer's functions, so that deposit insurance would essentially draw on the existing governance framework. As noted above, the Reserve Bank can create a legally separate entity to which it can delegate functions of the scheme.

The Reserve Bank notes that the benefits of Options 1 and 2 include mitigating potential safety net conflicts. The Reserve Bank sees that the Board could ensure that there are sufficient safeguards in internal processes to manage any potential conflicts of interest between deposit insurance and the Reserve Bank's other functions. Conflicts of interest are also made less likely by the narrow scope of functions of the DIS.

The Treasury supports the proposed approach.

4.8.Y.7 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to a standalone entity			
Depositors	Potential for insurer to not receive as much focus and resourcing compared with alternative models.	Low	Low
Total Monetised Cost			
Non-monetised costs		Low	Low
Expected benefits of proposed approach compared to a standalone entity			
Regulated industry	Synergies between Reserve Bank's existing functions and deposit insurance functions would see lower start-up and ongoing costs. As the Scheme is fully funded by industry these will be lower costs for industry.	Low	Medium
Depositors	To the extent that levies will be passed on to depositors, they will pay lower levies	Low	Medium
Total Monetised Benefit		Low	Medium
Non-monetised benefits			

4.8.Y.8 What other impacts is this approach likely to have?

No other impacts have been identified.

Z. Product and Depositor boundary

4.8.Z.1 What is the specific problem?

In order to give effect to the DIS, legislation needs to clearly define the level and scope of coverage. Clear and transparent rules defining the type of depositor and type of deposit covered are critical for ensuring the DIS can protect depositors from loss and thereby contribute to financial stability.

The International Association of Deposit Insurers (IADI) notes that consideration should be given to excluding deposits held by certain depositors (e.g. deposits held on behalf of other deposit takers, deposits of government bodies, and deposits held by related parties of DIS members).[93] The IADI suggests that the potential benefits of exclusions in limiting moral hazard should be weighed against the complications that any exclusions may cause for quickly determining coverage and executing prompt reimbursements.

The same trade-off applies to product exclusions. There is a range of available investment options catering to retail investors, from low-risk to high-risk products. If higher risk retail investment products are covered by deposit insurance, it is likely that tighter regulation and supervision will be employed to manage risks to the deposit insurer, which could lower their returns or threaten their existence entirely.

4.8.Z.2 What options are available to address the problem?

The Review considered the following options for the deposit product and depositor eligibility:

Option 1: Standard product coverage

This model would see transactional, savings and term deposit accounts currently offered by registered banks (and the equivalent products offered by other entities within the future regulatory perimeter) eligible for coverage by the DIS. Debt securities such as bonds, debentures and capital notes would not be eligible, representing their greater complexity and higher risk-return nature. Foreign currency accounts would be excluded. To support the flexibility of the product boundary over time, the Minister would be able to extend coverage via regulation to certain products that are broadly of the same economic substance as other products covered by the DIS. To support the credibility of the product boundary, there would be a restriction on the use of the word "deposit", such that only insured products can use the term "deposit".

Option 2: Broad product coverage

This model would have same features as Option 1, except debt securities such as bonds, debentures and capital notes would be eligible.

[93] International Association of Deposit Insurers. (2013). "Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage". Available at: https://www.iadi.org/en/assets/File/Papers/Approved%20Guidance%20Papers/IADI_Coverage_Enhanced_Guidance_Paper.pdf

Option 3: Narrow depositor exclusions

This model would see the vast majority of persons covered by the DIS. Exclusions would apply to certain more sophisticated depositors: financial institutions (e.g. managed funds, insurers, DIS members), and related parties of DIS members (e.g. senior managers and directors of Scheme members, large non-financial corporates and government bodies. For amounts held in accounts jointly held by two or more persons (otherwise known as joint accounts), each person is entitled to an equal share of the amount held in that account.

To allow the DIS to respond to financial market innovations over time, detailed eligibility rules will be set via regulations. These rules will cover how coverage applies to legal persons such as trusts, partnerships, and incorporated and unincorporated societies.

***Option 4: Wholesale** depositor exclusion*

This model would have same features as Option 3, except wholesale depositors would be excluded based on a standardised definition of 'wholesale' depositor, such as that used for the Financial Markets Conduct Act 2013.

Note that while Options 1 and 2, and Options 3 and 4 are mutually exclusive, respectively, the other options are not and more than one could be adopted in response to the identified problem.

4.8.Z.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The Review considered the following criteria:

Supports prompt reimbursement

Complex rules for deposit insurance eligibility can result in difficulty for the deposit insurer executing payout, potentially weakening the public confidence benefits from deposit insurance. Highly complex eligibility rules can also create difficulty for depositors to understand their eligibility.

Financial system distortions and implementation costs

Eligibility rules generate costs for regulated industry to implement the rules into their systems. To the extent possible eligibility rules should minimise the impost on deposit takers required to implement the framework and distortions resulting from incentives to 'game the system'.

Equity

Coverage of products is consistent across entities and the manner in which depositors choose to hold their deposits does not prejudice their coverage under the insurance scheme. The level of coverage provided should be consistent with the intent of the scheme to protect less sophisticated depositors.

4.8.Z.4 What other options have been ruled out of scope, or not considered, and why?

A range of variations on the models assessed could also be considered, such as different variations on the products covered. We selected the variations on the different approaches that were most likely to meet the assessment criteria.

4.8.Z.5 What do stakeholders think?

There was a range of feedback on deposit and depositor exclusions. Banks did not support excluding related party deposits as regulations already require offerings to related parties to be no more favourable than those offered to other customers. Banks also noted that small-to-medium sized exporters (that are likely to be less sophisticated) make use of foreign currency deposits for day-to-day business. Submissions from individuals supporter excluding all deposits from financial institutions, and that the rules of the DIS should limit the ability for depositors to increase coverage through arranging their affairs through trusts.

Finance companies did not support the exclusion of debentures from the deposit insurance scheme, on the basis that their products are similar to terms deposits and that under the proposed regulatory perimeter they will be subject to the same regulatory regime as banks.

4.8.Z.6 Impact analysis

	Option 1: Standard product coverage	Option 2: Broad product coverage	Option 3: Narrow depositor exclusions	Option 4: Wholesale depositor exclusions
Supports prompt reimbursement	+ Few exclusions from the scheme would limit risk associated with payout process.	+ Few exclusions from the scheme would limit risk associated with payout process.	+ Deposit takers will make systems investments to ensure exclusions do not pose material risk to payout timeframes.	-- Would require collection of a significant amount of information, and on-going determination of whether a person is a 'wholesale' or 'retail' depositor, creating significant risk for the payout process.
Financial system distortions	+ Limited cost for deposit takers to implement.	-- Prevents the continued existence of higher risk-return uninsured retail debt products by deposit takers, negatively impacting financial system diversity.	- Some cost to deposit takers, including having to collect comprehensive information on turnover and/or assets of non-financial corporates.	0 Requires a significant cost to be imposed on deposit takers. Reduced distortions as excluded depositors applying more market discipline.
Equity (Fairness)	0 $100,000 cap limits coverage for more sophisticated borrower types.	0 $100,000 cap limits coverage for more sophisticated borrower types.	+ Limited exclusions increase consistency with intent to cover less sophisticated depositors.	++ Greater consistency with intent to cover less sophisticated depositors.
Overall assessment	+	-	+	0

Key
++ much better than doing nothing/the status quo
+ better than doing nothing/the status quo
0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- - much worse than doing nothing/the status quo

4.8.Z.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Options 1: Standard product coverage and 3: Narrow depositor exclusions.

Option 1 draws a clear boundary between products used by everyday depositors and higher risk-return retail investments. This allows the DIS to achieve its objective by covering products that are widely held thus covering the vast majority of depositors. The option also allows for the continuation of higher risk-return retail debt products to be offered, promoting financial system diversity. The credibility of this boundary will be supported by restrictions on the use of the word 'deposit'.

Option 3 is broadly in line with international best practice guidance issued by the IADI and balances supporting prompt reimbursement against the moral hazard risks associated with extended coverage. The Reserve Bank notes that while the intention of the DIS is not to cover sophisticated depositors (otherwise known as 'wholesale' depositors), the lack of a clear and concise definition, and the complexity associated with implementing any wholesale depositor exclusion is likely to outweigh the benefits of excluding them. However, the proposed set of exclusions should help narrow the scope of sophisticated depositors covered by the DIS. In addition, at a $100,000 coverage limit, the total amount of wholesale depositors' deposits not protected by the DIS should give them sufficient incentives to continue exerting market discipline.

The ability to set detailed eligibility rules via regulation should also allow the DIS to respond to changes in the financial system and deposit holdings over time.

The Treasury supports the proposed approach.

4.8.Z.8 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment***: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*

Additional costs of proposed approach			
Finance companies	At the outset of the DIS, based on the proposed scope of product coverage, many products issued by finance companies would not be covered. To gain coverage under the DIS, finance companies would need to transition their existing products to products that are more akin to 'deposits'.	Medium	Medium

Regulated industry	Regulated industry will need to invest in ensuring that their systems can identify the relevant products and depositor types to promptly calculate entitlements to support prompt payout. Deposit insurers typically refer to this as a 'single customer view'. Regulated industry will also need to adapt their product offerings to restrictions on the word 'deposit' and any changes to the Financial Markets Act 2013 disclosure requirements that may arise from these legislative changes.	Medium	Medium
Total Monetised Cost		Medium	Medium
Non-monetised costs		Low	Low

Expected benefits of proposed approach			
Depositors	The limited set of exclusions will support prompt reimbursement of depositors' entitlements in the event their deposit taker fails.	Medium	Medium
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.8.Z.9 What other impacts is this approach likely to have?

No other impacts have been identified.

AA. Funding framework

4.8.AA.1 What is the specific problem?

The deposit insurer's funding has a direct bearing on its ability to achieve its statutory objective. While the Deposit Takers Act will not determine the level of funding provided to the DIS, it will establish the funding model. A well-designed funding model maintains operational independence with accountability checks that ensure depositors and deposit takers are getting good value for money.

IADI Core Principles for Effective Deposit Insurance Systems highlight that the deposit insurer should have readily available funds and all funding mechanisms necessary to ensure prompt reimbursement of depositors' claims including assured liquidity funding arrangements.[94] The IADI further notes that responsibility for paying the costs of deposit insurance should be borne by banks. The IADI notes a number of essential criteria for sources and uses of deposit insurance funding:

- Funding for the deposit insurance system is provided on an *ex ante* basis (i.e. funding is accumulated prior to an institution failing).
- Emergency funding arrangements for the deposit insurance system, including pre-arranged and assured sources of liquidity funding, are explicitly set out (or permitted) in law or regulation.
- Where the deposit insurer is not the resolution authority, it has the option, within the legal framework, to authorise the use of funds for resolution of member institutions other than liquidation provided that:
    a. Contributions are restricted to the costs the deposit insurer would otherwise have incurred in a payout of insured depositors in a liquidation net of expected recoveries
    b. Procedural and reporting requirements are placed on the use of funds (such as actions and decisions being subject to *ex post* review, and that the use of the deposit insurer's funds is transparent and documented, and is clearly and formally specified.

4.8.AA.2 What options are available to address the problem?

Two options have been assessed. Under both options we assume that the deposit insurer's funds can be used outside of a liquidation and payout. Consistent with guidance from the IADI, DIS funds could be used outside liquidation 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. This would ensure that, regardless of the resolution tool used, the DIS can achieve its objective to protect depositors to the extent that they are covered by the scheme and thereby contribute to financial stability.

***Option 1: Establishing a Deposit insurance fund* (with ex ante funding)**

This model would see member institutions paying levies to both pre-fund the DIS and recover any costs (from payouts and operational costs) incurred by the DIS over time. A deposit insurance fund would be established and managed by the DIS, which could act as the first port-of-call for funding payout. The DIS would be supported by a fiscal backstop provided by the government that will ensure the DIS can always meet its obligations. Any funding provided under the backstop would be fully repayable, with interest, by industry.

[94] International Association of Deposit Insurers. (2014). "The Revised Core Principles for Effective Deposit Insurance Systems". Available at: https://www.iadi.org/en/assets/File/Core%20Principles/cprevised2014nov.pdf

The Minister of Finance would publish a funding strategy at least every five years. The funding strategy would set out risks to the DIS, projected costs of the DIS over time, how depositor reimbursement via the DIS will be funded, guidance for levy setting, guidance for how the DIS should manage the fund and how the Crown's exposure as backstop to the DIS will be managed. The Minister would be required to consult with the public and have regard to the advice of the Reserve Bank (as deposit insurer) when setting the funding strategy. The DIS would be required to act consistently with the guidance on fund management.

The funding strategy and corresponding levies will be set according to funding considerations along the lines of:

- the DIS should be funded by industry over time
- the financial position of the Crown (as backstop for the DIS)
- that levies reflect the amount of claims made of likely to be made by a licensed deposit taker or class of licensed deposit taker
- the stability of licensed deposit takers of class of licensed deposit takers, and
- the desirability of consistency and predictability in levies.

Following the publication of the funding strategy, the DIS would provide advice on levies that would give effect to the funding strategy and the principles. Levies would then be set by Order in Council. The levies would be paid into a fund managed by the DIS, and would be used to cover the operating costs of the DIS and any insurance payouts.

The funding framework and levy setting process would be flexible and allow for the Minister to set differential levies (for example, deposit takers could pay levies commensurate with the risk they pose to the DIS). In addition, the framework allows for a range approaches to fund management, including in manner that is consistent with the Crown's overall approach to managing its liabilities.

In the event of a payout, the DIS would have the power to subrogate the insured depositors' claims and recover funds through its claim on the assets of the failed deposit taker in the resolution process

***Option 2: Ex-post funding* (Australian Financial Claims Scheme model)**

This model is broadly based on the funding model used for Australia's Financial Claims Scheme. As with Option 1, the DIS would be supported by a fiscal backstop provided by the government that will ensure the DIS can always meet its obligations. Payout in the event of a failure would be first advanced by the Government. If the assets of the failed deposit taker were insufficient to meet the Government's claim the Minister would have the authority to set levies on the deposit taking industry to meet and shortfall. Levies would be charged at a flat rate. Through these recoveries and levies the scheme would be able to repay any funds provided by the Government.

4.8.AA.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The following criteria are used to assess the options:

Legitimacy

The funding model should promote both accountability for the delivery of the deposit insurer's objectives and functions, as well as *ex post* accountability for the efficient expenditure and management of funds. It should be easy to demonstrate the link between the levies and their use in ensuring depositors are protected from loss and promptly reimbursed, to the extent that they are covered by the DIS.

Complexity

A funding framework should be as straightforward and understandable as possible and should avoid unnecessary administrative costs. The persons who bear the costs of the scheme should have clarity around the funding approach over time. The framework should also be flexible enough to accommodate changing risks to deposit takers over time that may require a reassessment deposit insurer's funding needs.

Equity

The funding framework should seek to impose the costs of the scheme on the beneficiaries of the scheme over time, whilst recognising the wider financial stability benefits the scheme provides.

Supports deposit insurer to achieve objectives and functions

The funding framework should support and enable the deposit insurer to achieve its objectives of *protecting depositors to the extent they are covered by the deposit insurance scheme and thereby contributing to financial stability*, and its functions to promptly reimburse depositors. To achieve this the framework should ensure funding is available within timeframes consistent with the scheme's function of promptly reimbursing depositors, and result in a credible framework for funding that supports public confidence in the safety of deposits.

4.8.AA.4 What other options have been ruled out of scope, or not considered, and why?

A range of variations on the models assessed could also be considered, such as different variations on the principles for funding or roles in the funding framework. We selected the variations on the different approaches that were most likely to meet the assessment criteria.

4.8.AA.5 What do stakeholders think?

Nine submissions were received on this topic. Submitters supported charging levies to deposit takers ahead of any failure(s) occurring. Deposit takers, including banks, stressed that levies should take into account the Reserve Bank's recent decision to increase capital requirements for the banking sector which, all else equal, reduces the likelihood that the scheme is drawn on. The sector stressed that *ex ante* levies have an opportunity cost, in that those funds would otherwise be used to support productive lending or build capital, and that the levies would also need to be set with regard to the capacity of the sector to absorb higher costs at a given time. An individual submitter stressed that the *ex ante* levies, including the amount held in any deposit insurance fund, should be set based on objective criteria and international comparisons.

Submitters provided a range of views on the approach to differential pricing. Banks supported a risk-based approach to setting levies and stressed that further consultation should take place before the levy amounts are determined. Small banks, CUBS and finance companies stressed that the levy setting needed to be proportionate and take into account the potential impact on their ability to compete with large banks; reflect the systemic risk posed by larger banks; and should not rely solely on simple measures such as credit ratings which are distorted by parental or implicit Government guarantees. Submissions from individuals supported differential pricing.

Banks and one individual submitter questioned to what extent deposit takers should pay for the cost of funds provided through the Government backstop, given that the provision of these funds is supporting the public policy objective of protecting depositors. The sector proposed that any charge for the backstop should be on a cost recovery basis, and the Crown should not make a profit from the provision of insurance.

4.8.AA.6 Impact analysis

	Option 1: Establishing a deposit insurance fund with ex ante funding (treated as status quo)	Option 2: Ex-post funding
Legitimacy	0 Funding statement would set out the strategy for levies. A deposit insurance fund makes it easier to demonstrate the scheme is fully funded and to connect levies to the purpose of the DIS.	- The operational costs of the DIS would need to be funded by taxpayers. Taxpayer funds would be used for all payouts at the outset but recovered from industry over time.
Complexity	0 Requires framework to collect and justify *ex ante* levies. Requires dedicated resource to manage the deposit insurance fund.	+ This Option would not require a model to charge levies *ex ante*, which could be complex given the likely infrequent nature of financial risk events arising from the scheme.
Equity	0 Deposit takers bear the cost of the DIS over time.	-- The failed deposit taker would not pay for the cost incurred by the DIS from its failure. Creates a large and uncertain future liability for deposit takers, and potentially the Crown.
Supports deposit insurer to achieve objectives and functions	0 Statement of Funding Approach would set out combined role of fund and backstop to support public confidence in the DIS.	- Levies cannot be used to manage moral hazard risk and associated financial stability issues.
Overall assessment	0	--

4.8.AA.7 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 1: Establishing a deposit insurance fund (with ex ante levies). The ability to charge *ex ante* levies for the scheme supports fairness and equity; it minimises pro-cyclicality (large *ex post* levies on the sector during periods of stress); it enables management of moral hazard risk through differential pricing; and provides a potential source of funds that could be drawn on prior to the use of the Government backstop.

The funding strategy will help to underpin public confidence in the DIS, by disclosing how the DIS will have sufficient funding from a whole-of-Crown perspective, regardless of the amount accumulated in any fund. The funding strategy will provide for significant flexibility to adapt the funding model over time as the financial system changes. To balance this flexibility, publication of the strategy and requirement to consult on the strategy will provide ongoing transparency about the funding approach.

The deposit insurance fund would enhance public perceptions that levies are being used consistent with the purpose of the scheme, and make it easier to demonstrate to the public that the costs of the DIS are fully funded by deposit takers. The existence of a fund may also support public confidence by reducing reliance on the Crown backstop to fund upfront payout to depositors.

The Treasury supports this approach.

4.8.AA.8 Summary table of costs and benefits of the preferred approach

Additional costs of proposed approach			
Regulated industry	Regulated industry will need to pay for the operating costs of the DIS over time.	Low	Medium
Crown	Management of levies in a ring-fenced fund introduces inefficiencies to liability and asset management by duplicating resource for management of the liability across different parts of the Crown (although this can be managed through a co-ordinated approach to liquidity management).	Low	Medium
Total Monetised Cost		Low	Medium
Non-monetised costs			

Expected benefits of proposed approach			
Crown	Relative to alternative Options, this Option would see a reduced likelihood of the Crown being required to temporarily provide funds to support the Deposit Insurer to reimburse depositors.	Low	Medium

Regulated industry	A clear and transparent funding framework provides industry with certainty of the levy approach over time. Building up funds over time through levies reduces the likelihood of the DIS needing to charge pro-cyclical levies (i.e. large *ex post* levies on the sector during periods of stress.	Medium	Medium
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

4.8.AA.9 What other impacts is this approach likely to have?

No other impacts have been identified.

Section 4.9: Appeal rights

BB. Appeal rights

4.9.BB.1 What is the specific problem?

The current Reserve Bank of New Zealand Act does not provide for appeal rights on bank registration decisions, including on whether directors and senior managers are fit and proper persons. The ability to challenge these decisions is limited to judicial review. While the NBDT Act provides for appeal rights in relation to fit and proper decisions, it does not provide for appeals on other elements of the Reserve Bank's licensing decisions.

The current conditions of registration (CoRs) for banks, which are used to set the primary rules applicable to registered banks, such as capital, liquidity or corporate governance, are not subject to parliamentary oversight, or potential disallowance. Disclosure rules – a sub-set of the broader prudential rule-book – are set by Orders in Council.

The DTA proposals will empower the Reserve Bank to set standards, issue exemptions and designations (secondary legislation) and exercise a range of administrative decision-making powers, including assessing applications for a deposit taking licence, making subsequent changes to an entity's licence conditions, and using various enforcement tools.

A system of appeal acts as a procedural safeguard and accountability mechanism to ensure parties whose rights or interests are affected by the Reserve Bank are afforded a right of recourse to challenge that decision. Appeal rights ensure decisions are in accordance with the law and help incentivise high quality decision making. However, appeals in a prudential context need to strike the right balance between protecting the interests of affected parties and enabling the Reserve Bank to pursue its statutory mandate efficiently and effectively.

Every-Palmer[95] (p. 32-33) notes that where the Reserve Bank carries out a function that involves a determination in respect of a person's rights, obligation or interests, the Reserve Bank is under an obligation to observe the principles of natural justice:

> *The requirements of natural justice vary with the circumstances. In short, the Reserve Bank is required to act fairly. The basic requirements are that Reserve Bank must give the bank/person an opportunity to be heard and must be disinterested and unbiased. It is also likely to require the Reserve Bank to put the case (and relevant information and documents) against the bank / person to it so that it has an opportunity to answer it. In some cases, it may also require the Reserve Bank to give reasons for its decision.*

4.9.BB.2 What options are available to address the problem?

The Reserve Bank's standard-setting, exemptions and designation powers will be subject to judicial review, which would allow applicants to challenge the process by which decisions are

[95] Every-Palmer QC, Dr James (2017) 'Reserve Bank Prudential Regulation of Banks'. Available at: https://www.treasury.govt.nz/sites/default/files/2018-04/rbnz-rev-prudential-regulation-banks.pdf

made (in particular, whether the Reserve Bank acted within its powers and consistently with the legal framework). As secondary legislation, these powers of the Reserve Bank would be subject to scrutiny by Parliament via the Regulations Review Committee, and can be disallowed by the House in certain circumstances. The DTA will also specify appropriate procedural safeguards for the exercise of these powers.

In addition to these powers being subject to judicial review, we are proposing that the DTA will, where appropriate, provide for a right of appeal if the rights or interests of a particular person are affected by an administrative decision.[96] The two main options available for judicial scrutiny are:

- **A 'merits review':** enabling the merits of a decision to be re-examined through an assessment of questions of fact (rather than just an assessment of the process by which the decision was made, which is what is examined in a judicial review).
- **An appeal on questions of law:** limiting the scope of appeal to questions of law (that the decision-maker applied the law correctly) excludes examination of whether the decision erred in the conclusions as to the facts (to which they applied the law). This makes it similar to judicial review.

In considering the approach to the proposed system of appeal, the Review has considered other systems of appeal, particularly where entities may be regulated under both the proposed regulatory perimeter for the DTA and other regulatory environments. For example, the Review considered the approach for licensing decisions taken under the Financial Markets Conduct Act, which distinguishes appeals allow for some decisions, such as declining to issue a licence (full appeal) from other FMA decisions (appeal on questions of law only).

Option 1: Proposed appeal rights

Our preferred approach is as follows:

- Decisions subject to merits review:
    - Fit and proper decisions in relation to directors and senior employees.
    - The decision to not grant a deposit taker licence.
- Decisions subject to appeal on questions of law:
    - Decisions by the Reserve Bank that affect the rights and interests in relation to an initial licence (i.e. conditions of licence, approvals to carry on certain activities).
- Decisions that would have no formal appeal rights attached[97]
    - Decisions by the Reserve Bank in relation to enforcement or direction.

[96] There are a number of decision-making powers for which existing legislation sets out the procedure for the conduct of the proceedings, including appeal rights. This includes the Search and Surveillance Act 2012 and the Criminal Procedure Act 2011.

[97] Other than the inherent judicial review power of the High Court, which encompasses questions of law

Civil and criminal penalties, which are court ordered remedies, are automatically subject to appeal rights under rules of civil and criminal procedure.

4.9.BB.3 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The following table outlines the factors in favour of more or less judicial oversight when considering pathways to challenge a decision.

Factors in favour of more judicial oversight	Factors in favour of less judicial oversight
Improvement of decision-making through review process. Protection of rights of regulated entities or individuals. Enhanced accountability.	Potential costs.* Implications of delay.* Significance of the subject matter. Regulator has better information and technical expertise than the Courts. Need for finality. Create uncertainty. ** Concerns about cost and delay should usually be dealt with by limiting the right of appeal, rather than denying it altogether.*

Adapted from Every-Palmer QC and LDAC Guidelines

As noted above, the system of appeal within the prudential framework needs to strike the right balance between protecting the interests of affected parties versus enabling the Reserve Bank to pursue its statutory mandate efficiently and effectively.

4.9.BB.4 What other options have been ruled out of scope, or not considered, and why?

We have also considered whether the DTA should provide for and set out the procedure for an internal review of any of the Reserve Bank's decision-making powers. The Legislation Design and Advisory Committee notes that, in some circumstances, the legislation should also include a prior process of internal review of the merits of a decision. Internal reviews are an effective way of identifying and correcting mistakes without the cost and publicity that an appeal to an external body or judicial review may attract. However, they are not a substitute for considering whether or not a right of appeal is appropriate.

Internal reviews are particularly appropriate where there are lots of decisions being made that involve findings of fact and an internal review process will ensure quality and consistency of decision-making across multiple decision-makers (for example, decisions on benefits). We have decided against legislating for an internal review as the Reserve Bank operates internal review procedures without legislative provision and legislating for these procedures risks that the procedures will become out-of-date.

We have not considered ouster clauses (sometimes called privative clauses), which remove or limit (either substantively or through procedural limits) the ability of the courts to judicially review the decision.

Appeal rights for decisions made by the resolution authority will be considered once the no creditor worse off framework has been confirmed.

4.9.BB.5 What do stakeholders think?

During the third consultation, two individual submitters noted the importance of appeal rights for aspects of licensing decisions where interpretation is required. An individual submitter noted that the High Court may not have sufficient expertise for hearing appeals beyond a judicial review.

4.9.BB.6 Impact analysis

	Status quo	Option 1: Proposed approach
Clarity	0	++ Would enable the Reserve Bank to pursue its statutory mandate efficiently and effectively. This approach mitigates potential risks to financial stability, and recognises the expertise of the decision maker.
Protecting the interests of affected parties	0	+ Overall system of appeal would provide greater opportunity for affected parties to challenge the Reserve Bank's decisions than under status quo.
Overall assessment	0	+

4.9.BB.7 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

The Reserve Bank prefers Option 1: the proposed approach.

The Treasury agreed on the above system of appeal rights for the Reserve Bank's administrative decision-making powers, other than in relation to:

- appeals from decisions affecting the rights and interests attaching to deposit taking licences: the Treasury considers that these decisions should be subject to full ('merits') appeal, and
- appeals from decisions on enforcement or direction: the Treasury considers that these decisions should be subject to appeal on questions of law.

The different conclusions by the Treasury and the Reserve Bank reflect a difference in judgement on the right balance to be struck between protecting the interests of affected parties versus enabling the Reserve Bank to pursue its statutory mandate efficiently and effectively. In general, a limitation reflects the need for certainty, including potential risks to financial stability, and the expertise of the decision maker.

4.9.BB.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** $m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	**Evidence certainty** (High, medium or low)
Additional costs of proposed approach compared to taking no action			
Regulated parties			
Regulators	Costs in engaging with any potential appeal on decision.	Low	Medium
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Medium
Expected benefits of proposed approach compared to taking no action			
Regulated parties	Benefits through increased ability to appeal decisions by the Reserve Bank.	Low	Medium
Regulators	Benefits in supporting the Reserve Bank to make decisions that are of the highest possible quality.	Low	Medium
Wider government			
Other parties			
Total Monetised Benefit			
Non-monetised benefits		Low	Medium

4.9.BB.9 What other impacts is this approach likely to have?

No other impacts have been identified.

Section 5: Conclusions

5.1 What option, or combination of options, is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

An overview of the Reserve Banks's preferred approach for the package, as covered in detail in Section 4, is outlined below. As noted, these proposals are inherently interlinked, with later proposals aiming to build on the strengths of earlier proposals, while mitigating any risks or weaknesses.

On balance, we consider that the package of changes will significantly strengthen New Zealand's prudential regulation framework, proportionally responding to financial stability risks, including striking an appropriate balance between flexibility, and clarity and legitimacy, for example. While the changes would be significant in terms of the way that the Reserve Bank operates, they should not pose unnecessary costs on the financial sector or the public relative to the reform's benefits.

The Reserve Bank's package of recommendations

Previous Cabinet in-principle decisions

Cabinet is being asked to confirm its previous in-principle decisions, which include:

- regulating and supervising banks and non-bank deposit takers under a single prudential regime
- using 'standards' as the primary legislative mechanism for imposing prudential requirements
- enhancing the accountability and liability of directors of deposit takers
- giving the Reserve Bank an on-site inspection power and a more graduated enforcement and penalty framework with a broader range of potential sanctions
- establishing a deposit insurance scheme, and
- designating the Reserve Bank as the resolution authority with a broader range of powers.

Additional and consequential recommendations, following on from the decisions set out above, are as follows:

The framework for the regulation and supervision of deposit takers

- define the legislative purposes of the DTA and the decision-making principles that will help guide the exercise of powers under the Act
- define which financial institutions will be regulated and supervised as 'deposit takers' and the flexibility afforded to the Reserve Bank to manage entities that sit close to the boundary of the prudential perimeter (i.e. exemption and designation powers)
- empower the Reserve Bank to set prudential requirements on deposit takers via standards within a permitted scope, with a high degree of flexibility to tailor requirements given the diversity of the sector

- empower the Reserve Bank to license and de-license deposit takers, subject to criteria specified in the DTA, and in consultation with the Financial Markets Authority (FMA) which will be licensing the same set of financial institutions from a market conduct perspective
- empower the Reserve Bank to set 'fit and proper' requirements on directors and senior managers in line with those requirements in the Insurance (Prudential Supervision) Act 2010;
- provide greater assurance that directors of deposit takers are prudently managing risks to their institution, via the imposition of an on-going duty to ensure that there are adequate systems, processes and policies in place so that the entity complies with its prudential obligations
- provide for an on-site inspection power and a more graduated enforcement and penalty framework with a broader range of potential sanctions
- calibrate the scope of the Reserve Bank's regulatory and supervisory powers for 'associated persons' of deposit takers as appropriate – i.e. entities that have a relationship with the deposit taker and whose activities may pose a risk to the soundness of the deposit taker and/or the stability of the financial system, and
- provide for a well calibrated framework for appeal rights in the prudential framework – i.e. the ability of affected parties to challenge decisions of the Reserve Bank, in a way that strikes the right balance between protecting the rights of affected parties while enabling the Reserve Bank to pursue its statutory mandate effectively and efficiently.

Crisis management and resolution

- the design of some key elements of the new resolution and crisis management framework, including the introduction of statutory bail-in[98], the Minister's role in the framework at specific decision points, the triggers for resolution and the liabilities eligible for bail-in.

Deposit insurance

- the DIS would be compulsory for all licensed deposit-taking institutions, would be fully funded by levies on member institutions, and would be supported by a government funded backstop that will enhance the credibility of the DIS
- a reframing of the objective of the deposit insurance scheme along the lines of "protecting depositors to the extent they are covered by the deposit insurance scheme and thereby contributing to financial stability"
- the governance and mandate of the deposit insurer
- the funding framework, and
- the boundary for eligible products and depositors.

[98] 'Bail-in' is a resolution tool where unsecured liabilities are written down or converted into equity. This power would provide a new option for imposing costs of a deposit taker failure on investors and creditors rather than taxpayers.

Cabinet paper proposals

The Cabinet paper reflects the Reserve Bank's preferred approach, with the exceptions noted below.

Section 4.4.H The role of the Minister of Finance in changing the scope of lending standards

- Lending restrictions used for macro-prudential policy may generate 'distributional' consequences, and may have implications for other areas of government policy. It is therefore important to clarify the role of the Minister as it relates to the Reserve Bank's use of such tools. There are trade-offs between the degree of Ministerial involvement in prudential policy and the Reserve Bank's degree of operational independence.
- The Reserve Bank prefers Option 1: A requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards only in accordance with a recommendation of the Reserve Bank.
- The Treasury prefers Option 2: A requirement that the Minister of Finance can make regulations defining or changing the scope of lending standards after consultation with the Reserve Bank. This option is reflected in the Cabinet paper.

Section 4.8.W Deposit insurance and the insurance limit

- A common and long-standing approach used overseas is to establish a deposit insurance scheme that protects eligible depositors up to a pre-set maximum or 'coverage limit' if their deposit taker failed.
- The Reserve Bank prefers the introduction of deposit insurance with a $50,000 limit to address the issues in relation to enhancing New Zealand's financial safety net. A well designed DIS can protect depositors from risks beyond their control, mitigate the potential hardship that depositors would face from loss of access to, and loss on, their transactional accounts. This in turn can raise public confidence, reduce the likelihood and severity of bank runs and disorderly bank failures, and contribute to financial stability.
- The Reserve Bank considers that this option would sufficiently protect depositors from loss by mitigating any hardship depositors would face through lack of access to and loss faced on amounts up to $50,000. The Reserve Bank places substantial weight on the moral hazard risks that arise from protecting depositors from loss at higher coverage limit, and the greater reliance on costly and imperfect mitigation tools that this creates. At higher coverage limits under Options 3b and 3c there would be material moral hazard risks for little marginal benefit in terms of additional depositors fully covered.
- The Treasury prefers the introduction of deposit insurance with a $100,000 limit. The Treasury sees that there is significant uncertainty about the appropriate coverage limit. This option is reflected in the Cabinet paper.
- A $100,000 limit would cover a substantial number of depositors who are otherwise not necessarily well placed to monitor their deposit taker, such a first-home buyers and retirees. The Treasury notes that there is substantial variation in the number of deposit takers fully covered at each institution under the coverage limit options. At a $100,000 limit the vast majority of depositors would be fully covered at the vast

majority of deposit takers, while leaving a significant amount of the value of deposits unprotected. A $100,000 limit would support future Governments' willingness use resolution tools that impose losses on depositors, knowing that the vast majority of deposit takers are fully covered.

- A $100,000 limit would also support confidence in the financial system, without materially blunting incentive of more sophisticated depositors to monitor risks. While the Treasury sees moral hazard as a key consideration for depositor protection, the increase in risk-taking and the Crown's contingent liability would need to be managed using the enhanced monitoring, supervisory, and regulatory powers being provided to the Reserve Bank under the Deposit Takers Act and through levies differentiated according to the level of risk. It is also unclear whether depositors up to $100,000 are currently engaging in risk monitoring.

Section 4.8.X Depositor preference

- Bank deposits – including those deposits covered by the DIS – under the current creditor hierarchy rank pari passu (have equal rank) with other senior unsecured creditors. That means that depositors and other unsecured creditors absorb losses equally in proportion to their claim. A depositor preference would rank preferred depositors ahead of the other unsecured creditors, thereby increasing the amount of recoveries received by these creditors from the assets of the failed deposit taker.
- The Reserve Bank, on balance, favours Option 2: Insured Depositor Preference (preference for the deposit insurance scheme) over the status quo. Option 2 would provide material benefits to the operational effectiveness of resolution tools. Furthermore, the costs identified with a preference for the deposit insurance scheme, and any associated impacts on competition will be partially mitigated by the increased capital requirements recently announced as part of the Reserve Bank's Capital Review, and the forthcoming enhancements to early intervention and resolution powers.
- The Treasury, on balance, favours Option 1: enhanced status quo (deposit insurance with the status quo creditor hierarchy). The Treasury's view is that the preference decision is a difficult on-balance judgement weighing up implications for market structure, ease of resolution options, and the burden of costs in a resolution. On balance, the Treasury favours no preference due to the adverse effects on smaller deposit takers of the other options. The Treasury's concern with insured depositor preference for the deposit scheme is that losses are concentrated on uninsured depositors, which may create political economy difficulties in allowing the losses to fall in this way, unless a government was fully committed to imposing losses on uninsured depositors. The Treasury accepts that preference for the deposit scheme would make some resolution options easier, however such resolution options can be facilitated without preference for the deposit insurance scheme.
- The Treasury notes that preference for the deposit insurance scheme weakens the link between who bears the immediate costs of the DIS and its beneficiaries. Losses would be borne in the first instance by the uninsured depositors and other unsecured creditors of the failing deposit taker, rather than the insured depositors and deposit takers more generally. The change to the creditor hierarchy would be clear ahead of failures, and to some extent non-preferred creditors may be able to shift the cost bank to deposit takers by seeking compensation through higher returns.

5.2 Summary of costs and benefits of the preferred approach

This package of proposals will help protect society from the damage to New Zealand's financial system and wider economy that could be caused by excessive risk taking by the deposit taking sector, and the failures of individual deposit takers. Taken together, the recommendations will strengthen New Zealand's financial system safety net.

The package of reforms are expected to provide wider benefits by way of improved public confidence in the regulation of deposit takers, reducing the likelihood and severity of bank runs and disorderly bank failures, and contributing to financial stability. The increased trust and confidence in the financial system would provide benefits across a range of well-being domains (e.g. income and consumption, jobs and earnings). The proposals may help investors to understand the risks associated with their investments and to price those risks accordingly.

The new prudential framework will enable the Reserve Bank to better manage risks that arise both to and from the New Zealand financial system, thereby supporting both the financial health of individual deposit takers and financial stability. In turn, this will help protect the financial capital of New Zealanders. A stable financial system, in which the public has confidence, protects people's jobs and earnings, and income and consumption, from unforeseen shocks arising from the financial system.

To the extent that the proposed changes to the Reserve Bank's prudential regulation increase its operating costs, future dividends to the Crown may be reduced if they can't be covered by revenue from a levy. The proposed levying power for the Reserve Bank's prudential functions, if implemented, would shift costs from taxpayers (reflected by the dividend) to regulated entities, with those costs potentially passed on by industry to deposit takers' customers. The costs directly associated with changes to the Reserve Bank's prudential regulation function have not generally been quantified as they are not expected to be significant. The costs are dependent on how the Reserve Bank chooses to implement the regime, and are generally not a determining factor in assessing appropriate prudential regulation by the Reserve Bank.

Finally, there would be benefits from alignment with international best practice as international investors would have clarity and certainty about the risk they face in the event of a resolution. This could have efficiency benefits in terms of better coordination of policies and improved or lower cost access of New Zealand banks to international markets. It could also (see the next point) reduce any costs associated with perceived inconsistencies of international regulatory approach.

We expect that there will be costs to the financial sector associated with the new prudential framework for deposit takers, although the extent of any cost increase will be dependent on how the Reserve Bank chooses to operationalise some of the legislative changes (e.g. whether the Reserve Bank undertakes on-site inspections in the context of a more intensive model of supervision). There will be one-off costs to the financial sector to implement the changes introduced by the new prudential framework. Some of these costs may be passed on to customers of deposit takers, although the extent of this is difficult to determine. Customers will also be among the main beneficiaries of the strengthened financial system safety net.

Resolution and crisis management

The proposed package of resolution and crisis management reforms would increase the range of resolution options and deliver resolution in an orderly manner without causing disruption to critical financial services or damage to financial stability. In particular, it would ensure continuity of systemically important financial services, and payment, clearing and settlement functions, and allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims. This will support pre-crisis preparedness and mitigate delay in responding to a crisis.

A fit-for-purpose resolution and crisis management regime allows the failures of financial institutions to be managed, and ensures that the financial system will be resilient to failures of financial institutions, both large and small – preventing shocks from spilling out into the broader economy and threating the economic and social well-being of New Zealanders. The proposals relating to the new crisis management regime will support the resilience of New Zealand at the national level.

Depositor protection

The proposed package of depositor protection reforms would help to mitigate hardship that depositors would face if they faced losses on their deposits and lost access to their deposits in the event that their deposit taker failed. The reforms would also enhance public confidence in the financial system, mitigating the likelihood of a destabilising 'bank run'. Deposit takers will also benefit from a more stable funding base, and the government benefits from a shift from an uncertain implicit guarantee, to a managed, limited, and user-pays explicit guarantee. A DIS will also support the proposed package of crisis management reforms, increasing the likelihood that future governments will allow deposit takers to fail without recourse to public funds.

The Deposit Insurance Scheme ultimately supports the financial safety of New Zealanders, and provides security and confidence from risk of financial harm. This supports the resilience of individuals and whānau. A credible deposit insurance scheme builds public confidence, and therefore promotes financial stability.

There will be costs to Deposit Insurance Scheme members in the form of levies to cover the costs of a deposit insurance scheme, and costs to upgrade their systems to implement the scheme (e.g. a single customer view). To the extent that costs of the insurance scheme would be passed on to customers, depositors could receive lower returns on their deposits, or other customers could bear (some of) the costs via increased rates on loans.

There are several variables within the proposed package of reforms that affect the overall costs of the DIS. The variables with the most significant impact are the deposit insurance coverage limit and depositor preference. The greater the value of deposits covered by the DIS the greater the cost that deposit takers and depositors will face and depositor preference would allocate a relatively larger portion of losses on to other creditors. The scope of eligible depositors and products covered will also affect the overall costs.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The changes are proposed to be given effect by a bill scheduled for introduction in late 2021. This bill will create a new Deposit Takers Act. Subject to the Parliamentary process, we would expect the bill to be enacted some time in 2022.

This process will be led by the Reserve Bank, and the legislation, once enacted, will be administered by the Reserve Bank. The Treasury will also monitor the performance of the Reserve Bank on behalf of the Minister of Finance.

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. A transitional period is expected to be required to allow for the licensing of entities that will form the new 'deposit taking' prudential perimeter as well as the development of prudential requirements appropriate for these entities. 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.

Deposit insurance will be developed and introduced alongside the other elements of the prudential framework discussed in this document. The implementation of the Deposit Insurance Scheme is planned for 2023. Many of the operational elements of the scheme will not be decided for some time, and will involve further public consultation. These elements include, for example, regulations that require each deposit-taking institution to be able to identify all the deposit accounts owned by a single customer at their institution (a 'single customer view') and the size of any deposit taker levies.

6.2 What are the implementation risks?

Risks associated with the implementation of the Deposit Takers Act are significant. The Reserve Bank needs to be sufficiently resourced for the new legislation to ensure we can fulfil our statutory responsibilities. The Reserve Bank has highlighted the implementation risks and resource requirements, and is planning to increase resourcing in affected areas.

Additional resources on the part of the Reserve Bank were sought as part of the development of its 2020 funding agreement. The cost implications for some of these changes are included in the Reserve Bank's forecast operating expenses under the 2020 funding agreement.[99] Other costs with a high degree of uncertainty were excluded from the funding agreement, including the establishment of the Deposit Insurance Scheme (DIS) and early policy and legal work, and developing and servicing operations for the DIS.

Deposit insurance will be implemented ahead of the rest of the DTA. This creates both moral hazard risks associated with increased risk taking by deposit takers and operational risk

[99] For further details on the 2020 Funding Agreement, see https://www.rbnz.govt.nz/about-us/funding-agreements/2020-funding-agreement

associated with failures occurring before infrastructure for the DIS is fully developed. The Reserve Bank will be able to mitigate these risks through its prudential supervision (and prepositioning a risk-based approach to key infrastructure for payout. On the other hand, delaying the implementation of the DIS increases the risk that a deposit taker failure needs to be managed without deposit insurance.

The development of new prudential requirements implemented through standards for deposit takers will also be a significant resource impost on the Reserve Bank. These standards will need to be proportionate, reflect the diversity of the deposit taking sector, and calibrated for the risk profile for different classes of entities or individual entities. There are risks the new framework might entail unintended inconsistencies in the trans-Tasman context. The new framework recognises the importance of both domestic and international cooperation and coordination, with a new statutory resolution function for the Reserve Bank of coordinating with other authorities. Given the significant Australian ownership of the deposit taking sector, this new function anticipates the importance of coordination with Australian authorities in the preparation for, and actual resolution of, an Australian-owned entity.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

As monitor for the Reserve Bank, to be established through the Institutional Act, the Treasury will need to establish robust ongoing monitoring arrangements, including establishing regular requirements for information from the Reserve Bank, and working with the Reserve Bank to identify and assess relevant performance metrics.

7.2 When and how will the new arrangements be reviewed?

As part of its role in administering the new Deposit Takers Act, the Reserve Bank will review the new prudential regime for deposit takers and a deposit insurance scheme five years after it has come into force. This review will provide an opportunity to evaluate the effectiveness of the new prudential regulatory regime and deposit scheme, and to ensure no unexpected issues have arisen. It will also allow the Reserve Bank to examine the interaction with the new Institutional Act.

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