Safeguarding the future of our financial system

Further consultation on the prudential framework for deposit takers and depositor protection

Phase 2 of the Reserve Bank Act Review

March 2020

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Foreword from the Minister

This document forms the basis for the third and final substantive consultation for Phase 2 of the Review of the Reserve Bank Act, which has been underway since June 2018.

In this term, the Government has amended the framework for the Reserve Bank's monetary policy decision making, and made decisions on the Reserve Bank's institutional form and governance which are now being progressed to legislation. In-principle decisions have also been made on the high level design of the Reserve Bank's regulatory powers and responsibilities, and on the proposed depositor protection scheme, including:

- the establishment of a single regulatory regime for deposit takers, subject to prudential standards set by the Reserve Bank
- increased accountability requirements for directors of deposit takers, with a separate workstream to consider executive accountability
- the establishment of a deposit insurance scheme, funded by levies on deposit takers, with a maximum coverage of $50,000 per-depositor, per-institution
- the designation of the Reserve Bank as the resolution authority for deposit takers, with clear statutory functions and objectives and the ability to restore to solvency or to recapitalise a failed deposit taker using statutory bail-in.

This consultation paper sets out more detailed proposals in all of these areas for public input, to take the Review to the point where legislation can begin to be drafted later in the year. These changes are intended to empower the Reserve Bank to make the right decisions to promote financial stability in New Zealand while supporting sustainable growth. The financial system is crucial to the economy, and has become much larger and interconnected in the 30 years since the Reserve Bank of New Zealand Act was passed. It is important that the Reserve Bank has sufficiently flexible powers to be able to adapt as the financial system continues to evolve in the next 30 years.

I look forward to receiving advice based on your input and these important matters progressing to legislative drafting in the months ahead.

Hon Grant Robertson
Minister of Finance

Executive summary

A glossary accompanying this document explains many of the technical terms used in this document.

This consultation document seeks your views on the next steps in Phase 2 of the Review of the Reserve Bank of New Zealand Act 1989 (the Review). Phase 1, completed in 2018, focused on modernising the Reserve Bank's monetary policy framework. Phase 2 is a broad review of the Reserve Bank's governance and accountability framework and its financial regulatory powers. In December 2019, after two rounds of public consultation, Cabinet made a series of in-principle decisions, including to progress Phase 2 through two pieces of legislation, described here as the 'Institutional Act', and the 'Deposit Takers Act'.

Your views are welcome on these important topics.
The deadline for submissions is 5pm on **23 October 2020**.

Context

The Institutional Act will give effect to decisions on the Reserve Bank's institutional form, objectives and governance. It is currently being drafted and is not part of this consultation.

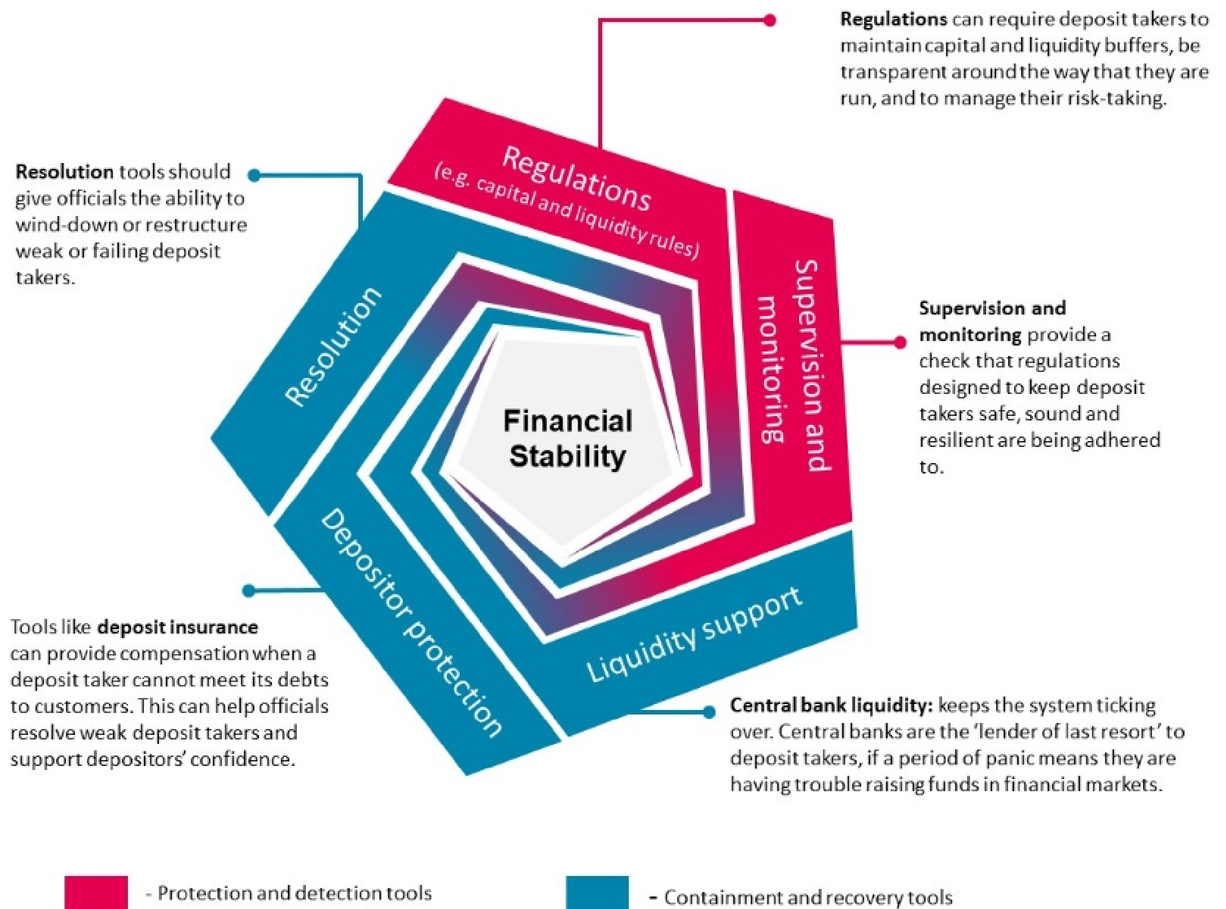
This consultation focuses on the **Deposit Takers Act**, which will:

- provide for a new prudential regulatory regime for 'deposit takers' – financial institutions that take deposits and provide loans, such as banks and credit unions, and therefore have a critical role in enabling borrowing and saving in the economy
- introduce a deposit insurance scheme, which will insure deposits up to $50,000 on a per-depositor, per-institution basis.

The consultation document proposes more details in both areas, building on the decisions announced in December. The Deposit Takers Act will help to protect society from the damage to the financial system and wider economy that could be caused by excessive risk taking by this sector, and the failure of individual deposit takers. How this is achieved is shown in Figure 1.

The likelihood of a deposit taker failing is mitigated by prudential requirements that enhance the resilience of deposit takers, supported by a supervision and enforcement regime that promotes compliance. In the unlikely event of failure, resolution tools (such as statutory management) and depositor protection can work together to mitigate the costs for depositors and the wider economy.

Figure 1: The financial safety net

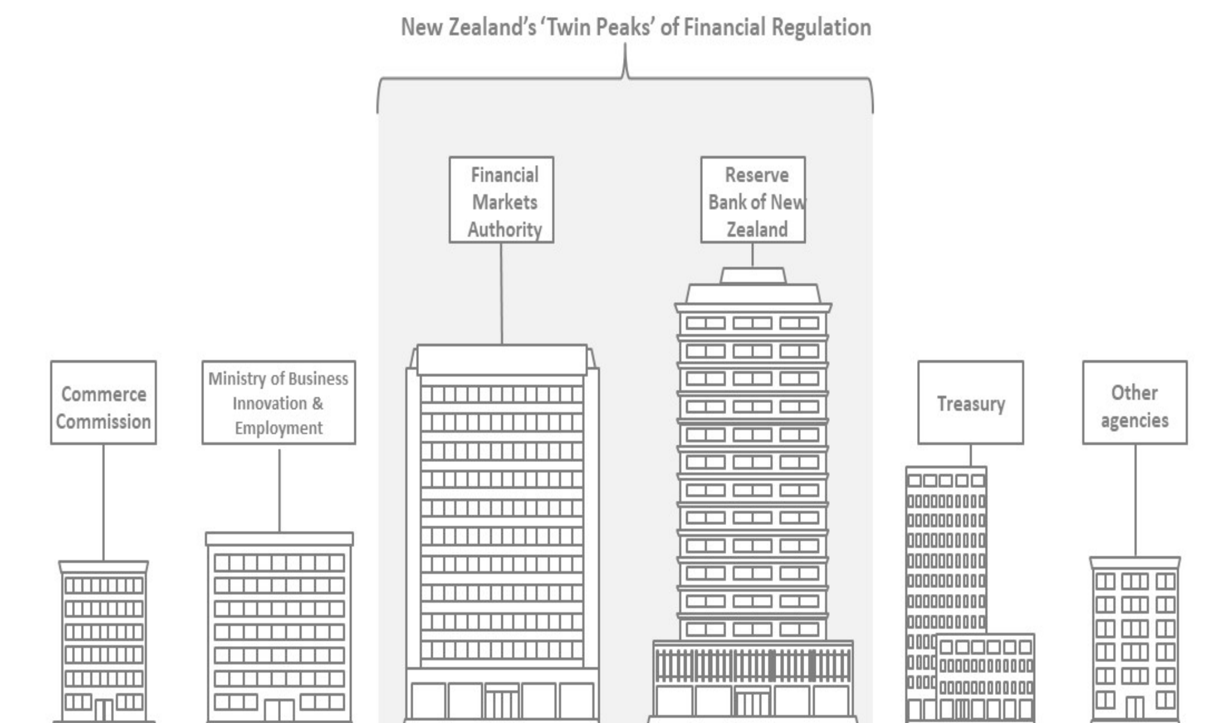


Other agencies are responsible for other parts of the regulatory system, in particular:

- the Financial Markets Authority (FMA) is responsible for promoting fair, efficient and transparent financial markets, including consumers being adequately informed and treated fairly
- the Commerce Commission is responsible for consumer credit and competition regulation
- the Ministry of Business, Innovation and Employment (MBIE) is the lead policy agency for financial markets conduct, consumer credit and competition issues and monitors the performance of the FMA and Commerce Commission
- the Treasury advises the Minister of Finance on fiscal policy and financial markets policy and will have responsibility for monitoring the performance of the Reserve Bank once the Institutional Act comes into force.

Effective coordination between these agencies is essential for them to deliver on their objectives. The Council of Financial Regulators (CoFR) is the main coordination forum for these agencies (Figure 2).

Figure 2: New Zealand's financial system regulators and policy agencies



This consultation document has eight parts, as summarised in Figure 3 and below:

Chapter 1: Update on the Review and proposed path for legislation

Chapter 1 puts this third round of consultation in the context of the wider Phase 2 Review, and the proposed legislative process for the Deposit Takers Act.

This third round of consultation will lead to Cabinet decisions in mid-2020, with the intention that drafting of new legislation begin shortly thereafter. Following the release of an exposure draft of the Deposit Takers Bill in 2021, it is anticipated that legislation will be passed in the first half of 2022.

Chapter 2: Purposes of the Deposit Takers Act

Cabinet has agreed that the Reserve Bank's high-level financial stability objective will be to "protect and promote the stability of New Zealand's financial system". This objective will be set out in the Institutional Act to cover all the entities and sectors the Reserve Bank prudentially regulates – deposit takers, insurers and financial market infrastructures. This chapter seeks feedback on:

- the specific purposes of the Deposit Takers Act - how it seeks to protect and promote financial stability through the regulation and supervision of entities within the 'regulatory perimeter'
- decision-making principles, which are designed to ensure the Reserve Bank pursues its statutory mandate by having regard to factors such as compliance costs imposed on regulated entities, as well as competition and innovation in the deposit-taking sector.

Chapter 3: The regulatory perimeter

Cabinet has agreed that the Deposit Takers Act will integrate – in a single, coherent, prudential regime – the regulation of banks and non-bank deposit takers (NBDTs). A key question for the new Act is which specific institutions the regime applies to and how it categorises them.

This chapter seeks feedback on the appropriate definition of 'deposit-taker' and the consequential treatment of entities that sit on the boundary of that definition. It also seeks feedback on the proposed approach to providing for flexibility in the regulatory perimeter.

Chapter 4: Standards and licensing

Cabinet has agreed in-principle that 'standards' issued by the Reserve Bank should be the primary tools for setting regulatory requirements for deposit takers (such as minimum capital and liquidity requirements). This chapter:

- explores issues around the permitted scope of the standard-making power, and the process requirements (such as consultation) that will apply
- seeks feedback on the licensing requirements and process for deposit takers, as well as de-licensing criteria.

Chapter 5: Liability and accountability

This chapter starts by discussing the proposed approach to liability for both deposit takers as legal corporate entities, and individuals (specifically directors), in relation to breaches of the Deposit Takers Act and breaches of prudential standards made under the Act. The appropriate split between civil and criminal penalties is considered.

The chapter then moves to its main focus: proposals to impose stronger and clearer requirements on directors of deposit takers through a 'positive accountability framework'.

These recommendations are designed to complement separate work the Government has announced which will add an accountability regime for directors and senior employees of deposit takers and insurers from both prudential and financial market conduct perspectives.

Chapter 6: Supervision and enforcement powers

As the prudential supervisor of regulated firms, the Reserve Bank requires powers to obtain the information necessary to assess whether firms are operating prudently and in accordance with the standards and other conditions imposed by the Reserve Bank. Cabinet has made an in-principle decision to enable the Reserve Bank to undertake thorough examinations of regulated entities at their premises ('on-site inspections'), in order to gain greater assurance that these firms are meeting their regulatory obligations.

In cases of non-compliance, in addition to potential civil and criminal penalties (discussed in the previous chapter), the Reserve Bank should have a range of enforcement tools so that it can take corrective action against the non-compliant regulated entity. This could include, among other things, statutory public notices, enforceable undertakings, action plans and remedial notices.

Chapter 6 seeks feedback on the design of the on-site inspection power and the proposed set of enforcement tools.

Chapter 7: Resolution and crisis management

It is international best practice to have special powers to manage, or 'resolve', a failing deposit taking institution. This recognises the fact that using ordinary liquidation or receivership for a large bank could be very disruptive and damaging for the economy.

Cabinet has made an in-principle decision that the Reserve Bank will be responsible for exercising the resolution function. However, this delegation will be balanced by a more specific set of resolution objectives than in current legislation. There may also be circumstances when the Minister of Finance should have a role, given that some strategies to resolve a troubled deposit taker may have fiscal consequences.

Chapter 7 seeks feedback on some of the more detailed issues that remain to be considered in light of the decisions made so far.

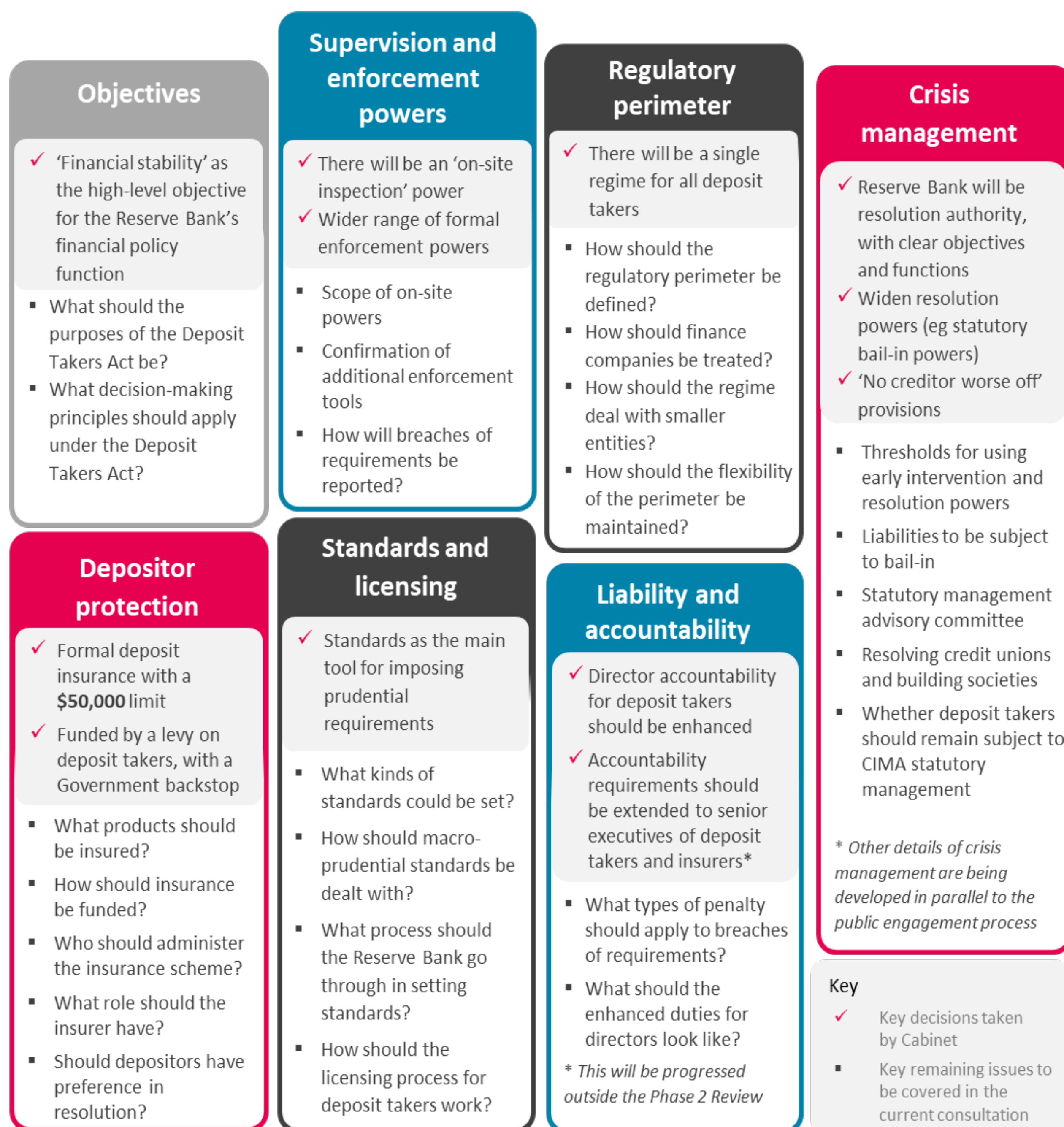
Chapter 8: Depositor protection

The Government has announced that deposits will be insured for up to $50,000 on a per-depositor, per-institution basis. Chapter 8 outlines proposals for delivering on this commitment in coming years, including:

- the scope of insured products that can be offered by deposit takers
- the functions that the deposit insurer will perform and how these will be governed
- the arrangements required to fund the deposit insurer's commitments.

The chapter also seeks feedback on whether to introduce a 'preference' for deposits, meaning that depositors would be given priority over other unsecured creditors of a failed deposit taker.

Figure 3: Decisions taken and key remaining issues in this consultation

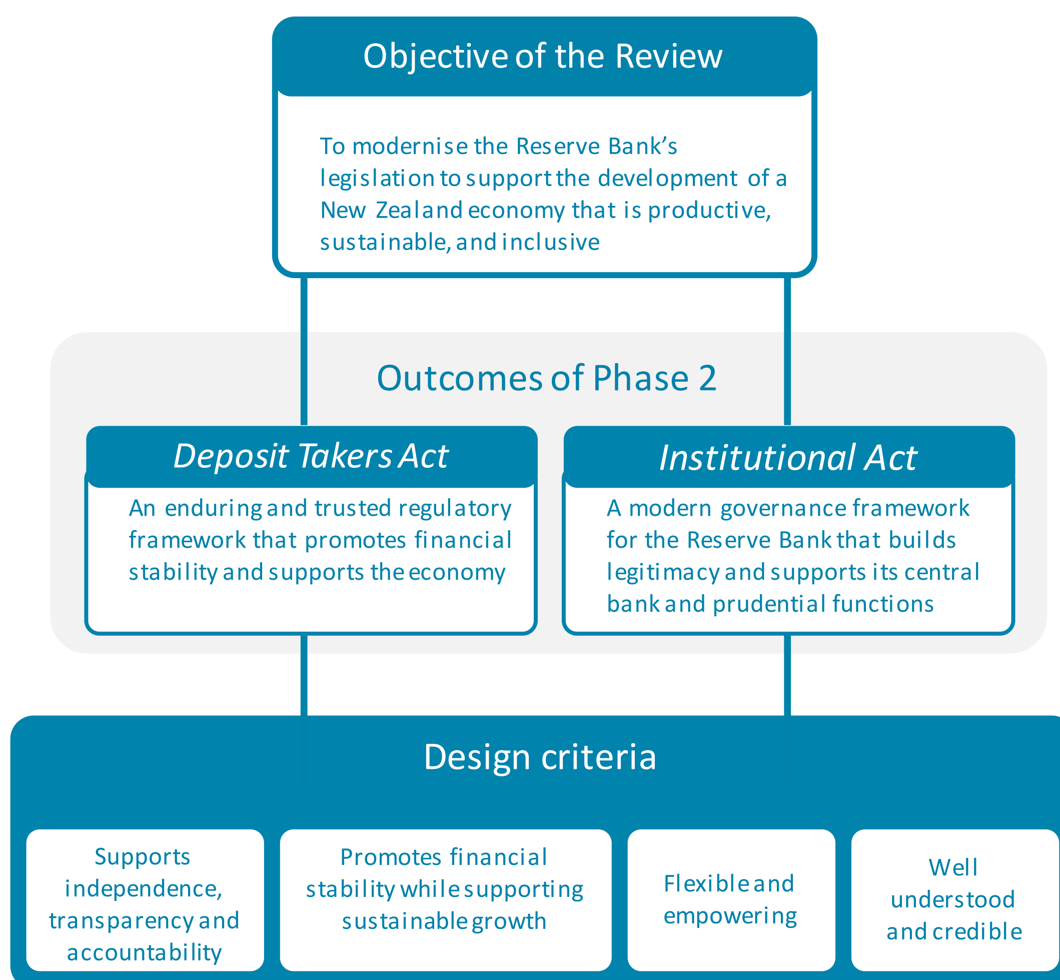


Overall objectives of the Phase 2 Review, and design criteria

The overall objective of the Review (as set out in its terms of reference) 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.

The following overall criteria (also shown in Figure 4) have informed the proposed design of the Deposit Takers Act.

Figure 4: Review objectives and design criteria



Supports independence, transparency and accountability

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.

The proposed approach to the Deposit Takers Act 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 proposed role of the Minister in the regime recognises that prudential regulation can have significant distributional and fiscal implications. While the balance between independence and accountability is an important consideration for the legislation as a whole, it is a particularly important consideration for chapter 2, which sets out the purposes of the legislation and decision-making principles for the Reserve Bank, and chapter 4, which outlines the Reserve Bank's proposed standard-setting and licensing powers.

Promotes financial stability while supporting sustainable growth

The proposed prudential framework for deposit takers and deposit insurance will promote financial stability through their impacts on the safety of deposits and the resilience of deposit-taking entities.

However, they can also impact on the efficiency of the financial system, including the range of financial products available to investors and their financial returns.

The objectives, purposes and principles the Reserve Bank is directed to use in decision-making need to balance stability against encouraging efficiency and growth. It should be clear to the Reserve Bank that financial stability should not be pursued without a consideration of the impacts of regulation on wider economic activity and the efficient provision of financial services. Macro-prudential regulation may avoid unsustainable growth (boom/bust cycles) while also boosting financial stability.

The Government has already decided to introduce deposit insurance, with a limit of $50,000 per depositor per institution, and that there will be a single regime for regulating institutions that take deposits. Chapter 3 discusses the appropriate definition of a deposit taker, and chapter 8 links this to the entities and financial products that will qualify for deposit insurance. As noted above, chapters 2 and 4 make recommendations to guide the Reserve Bank's approach to prudential regulation.

Provides a flexible and empowering regulatory framework

As a supervisor of regulated firms, the Reserve Bank requires powers to obtain the information necessary to assess whether firms are operating prudently and according to the standards and other conditions imposed by the Reserve Bank. The legislation needs to:

- provide the Reserve Bank with a flexible enforcement toolkit that allows it to proportionately and effectively promote compliance, as discussed in chapters 5 and 6
- enable the Reserve Bank to comply with global standards for prudential regulation to the extent it considers them appropriate for New Zealand, as well as deliver the more intensive and sceptical supervision model that it has recently articulated
- 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.

Well understood and credible

The legislation needs to be well designed and clear (to the Reserve Bank, and to the public), to make roles well understood and assist in building public trust. After the legislative phase, there will also need to be planning and system-building by the Reserve Bank (with partner agencies) to deliver on the commitments to enhanced regulation and supervision, as well as protect depositors and enable the orderly resolution of all deposit-taking institutions.

Creating a credible framework also involves ensuring that the frameworks for prudential regulation, deposit insurance and crisis management have the capacity to manage a financial crisis without requiring taxpayers to absorb losses, and without the frameworks requiring significant redrawing during a crisis. For example, crisis-management powers should enable the failure of a significant financial institution to be managed in an orderly manner, while the deposit insurance net (and limit) should protect enough customers to give Ministers comfort that the insurance will cushion the economic impacts of that failure. This should limit the risk of protections having to be extended in a rush, as happened in New Zealand and a range of other countries during 2008, or of taxpayers being required to bail out failing firms.

Questions for consultation

Chapter 2: Purposes of the Deposit Takers Act

2.A Do you agree with the proposed purposes? If not, what changes would you propose to the purposes? Are there any other purposes that we should be considering?

2.B Do you agree with the proposed decision-making principles? If not, what changes would you propose to the principles? Are there other principles that should be considered?

Chapter 3: Regulatory perimeter

3.A Do you agree with the proposed approach to defining the overall regulatory perimeter? If not, what approach would you suggest?

3.B Do you support the proposed exclusion for wholesale-only funded lenders? If not, what approach would you suggest?

3.C Do you support a maximum size threshold for the wholesale exclusion? If so, what would be an appropriate measure of size?

3.D Do you agree with the proposed territorial scope of the legislation? If not, what approach would you suggest?

3.E Do you have any comments on the application of the Deposit Takers Act to associated persons?

3.F Do you agree with retaining the restriction on the use of the words 'bank', 'banker' and 'banking', but limiting it to persons providing 'financial services'? If not, what approach would you suggest?

3.G Do you agree that the use of the words 'deposit', 'deposit taker' and 'deposit-taking' should be restricted? What restrictions would you suggest?

3.H Do you support the proposed approach to foreign bank branches? If not, what approach would you suggest?

3.I Do you agree that prudential regulation should be retained for finance companies funded via retail debt securities?

3.J Would you support the approach of creating a restricted licence category for finance companies funded via retail debt securities (option 1)? What do you think would be the benefits and costs of this approach?

3.K Under option 1, what restrictions should be placed on the services that a licensed finance company could offer without becoming a full licensed deposit taker?

3.L Should licensed financial market supervisors undertake the frontline supervision of finance companies under this model? If not, what approach would you suggest?

3.M Alternatively, would you support requiring finance companies to have full deposit taking licences to issue retail debt securities (option 2)? What do you think the benefits and costs of this approach would be?

3.N Do you support the proposed approach to small deposit takers, under which the Reserve Bank would be expected to calibrate its regulatory approach in light of the proposed purposes, the decision-making principles, and the contents of the Remit? If not, what changes would you suggest?

3.O Alternatively, would you support creating a separate tier in legislation for small deposit takers? If so, how would you suggest drawing this distinction?

3.P Do you think the use of the words 'bank', 'banker' and 'banking' should be restricted to a subset of deposit takers? If so, what criteria would be appropriate for their use?

3.Q Should current NBDTs have the same supervision, governance and disclosure exemptions from the FMC Act as banks? If not, what approach would you suggest?

3.R Should current NBDTs be subject to a disclosure regime that is similar to that for banks? If not, what approach would you suggest?

3.S Do you support the proposed approach to perimeter monitoring? If not, what approach would you suggest?

3.T Do you support the proposed designation power? If not, what approach would you suggest?

3.U Do you support the proposed exemption power? If not, what changes or alternative approaches would you suggest?

3.V What should the criteria be for the Reserve Bank granting an exemption? What other limitations or safeguards should be placed on the power?

Chapter 4: Standards and licensing

4.A Do you agree that the proposed scope of standards is appropriate? If not, what changes would you suggest?

4.B Do you agree with the proposed power for the Reserve Bank to set lending standards (such as LVRs and DTIs) in relation to mortgages? If not, what changes to the scope or additional safeguards would you suggest?

4.C Do you agree that the Reserve Bank should be able to issue differing standards for different entity classes? If not, what approach would you suggest?

4.D Do you agree that the Reserve Bank should be able to make standards that enable it to exercise supervisory discretion on matters and within ranges specified in the standards? If not, what approach would you suggest?

4.E What procedural requirements and protections should apply to the Reserve Bank's use of supervisory adjustment?

4.F Do you support the proposed approach to allowing the Reserve Bank to set reporting standards and lending standards in relation to categories of non-deposit-taking lenders that have been prescribed via regulations? Why or why not?

4.G Do you agree that the proposed procedural requirements for standards are appropriate? If not, why not? Should any other requirements be considered?

4.H Do you support the proposed licensing test for deposit takers? If not, what approach would you suggest?

4.I Are the proposed procedural requirements for licensing appropriate? If not, why not? Should any other requirements be considered?

4.J What scope of appeal rights should be provided for in relation to licensing decisions and why?

4.K Do you agree with the proposed approach to de-licensing? If not, what changes would you suggest?

4.L Do you agree with the proposed use of the register to record and apply standards and other requirements on deposit takers? If not, what approach would you suggest?

Chapter 5: Liability and accountability

5.A Do you agree with the general categorisation of the contraventions that should give rise to criminal and civil liability in the Deposit Takers Act?

5.B Do you agree with the specification of the new positive duties for directors of deposit takers? If not, why not?

5.C Do you agree that directors should not be indemnified or insured against loss in the performance of their duties?

5.D Do you see any specific issues with the relationship between the existing director duties in the Companies Act, and the new duties being proposed here?

5.E Do you agree that deemed liability should be retained for false and misleading disclosure? If not, what approach would you suggest?

5.F Do you agree with the proposed approach to maximum civil penalties on bodies corporate, including the use of maximum penalties based on the size of the institution or any benefit gained (or loss avoided)? If so, what specific metrics or amounts should be considered for these penalties?

5.G Should a lower tier of civil penalties be established for some contraventions, for example, those that do not adversely affect the deposit taker's prudential standing?

5.H What maximum level of individual civil penalty should be provided for and why?

5.I Should criminal offences relating to the obstruction of routine supervisory powers be subject to monetary penalties, but not imprisonment terms for an individual? If so, what level of maximum penalty would be appropriate and why?

5.J What monetary and imprisonment penalties should be considered for more serious criminal offences and why?

Chapter 6: Supervision and enforcement powers

6.A Do you agree that the on-site power for the AML/CFT regime is an appropriate comparator for a similar power for the Reserve Bank's prudential functions?

6.B Should this power be a generic power in the new Institutional Act, or specified in the Deposit Takers Act?

6.C Do you think any additional safeguards are necessary for the on-site power?

6.D Do you think the FMA's on-site inspection power should be expanded in the same way that is proposed for the Reserve Bank?

6.E Should an expanded FMA on-site inspection power apply in all circumstances and to all FMA-regulated entities or only some (e.g. in high-risk circumstances or for dual prudential-conduct regulated entities)?

6.F Do you have any comment on the appropriate legislative location of supervisory powers such as information gathering and sharing, on-site inspections, and other related powers? Do you see merit in consolidating similar powers from sectoral Acts into the Institutional Act?

6.G Should a breach-reporting requirement be directly provided for in legislation? Should this be provided for in the Deposit Takers Act, or located in the Institutional Act as a requirement for all entities regulated by the Reserve Bank?

6.H Do you agree that the Deposit Takers Act should provide for the Reserve Bank to accept a voluntary undertaking from a deposit taker that is enforceable in court?

6.I Should the Deposit Takers Act provide a statutory basis for the Reserve Bank to issue a formal notice to a deposit taker?

6.J Do you see any role for infringement notices in the Deposit Takers Act?

6.K Do you see a useful role for remedial notices and/or action plans in the Deposit Takers Act?

Chapter 7: Resolution and crisis management

7.A What are your views on the proposed triggers for placing a deposit taker into resolution and exercising resolution powers?

7.B What should be the scope of statutory bail-in in New Zealand? What liabilities should be expressly included or expressly excluded? How should deposits be treated?

7.C Should statutory bail-in have retrospective application?

7.D Is there still a role for a ministerially-appointed advisory committee to a statutory manager? If so, should legislation be more specific about the purpose and the composition of that committee?

7.E Should the Reserve Bank have the power to demutualise a building society or credit union that meets the criteria for being placed into resolution?

7.F Do you agree that deposit takers should only be subject to one statutory management and resolution regime?

7.G Do you favour option 1, option 2, or some other approach (including the status quo)?

Chapter 8: Depositor protection

8.A What are your views on the benefits and costs of a preference for insured depositors compared to no preference?

8.B If a preference for depositors is introduced, do you agree it should only cover insured deposits (not all deposits)?

8.C Do you agree with the proposed prescribed product approach for coverage under the new scheme? If not, what approach would you suggest?

8.D Do you agree that both retail and wholesale investors in insured deposit products should be covered up to the $50,000 coverage limit? If not, what approach would you suggest?

8.E Is the list of excluded deposit products appropriate? If not, what approach would you suggest?

8.F Do you agree with the proposed narrow mandate for the deposit insurer?

8.G Do you agree that the deposit insurer should be able to provide funding for resolutions other than a liquidation?

8.H If yes, do you agree with the limit on the amount of funds that can be used? What are your views on the appropriate safeguards?

8.I What are your views on the appropriate decision authority for the coverage limit?

8.J If a deposit insurance fund is established, should changes to the target size and the levies be made by ministers via regulations or by the deposit insurer itself?

8.K Should there be a legislated requirement to review the deposit insurance scheme? If so, how often should it be reviewed (e.g., every five years)?

8.L Has the Review identified the appropriate criteria for assessing the best organisational form of the insurer?

8.M Do you agree that the insurer should be located within the Reserve Bank? If not, what approach would you suggest?

8.N Do you agree that the insurer should build a deposit insurance fund ahead of a failure? If not, what approach would you suggest?

8.O What are your views on the appropriate size of any deposit insurance fund?

8.P Should the insurer charge higher levies to higher risk deposit takers? What are your views on how risk should be assessed?

8.Q What are your views on how the Government funding backstop should be designed?

How you can contribute

This public consultation process provides New Zealanders with the opportunity to give their views on the future shape of financial policy in New Zealand and the appropriate role for the Reserve Bank in safeguarding the financial system.

You are encouraged to make your views known on these important issues. An online form to assist you with providing written comments is available on the Treasury's website at http://treasury.govt.nz/rbnz-act-review.

All responses should be emailed to rbnzactreview@treasury.govt.nz. Alternatively, responses can be sent to the address below:

Phase 2 of the Reserve Bank Act Review
The Treasury
PO Box 3724
Wellington 6140

The deadline for submissions is 5pm on 23 October 2020.

Further information about Phase 2 of the Reserve Bank Act Review can be found on the Treasury's website at http://treasury.govt.nz/rbnz-act-review.

Questions about the consultation process can be sent by email to rbnzactreview@treasury.govt.nz.

Following the completion of the consultation process, the intention is to publish all submissions as well as a report summarising the key messages and emerging themes. If you have any objection to your submission or parts of it being published, please state this in your submission. If you wish your submission to be anonymised, please indicate this in your submission.

Submissions and the Official Information Act 1982

Submissions received are subject to the Official Information Act 1982 (OIA). Please set out clearly with your submission if you have any objection to any information in the submission being released under the OIA. In particular, clearly state which part(s) you consider should be withheld, and the reason(s) for doing so.

The OIA sets out reasons for withholding information. Reasons could include that the information is commercially sensitive or that you wish us to withhold personal information, such as names or contact details. An automatic confidentiality disclaimer from your IT system is not a reason to withhold information.

Your objections will be considered when responding to requests under the OIA.

Chapter 1: Update on Review and proposed path for legislation

In November 2017 the Government announced it would undertake a review of the Reserve Bank of New Zealand Act 1989 (Reserve Bank Act) to create a modern monetary and financial policy framework. Phase 1 of that review was completed in 2018 and focused on the objectives and decision-making arrangements for **monetary policy**. Phase 2 began in mid-2018 and has focused on the Reserve Bank's **financial policy framework and overall governance** (see Phase 2's terms of reference). An Independent Expert Advisory Panel has supported the policy development process.

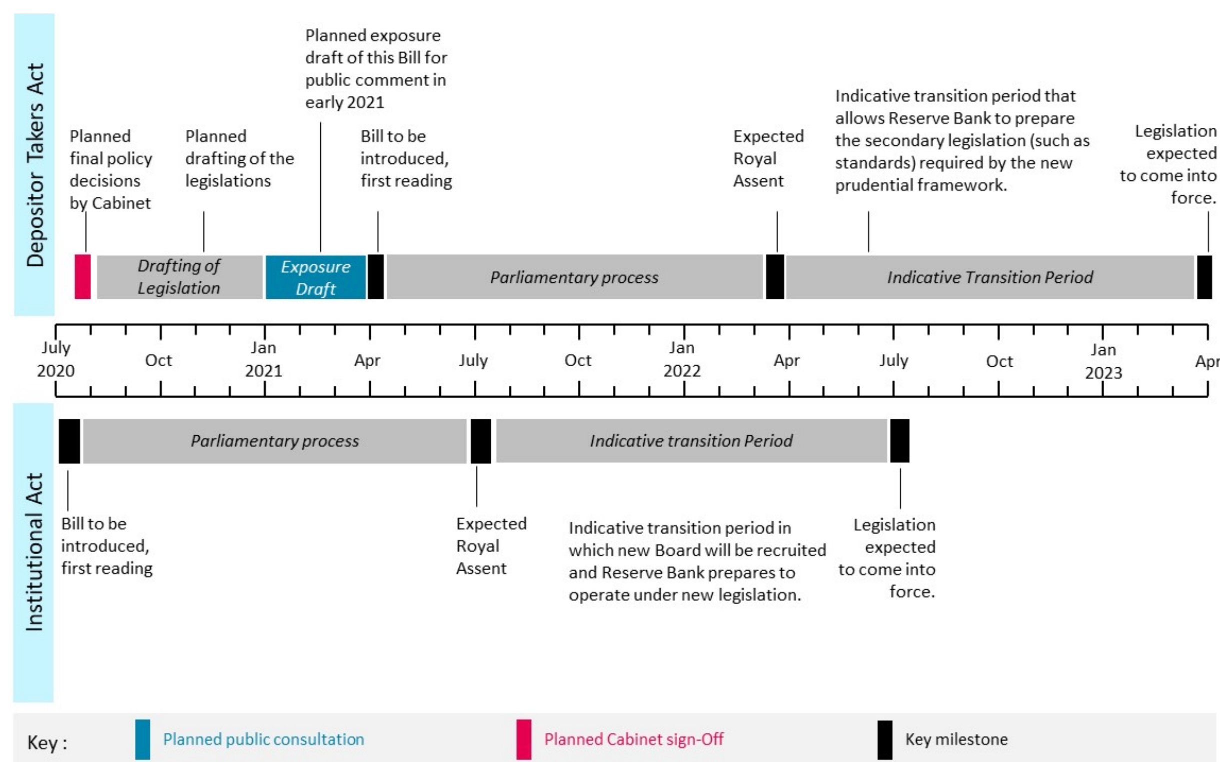
This consultation document is the last of three rounds of public consultation supporting the Phase 2 Review (the Review) and the development of legislative changes. The first round took place between November 2018 and January 2019 on five high-level topics that were important in shaping the general direction of regulatory reform. The Minister of Finance subsequently announced various in-principle decisions in June 2019 tied to the first consultation.

A second round of consultation was undertaken between June and August 2019. This summarised the Minister's in-principle decisions (Consultation Document 2A) and consulted on the remaining topic areas from the Phase 2 Review's terms of reference (Consultation Document 2B). Individual submissions and a summary of submissions from the second round are available at Public Consultation - second round (Reserve Bank Act Review).

Cabinet then made a series of decisions in December 2019, taking into account recommendations from the joint Reserve Bank-Treasury Review, feedback from stakeholders and the advice of the Independent Expert Advisory Panel. It was agreed that the current Reserve Bank Act would ultimately be replaced with two pieces of legislation, described in this document as the 'Institutional Act', and a 'Deposit Takers Act'.

The Institutional Act will give effect to decisions on the Reserve Bank's institutional form, objectives and governance. It is currently being drafted and legislation is expected to be introduced into Parliament in mid-2020.

Figure 1.1: Indicative timeframes for the Deposit Takers Act



The Deposit Takers Act – the focus of this consultation – will provide for a new prudential regulatory regime for 'deposit takers', such as banks, credit unions and building societies. Its development will be accompanied by the development of a deposit insurance scheme.

Cabinet's key decisions to date on the Deposit Takers Act are summarised in Figure 3 in the executive summary. This consultation document seeks feedback on the design of more key elements of the Deposit Takers Act, also described in Figure 3. It is intended that this consultation will lead to final recommendations to Cabinet in mid-2020, allowing for legislation to be drafted over the remainder of 2020.

The subsequent legislative process will include a number of further opportunities for external input. It is envisaged that an exposure draft of the Bill will be released for public comment in early 2021. Public input will also be sought through the select committee process as the Bill passes through Parliament. While the exact timeframes will depend on Government priorities, the legislation is expected to be passed in the first half of 2022.

After it passes, there will need to be a further period before it comes fully into force. This will allow the Reserve Bank to prepare the secondary legislation (such as standards) required by the new prudential framework and provide time for regulated entities to prepare for the new approach and go through the necessary licensing processes. As a result, the existing prudential framework – broadly, the Non-bank Deposit Takers Act 2013 (NBDT Act) and Parts 4 and 5 of the current Reserve Bank Act – will remain in force until that time.

Chapter 2: Purposes of the Deposit Takers Act

Introduction and progress to date

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

Consultation Document 2A 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. The Summary of Submissions from the Consultation 2 document contains a more detailed summary of stakeholder submissions on the proposed objectives.

Chapter 2
Overview

- ✓ 'Financial stability' as the high-level objective for the Reserve Bank's financial policy function
- ▪ What should the purposes of the Deposit Takers Act be?
- ▪ What decision-making principles should apply under the Deposit Takers Act?

- ✓ Key decisions taken by Cabinet
- ▪ Key remaining issues to be covered in the current consultation

Decisions taken so far

In December 2019, Cabinet made the following decisions about the Reserve Bank's objectives, decision-making principles and Financial Policy Remit (the Remit).

Overarching financial stability objective

The Reserve Bank will have an overarching financial stability objective along the lines of "protecting and promoting the stability of New Zealand's financial system". This objective will feature in the Institutional Act and will apply across the Reserve Bank's prudential functions and relevant sectoral Acts.[1]

The financial stability objective is to be interpreted broadly in light of the Reserve Bank Act's overarching statutory purpose to "promote the prosperity and well-being of New Zealanders and contribute to a productive economy".

Financial stability encompasses both macro and micro considerations:

- The **macro-level** considerations focus on maintaining the financial system's resilience by mitigating the build-up of systemic risks and promoting the ability of financial institutions to withstand shocks. This helps to promote well-being through reducing the risk of a financial crisis that would adversely affect economic activity and New Zealanders' living standards.

[1] 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.

- The **micro-level** considerations focus on maintaining the soundness and resilience of individual deposit takers, thus strengthening public confidence in individual institutions and the financial system. This recognises that the failure of an individual institution can have significant adverse impacts on the well-being of individuals or particular groups of individuals (such as depositors) and (in some cases, potentially) ultimately the financial system as a whole.

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 (see guidance from the Legislation Design and Advisory Committee [LDAC]).

The principles are designed to guide the exercise of powers under the Deposit Takers Act[2], ensuring that a wide range of implications is considered when pursuing the statutory objectives. In particular, the principles will capture the relevant concepts of efficiency (for example, the need to consider net benefits). Feedback on the detailed content of the principles is sought below.

Financial Policy Remit

The Minister of Finance will specify, through the Remit, matters that the Reserve Bank will have to take into account in pursuing its financial stability objective. It would not apply in relation to the formulation and implementation of monetary policy. The Remit would also not apply to decisions relating to individual regulated entities or persons, such as licensing and enforcement actions. Indicative matters that could be addressed in the Remit include:

- potential impacts on government policy objectives and priorities that the Minister of Finance would like the Reserve Bank to take into account in pursuing the financial stability objective, such as those tied to fostering competition or innovation in the financial system, or objectives relating to climate change
- high-level expectations around a government's risk tolerance for certain financial system outcomes, for example, the expectation that the prudential regime contributes to a low, but non-zero incident of failure of regulated entities.

Although the Remit is similar to a Letter of Expectations, it would have a legislative backing and would be directly linked to the financial stability objective.

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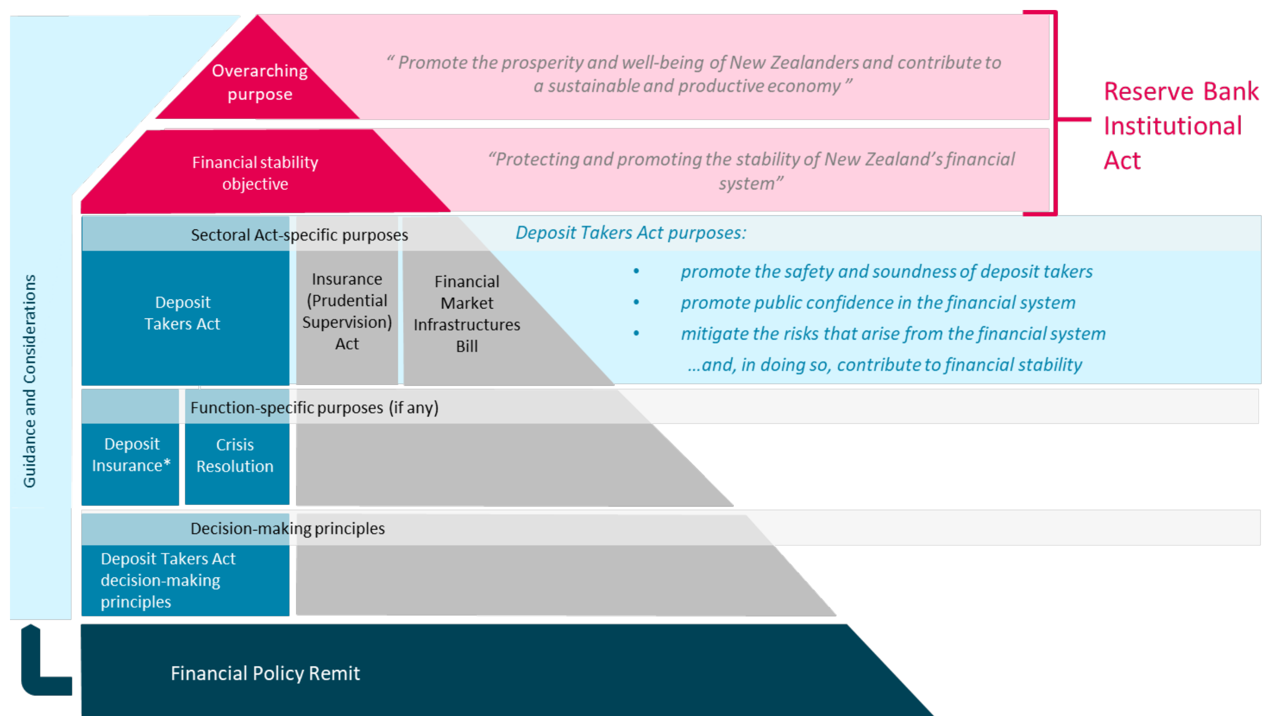
[2] Cabinet indicated that the decision-making principles would be in the Institutional Act, but this may be reconsidered as part of the legislative drafting process.

2.1 Remaining issues and options

This chapter seeks feedback on the two key undecided pieces of Figure 2.1: the Deposit Takers Act's purpose statement; and the decision-making principles. These will provide guidance on the Act's application and in doing so shape the way in which the Reserve Bank seeks to achieve financial stability through this legislation.

Figure 2.1: Stylised illustration of the Reserve Bank's hierarchy of objectives and purposes



*The final legislative location of the deposit insurance scheme is subject to institutional location and other considerations covered in Chapter 8.

The purpose of the Deposit Takers Act

The purpose clause of the Deposit Takers Act will set out the way in which the Act intends to contribute towards the financial stability objective. The purpose statement would explain 'why' the legislation is being enacted, while the substantive provisions in the Act would provide for 'what is required?'.[3] In doing so, it will shape how the legislation is interpreted and the way in which the functions and powers provided for under the Deposit Takers Act are exercised.

The purpose statement(s) of the Deposit Takers Act (and the other sectoral Acts) should be consistent with the Reserve Bank's overarching financial stability objective, although they may introduce additional considerations.

In addition to the objectives set out in the purpose clause of the Deposit Takers Act, the Reserve Bank will have function-specific objectives and purposes relating to its role as the resolution

[3] 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 LDAC, a body responsible for setting guidelines for making good legislation).

authority, as outlined in Chapter 7. Cabinet has also agreed in-principle that the deposit insurance scheme will have a specific purpose, as outlined in the December 2019 Review Update.

In forming the proposed legislative purposes of the Deposit Takers Act, the Review has considered:

- the need to achieve 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
- feedback from stakeholders in the first two rounds of consultation.

This consultation proposes three purposes for the Deposit Takers Act. Figure 2.1 illustrates the relationships between these purposes, the Reserve Bank's financial stability objective, the decision-making principles and the Remit.

Proposed approach 2.1: *the purposes of the Deposit Takers Act are to*

- *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.

Promote the safety and soundness of deposit takers

This purpose reflects the Reserve Bank's micro-prudential role under the Deposit Takers Act. It links to financial stability through recognising the potential impacts of a failure of a systemic deposit taker or a group of non-systemic deposit takers on financial stability, and it supports other purposes of the Deposit Takers Act, for example by promoting public confidence in the financial system.

The words 'safety' and 'soundness' would encourage the Reserve Bank to safeguard individual deposit takers' risk taking, relative to their individual ability to manage and mitigate risk.

The failure of a deposit taker can have significant impacts on the stability of the financial system and the wellbeing of individual deposit takers, and can diminish trust in the financial system. In recognition of this, the term 'deposit takers' has no qualifying limitations, so this objective requires the Reserve Bank to consider small, non-systemic entities alongside large deposit takers and provide them with an appropriate focus and resourcing, ensuring they are held to certain minimum standards of risk management. That said, the Reserve Bank would apply of focus and resourcing to individual deposit takers through a risk-based lens, recognising that larger and more systemic institutions will generally require more attention.

The use of the word 'promote' avoids the implication that the Reserve Bank should run a zero failure banking regime for deposit takers. In addition, the Reserve Bank would be required to consider this objective in light of decision-making principles such as proportionality and the desirability of minimising unnecessary costs from regulation (see below).

This purpose also links to the implementation of depositor protection. Providing deposit insurance for all deposit takers generates a potential moral hazard – that is, individual deposit takers may be

incentivised to take on more risk than is socially desirable in an effort to get the greatest potential benefits (in the form of profits), whereas losses are spread through deposit insurance (Chapter 8 discusses this in more detail).

Promote public confidence in the financial system

This purpose reflects the regulatory regime's role in promoting confidence in the financial system as a whole, through regulating risk-taking by deposit takers.

Promoting public confidence helps to ensure that savers feel secure in investing their funds in deposit takers, and that the sector can play its core role of intermediating society's collective wealth between lenders and borrowers. Promoting public confidence in good times can also help to reduce the risk of 'runs' on deposit takers in times of stress. Ensuring public confidence is an important part of the Reserve Bank's crisis management and resolution function.

More generally, this purpose helps to underscore the importance of the Reserve Bank working with other agencies in the wider financial regulatory system.

Public confidence in the financial system is tied to stakeholders having confidence in the Reserve Bank as a prudential regulator and the extent to which they believe the Reserve Bank is fulfilling its statutory mandate. This reinforces the need for the Reserve Bank to be transparent and clear in its communications, ensuring that the public understands the rationale for its decisions.

Mitigate the risks that arise from the financial system

This purpose is intended to:

- reflect the regulatory regime's role in strengthening the resilience of the financial system as a whole
- empower the regulatory regime to limit the build-up of systemic financial risks, such as those that may arise to the broader economy from the financial cycle.

The purpose recognises that keeping individual deposit takers sound is not enough to ensure financial stability and that there are strong interlinkages between individual deposit takers, the financial system and the economy.

Question for consultation

2.A Do you agree with the proposed purposes? If not, what changes would you propose to the purposes? Are there any other purposes that we should be considering?

Decision-making principles

The decision-making principles apply to the Reserve Bank's prudential regulatory functions in the Deposit Takers Act. The application of these principles to small deposit takers is discussed further in Chapter 3.

The principles have been designed to guide the exercise of powers and duties under the Deposit Takers Act, and ensure that a wide range of implications is taken into account when pursuing the statutory objectives. This includes ensuring that:

- 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.
- longer-term risks are considered, for example the risks associated with climate change.

The consultation proposes six decision-making principles for the Deposit Takers Act.

Proposed approach 2.2: *the decision-making principles for the Deposit Takers Act will be:*

- *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.*

The desirability of minimising unnecessary costs of regulatory actions, taking into account the benefits of the outcomes to be delivered

This principle captures regulatory efficiency – the desirability of considering the costs of regulation for deposit takers when assessing options to achieve a desired outcome. Under this principle, the Reserve Bank would need to ensure there are clear net benefits in taking regulatory actions in relation to entities regulated under the Deposit Takers Act.

The desirability of taking a proportionate approach to regulation and supervision, and ensuring similar institutions are treated consistently.

This principle captures proportionality – encouraging the Reserve Bank to tailor its regulation and supervision to reflect deposit takers' sizes, systemic importance, complexity and risk profiles. For example, it means the Reserve Bank would seek to avoid imposing high costs or a regulatory burden on small, non-complex and non-systemic deposit takers that would unduly diminish their competitive positions without subsequent benefits.

This principle is also about consistency – encouraging the Reserve Bank to set regulatory requirements that apply to whole entity classes, to ensure they are treated equally and fairly and to contribute to keeping the regulatory system simple.

The desirability of sectors regulated by the Reserve Bank being competitive, taking account of the size of the market

This principle captures competitive efficiency – requiring the Reserve Bank to take into account how its regulatory settings affect competition and, where consistent with its financial stability objective and the purposes of the Deposit Takers Act, tailor policies to protect and support competition.

This principle would not require the Reserve Bank to first and foremost promote competition in the deposit-takers market. Instead, it would, for example, require the Reserve Bank to consider how regulatory actions may present barriers to future deposit takers' entry to the market.

The value of transparency and public understanding of the Reserve Bank's objectives and how the Reserve Bank's functions are exercised

This principle recognises the importance of the Reserve Bank's legitimacy and that public confidence in the Reserve Bank and its legitimacy can be enhanced by increasing public visibility and understanding of the Reserve Bank's purposes, objectives and activities.

Clear and transparent communication may make an important contribution to financial stability and effective regulation and supervision, as it helps to shape the expectations of the regulated entities and influences their business models and governance.

Consideration of the practice by relevant international counterparts carrying out similar functions, as well as guidance and standards from international bodies

This principle encourages the Reserve Bank to align with international best practice as far as practicable and when it is relevant for New Zealand's circumstances. It also encourages the Reserve Bank not to impose undue costs on entities that operate in multiple jurisdictions. For example, the Australian Prudential Regulation Authority (APRA) makes on-site visits to New Zealand's four largest banks to fulfil its prudential function. This principle would encourage the Reserve Bank to take this into consideration when undertaking its own regulatory and supervisory activities.

The desirability of taking into account long-term risks to financial stability

This principle would require the Reserve Bank to consider longer-term risks appropriately. These risks could include digital disruption to the financial sector and the risks associated with climate change.

Question for consultation

2.B Do you agree with the proposed decision-making principles? If not, what changes would you propose to the principles? Are there other principles that should be considered?

Summary

This chapter has proposed purposes and decision-making principles for the Deposit Takers Act. It has also explained how the purposes and decision-making principles fit with the purposes of the Institutional Act and the Remit.

Chapter 7 discusses the Reserve Bank's function-specific objectives and purposes in relation to its role as the resolution authority. The purpose of the deposit insurance scheme is outlined in the December 2019 Review Update.

Chapter 3: The regulatory perimeter

Introduction and progress to date

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 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. 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
- '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.

Chapter 3 Overview

✓ There will be a single regime for all deposit takers

- How should the regulatory perimeter be defined?
- How should finance companies be treated?
- How should the regime deal with smaller entities?
- How should the flexibility of the perimeter be maintained?

✓ Key decisions taken by Cabinet

- Key remaining issues to be covered in the current consultation

An appropriate regulatory perimeter:

- balances the benefits of managing these 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. This is particularly important in relation to financial markets conduct legislation, which is enforced by the Financial Markets Authority (FMA). The FMA seeks to promote the development of fair, transparent and efficient financial markets through disclosure, licensing and governance requirements.

Previous consultation

Consultation Document 1, released in November 2018, sought feedback on which financial firms the Reserve Bank should regulate, and how the regulatory perimeter should be set. Following feedback from stakeholders, Cabinet made an in-principle decision in April 2019 to integrate – in a single, coherent, 'licensed deposit taker' framework – the registered banks and licensed non-bank deposit takers (NBDTs – institutions that are not registered banks, such as finance companies, building societies and credit unions).[4]

This new framework would:

- centre on an activities-based definition of deposit taking, capturing firms that are in the business of borrowing and lending
- be regulated and supervised by the Reserve Bank under a single piece of legislation
- retain restrictions on the use of certain words such as 'bank' and 'banking'
- provide for a risk-based licensing and regulatory framework by aligning entities' compliance requirements with the scale of their activities and the risks they pose to the financial system.

The decision to make this change was based on an assessment that a single licensed deposit taker framework has three key advantages over the status quo:

- Increased 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.
- Regulatory neutrality: currently, firms undertaking similar activities are not treated the same way. For example, NBDTs do not have the same disclosure and governance exemptions as banks, and cannot use certain terminology. This can create the perception that NBDTs are 'second-class' firms, reducing their ability to compete. While NBDTs are subject to less prescriptive capital and operational requirements than banks, the differences in treatment between banks and NBDTs are not explicitly risk based.
- 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 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.

A single licensed deposit taker framework is also more compatible with a deposit insurance scheme that covers all deposit takers (see Chapter 8). In other jurisdictions, such as Australia and the United Kingdom, these schemes usually extend to all licensed deposit takers on the basis that they are

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[4] Currently registered banks are regulated and supervised under Part 5 of the Reserve Bank Act. The prudential framework for NBDTs is provided for under the NBDT Act 2013, where the Reserve Bank has responsibility for setting prudential requirements, but supervision is separately undertaken by trustees who are licensed by the FMA.

subject to broadly similar regulatory requirements. Introducing depositor protection would be more complicated under the current regulatory framework; given the different rules and supervisory arrangements that apply to banks and NBDTs, the two regimes cannot be seen as directly comparable.

While most submitters in the second round of consultation supported the in-principle decision to have a single regulatory framework for all deposit takers, a number raised concerns that the costs of compliance under a single regime could be prohibitive for small deposit takers such as credit unions and building societies. They sought more clarity on how these small deposit takers would be treated under the new regime, including the standards that the Reserve Bank would seek to impose and how intensively it would seek to supervise them. Some stakeholders suggested better aligning the regulatory regimes for banks and NBDTs, rather than moving to a single regulatory regime.

Overall, the benefits of an integrated deposit-takers regime appear to outweigh any potential costs and risks. However, the Review is conscious of the real challenges that its implementation will present for many regulated entities and for the Reserve Bank itself.

Decisions outstanding

This chapter seeks further feedback on the scope of the Deposit Takers Act and the way it treats different entity categories. In particular, it seeks feedback on how current NBDTs, such as finance companies and other small deposit takers, should be treated under the new regime. It also consults on proposed mechanisms for maintaining the flexibility of the regulatory perimeter, including on the scope of the Reserve Bank's designation and exemption powers.

3.1 Defining the overall regulatory perimeter

Proposed approach 3.1: *all persons that carry on the business of borrowing and lending should be required to be licensed under the Deposit Takers Act, other than wholesale-funded non-bank lenders whose New Zealand business does not exceed a prescribed size threshold.*

The proposed regulatory perimeter (as represented in Figure 3.1) would capture the banks, credit unions, building societies and finance companies currently regulated under the Reserve Bank Act and the NBDT Act. These entities present the strongest case for prudential regulation, due to their retail customer base and role in providing credit intermediation. The option of creating a separate, restricted licence category for finance companies in this perimeter, reflecting their lower levels of systemic risk, is considered in section 3.2.

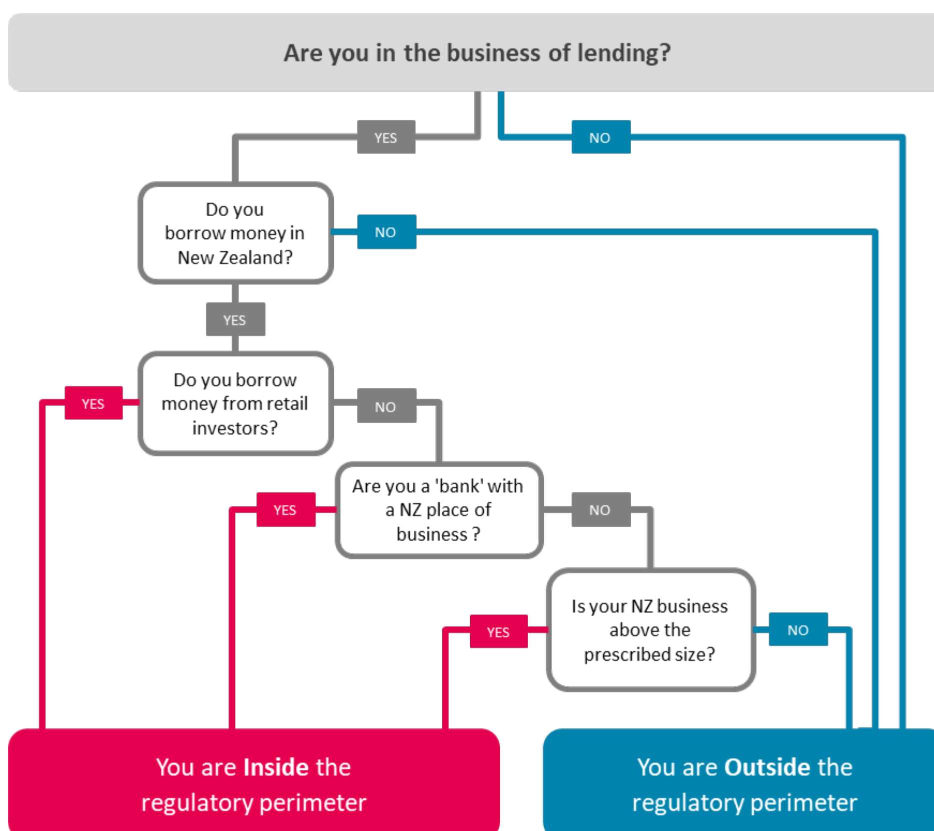
The perimeter could also capture some lenders that raise funds in New Zealand wholesale markets. The potential treatment of these entities under the Deposit Takers Act is discussed below.

'Lending' could be defined as the provision of credit under a credit contract (regardless of where that credit is provided), with the definitions of credit and credit contract based on the Credit Contracts and Consumer Finance Act 2003.

'Borrowing' could be defined as issuing a debt security, as defined in the Financial Markets Conduct Act 2013 (FMC Act) as "a right to be repaid money or paid interest on money that is, or is to be, deposited with, lent to, or otherwise owing by, any person". This would capture a broad range of financial instruments, including bonds, debentures and notes, as well as transactional accounts and term deposits. As outlined in Chapter 8, only certain deposit products are proposed to be subject to deposit insurance.

The Reserve Bank's proposed exemption powers (as discussed in section 3.4) would allow it to address any entities unintentionally captured by the proposed regulatory perimeter. There are currently a number of exemptions from the NBDT regime, such as intra-group funding vehicles and payment facility providers. Some entities are also effectively exempted from the Reserve Bank Act by class authorisations. To the extent that these entities are captured by the new definition it is expected that these exemptions will continue.

Figure 3.1: Proposed regulatory perimeter



Treatment of wholesale-funded lenders

The proposed regulatory perimeter would exclude some lenders that are solely funded on wholesale markets (i.e. they do not issue retail debt securities, instead solely issuing debt securities to wholesale investors such as high-net-worth persons and investment businesses).[5]

While wholesale-funded lenders that are large or otherwise highly connected to the rest of the financial system could generate financial stability risks, these risks would typically be lower than those presented by deposit-takers that raise funds/take deposits from the general public. Wholesale investors are also better placed to address the information asymmetry issues associated with credit intermediation, as discussed in Consultation Document 2A.

[5] The definition of a wholesale investor would be expected to align with the definition in Schedule 1 of the FMC Act. Financial products that are solely offered to wholesale investors are not 'regulated products' under the FMC Act and are not subject to the FMC Act's governance and disclosure requirements.

Internationally, wholesale-funded lenders are generally either subject to lower levels of prudential regulation or exempted from prudential regulation entirely. In Australia, for example, registered financial corporations (RFCs) that do not take retail deposits are exempt from the requirement to be licensed as authorised deposit-taking institutions (ADIs) (although other regulatory and monitoring requirements apply).

Stakeholder feedback is sought on whether this exclusion should be subject to a maximum size threshold for an entity's New Zealand operations (prescribed through regulations) and, if so, what size threshold would be appropriate. A threshold could be based on the assets, revenue or liabilities of an entity's New Zealand business.

- At one end of the spectrum, a comparatively low size threshold could be adopted, such as the existing financial reporting threshold for large companies in the Companies Act 1993 and the Financial Reporting Act 2013.[6] This approach would allow the Reserve Bank to license and prudentially regulate moderate- to large-sized wholesale funded lenders, while excluding smaller lenders that are not likely to be of interest from a financial stability perspective. The Reserve Bank could use the flexibility of the regime to set requirements for these entities that appropriately reflect the lower level of financial stability risk presented by wholesale funded lenders. The Reserve Bank could also exempt these entities from requirements entirely where this is considered appropriate.
- Alternatively, a focus on entities that have the potential to present risks to the overall financial system would suggest setting a much higher threshold. For example, the Reserve Bank currently defines a 'systemically important' bank as one with more than $15 billion in New Zealand liabilities. Such a threshold would not necessarily capture any current wholesale-funded lenders. This approach would make greater use of other tools to monitor the financial stability risks associated with wholesale lenders, such as perimeter flexibility tools (see section 3.4) and the ability to allow the Reserve Bank to set macro-prudential and reporting standards on unlicensed categories of lenders (see section 4.3).

Territorial scope

The intended territorial scope of the perimeter would aim to capture entities that borrow money in New Zealand and that undertake the business of lending (regardless of whether the lending takes place in New Zealand). The proposed exclusion for wholesale-funded entities (as discussed above) would effectively provide for this territorial scope by excluding non-bank lenders that do not make regulated offers under the FMC Act, unless their New Zealand business exceeds the prescribed level.

The current approach to wholesale-funded banks (as provided for in the Reserve Bank's recent authorisation notice) would be retained. This would exempt banks that do not have a place of business in New Zealand from the requirement to be licensed in relation to wholesale banking and lending activities.

6 The Financial Reporting Act 2013 defines a New Zealand company as large if it has assets exceeding $60 million, or revenue exceeding $30 million per annum. A large overseas company is large if it has assets exceeding $20 million or revenue exceeding $10 million.

Application to associated persons

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.

The Reserve Bank currently has a range of powers in relation to 'associated persons' of registered banks, such as powers to issue directions, remove, replace and appoint directors, and place associated persons into statutory management. The Reserve Bank Act and the Insurance (Prudential Supervision) Act 2010 (IPSA) have different definitions of an associated person, with the latter applying different control thresholds and capturing a broader range of entities in a regulated entity's group structure.

The appropriate definition of an associated person and related issues, such as the application of crisis-management powers to associated persons, will be considered as part of final policy decisions, and subsequently tested through the exposure draft of the Bill.[7]

Questions for consultation

3.A Do you agree with the proposed approach to defining the overall regulatory perimeter? If not, what approach would you suggest?

3.B Do you support the proposed exclusion for wholesale-only funded lenders? If not, what approach would you suggest?

3.C Do you support a maximum size threshold for the wholesale exclusion? If so, what would be an appropriate measure of size?

3.D Do you agree with the proposed territorial scope of the legislation? If not, what approach would you suggest?

3.E Do you have any comments on the application of the Deposit Takers Act to associated persons?

Restricted words

Currently an entity can only use the words 'bank', 'banker', and 'banking' in its name if it is:

- the Reserve Bank
- a registered bank
- a person who is otherwise authorised by the Reserve Bank
- an entity whose use of the word 'bank' signifies a place name or the name of a natural person and where the entity is not a financial institution.

[7] The definition of associated persons also potentially affects the treatment of covered bonds. However, covered bonds as a specific topic area are outside the scope of the Review (except to the extent that any issues requiring changes are identified during the process).

Non-bank financial institutions are only permitted to use these words in advertising where the words are accompanied by statements that the institutions are not registered banks. The use of translations of restricted words into other languages is also restricted.

The perimeter of the current prudential regime for banks is based on restricting the entities that can use these words. So while NBDTs can provide financial services that are similar to those provided by banks – transactional services and intermediating between savers and borrowers – they are not regulated under the Reserve Bank Act and therefore may not call themselves 'banks'.

The Reserve Bank has recently issued guidance for overseas banks on limitations on the use of restricted words and its approach to authorising the use of these words, for example by overseas banks that undertake limited business in New Zealand.

Proposed approach 3.2: *restrict the use of the words 'bank' and 'deposit' (and related words) by financial service providers that are not licensed deposit takers.*

As noted in Consultation Document 2A, a restriction on the use of the words 'bank', 'banker' and 'banking' in entities' names and in advertising is expected to be retained in the Deposit Takers Act.

While the Deposit Takers Act will have an activity-based regulatory perimeter (as outlined above), 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.[8]

Whether all deposit takers or a subset of deposit takers should be permitted to use the words 'bank', 'banker' and 'banking' is discussed in section 3.3.

Given the introduction of a regulatory regime based on the activity of deposit-taking, and the introduction of deposit insurance for retail deposits, feedback is also being sought on the merits of restricting the use of the words 'deposit taker', 'deposit-taking' and 'deposit'. These restrictions would prevent uninsured financial products being marketed as deposits – see the proposed scope of insured deposit products in section 8.2. Otherwise, investors may be misled into thinking their investments are covered by the deposit insurance scheme when they are not, undermining confidence in a downturn and exacerbating financial stability risks. It is not intended that this restriction would capture more general uses of the word 'deposit', such as 'no-deposit finance'.

It is important that the scope of restrictions on the use of 'bank', 'deposit' and associated terms is no broader than necessary in order to comply with the Bill of Rights Act 1990 in relation to restrictions on free speech. As the restrictions would only apply to persons that provide 'financial services',[9] entities that do not provide financial services (such as food banks) would be permitted to use these words, whereas entities that provide financial services (including overseas entities) could only use these words in their New Zealand-related activities if they were licensed as deposit takers. There would seem to be limited scope for public confusion in relation to entities that do not provide financial services. The Reserve Bank Act already allows non-financial service providers to use 'bank' where it refers to a person's name or place name.

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[8] See the Basel Committee on Banking Supervision's Core principles for effective banking supervision, September 2012.

[9] Defined based on section 5 of the Financial Service Providers (Registration and Dispute Resolution) Act 2008.

The Reserve Bank would still be able to authorise financial service providers that are not licensed as deposit takers to use any of the restricted words. For example, overseas banks that are not deposit takers (i.e. they do not carry on the business of borrowing and lending in New Zealand) could be authorised to use the work 'bank', 'banker' and 'banking' subject to any conditions that the Reserve Bank considers appropriate.

Questions for consultation

3.F Do you agree with retaining the restriction on the use of the words 'bank', 'banker' and 'banking', but limiting it to persons providing 'financial services'? If not, what approach would you suggest?

3.G Do you agree that the use of the words 'deposit', 'deposit taker' and 'deposit-taking' should be restricted? What restrictions would you suggest?

Foreign branches

Of the 26 banks currently registered in New Zealand, 10 operate as branches of overseas-incorporated banks.[10] Because these branches are part of overseas banks rather than separate New Zealand-incorporated legal entities, the Reserve Bank is comparatively limited in the prudential requirements that it can effectively impose. The initial registration (i.e. licensing) process includes an assessment of the adequacy of the overseas bank's home regulatory regime, and conditions of registration (CoRs) that apply to branch banks mainly require ongoing compliance with those overseas regulatory requirements. Other requirements, such as disclosure and loan-to—value-ratio (LVR) requirements, are also imposed.

Regardless of the adequacy of their home regulatory regime, bank branches present particular risks that need to be managed. In particular:

- prudential supervisors' objectives can differ between home and host countries
- some home countries give their domestic creditors priority claims over banks' assets in the event of failure
- jurisdictional boundaries can make it legally and practically difficult for the Reserve Bank to enforce undertakings made by overseas banks
- the interests of a parent bank may differ from those of the local banking operation (and those of New Zealand society).

The Reserve Bank's local incorporation policy, as set out in the Banking Supervision Handbook's Statement of principles – bank registration and supervision (BS1) places a range of restrictions on the activities of branches, including thresholds at which an overseas bank is required to establish a locally incorporated subsidiary rather than operate a branch (for example, banks with New Zealand liabilities over $15 billion).

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[10] See the Reserve Bank's register of registered banks, which notes which banks operate as branches. The Reserve Bank permits foreign-owned banks to be 'dual-registered' – that is operate both as a branch and a locally incorporated subsidiary. Three of the four large Australian banks have registered bank branches that operate alongside the New Zealand subsidiaries. There is also a specific dual-registration policy for small foreign banks.

Proposed approach 3.3: *enable the Reserve Bank to treat branches of foreign banks as a class of deposit taker, subject to applicable standards and further requirements and restrictions established through licence conditions.*

Under the proposed regulatory perimeter, foreign bank branches would need to be licensed to carry out the business of borrowing and lending in New Zealand, unless they are solely wholesale funded, do not have a place of business in New Zealand and are below any prescribed size threshold.

The proposed framework would provide the Reserve Bank with enough flexibility to treat foreign branches of deposit takers as a class of deposit taker, and to establish applicable standards for this class (see section 4.3). However, given the reliance on the adequacy of home jurisdiction prudential requirements, these standards may relate to a more limited range of matters than those applying to New Zealand incorporated entities. Other requirements seeking to manage the risks associated with branches would be imposed through licence conditions (see section 4.5). A number of these requirements could be standardised for all foreign branches.

The process of licensing branches would provide an opportunity to review the requirements and restrictions applying to branches to ensure they are consistent and that the risks associated with branches are being managed adequately. In particular, risks associated with the introduction of deposit insurance will need to be managed, for example by restricting branches' ability to take retail deposits or via risk-based pricing (see Chapter 8).

Question for consultation

3.H Do you support the proposed approach to foreign bank branches? If not, what approach would you suggest?

3.2 Regulation of finance companies that do not take insured deposits

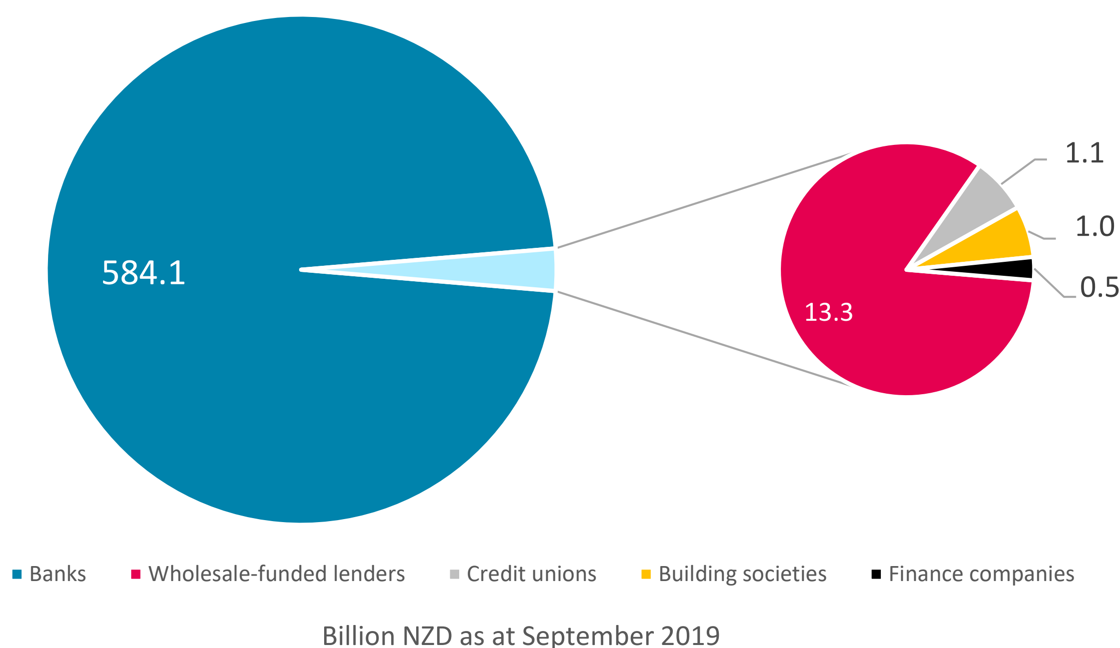
The proposed regulatory perimeter outlined in section 3.1 would capture entities (typically referred to as 'finance companies') that do not take on-call deposits or offer transactional services, but that issue other types of debt securities to retail investors. These investment products are often referred to as debentures but are also marketed as 'term deposits' and 'secured term deposits'.[11]

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 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.

[11] While the term 'debenture' does not have a well-defined legal meaning, it typically refers to a form of debt security that is secured against an entity's overall assets. These debentures are typically longer-dated (between 6 months and 5 years). Some finance companies currently market their debentures as 'term deposits' or 'secured term deposits'.

Finance companies are currently regulated under the NBDT Act if they raise funds from the public via a regulated debt offer under the FMC Act.[12] Currently eight NBDTs could be described as finance companies.[13] Combined, they have $471 million in assets compared to the $16 billion in assets held in the broader non-bank sector (which includes both wholesale- and retail-funded lenders) and the $584 billion in assets held by banks.[14] Most retail funded finance companies currently offer debt securities with maturities of between six months and five years.

Figure 3.2: Bank and non-bank lending sector assets



The failure of a large number of financial companies in the years around the global financial crisis (GFC) was a major factor behind the introduction of a new prudential regime for NBDTs in 2008.[15] Between 2006 and 2011, 45 finance companies failed in New Zealand, costing investors hundreds of millions of dollars, and the Crown paid out more than $2 billion under the temporary Crown Retail Deposit Guarantee Scheme (approximately $1.6 billion of which was recovered). A subsequent Parliamentary inquiry identified four main reasons for these failures:

- **Poor governance and management**: the finance companies' business models led to poor governance by their managers and directors, and an inadequate management of risk (which was often concentrated in excessive lending to related parties).

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12 Wholesale-funded non-bank lenders are also sometimes referred to as finance companies. These entities are not regulated under the NBDT Act as they are wholesale or equity-funded rather than retail-funded (e.g. they obtain funding on wholesale markets or from their parent companies). The treatment of wholesale-funded lenders is discussed in section 3.1.

13 Asset Finance Limited, Christian Savings Limited, FE Investments Limited, Finance Direct Limited, General Finance Limited, Gold Band Finance Limited, Liberty Financial Limited and Mutual Credit Finance Limited.

14 As of the Reserve Bank's November 2019 Financial Stability Report.

15 The Reserve Bank Act was amended in 2008, with the relevant sections carved out into separate legislation with the introduction of the NBDT Act in 2013.

- **Criminal misconduct:** in several cases directors' and managers' behaviour was not merely poor, but negligent and even unlawful. There were instances of serious misconduct ranging from misrepresentation of risks and non-disclosure of related-party lending, to outright fraud.
- **Deficiencies in disclosure, advice and investors' understanding:** the information and advice provided to investors was often poor, with investors unaware of advisers' interests in promoting certain financial products and poorly informed of the associated risks. This was compounded by deficiencies in investors' own understanding of the nature of risk and reward.
- **Inadequate supervision:** the supervisory framework was fragmented and insufficiently rigorous. Trustees did not always do a good enough job. The different regulators operated under relatively narrow legislative mandates, and overlapping responsibilities and inadequate funding led to things slipping through the cracks.

Investigations and subsequent civil and/or criminal proceedings initiated by FMA and/or the Serious Fraud Office also focused on issues arising from poor governance, related party lending, conflicts of interest, poor liquidity management, and disclosure misrepresentations. While some of these issues have since been addressed through legislation such as the FMC Act and the Financial Markets Supervisors Act 2011, the NBDT Act continues to play a key part in managing some of the risks that crystallised during the finance company collapses.

Consultation to date

Consultation document 2A sought feedback on how the boundary of the deposit-taking perimeter should be set, signalling that the regime would likely focus on firms that take retail deposits, rather than retail issuers of longer-dated 'capital markets' products such as bonds, debentures and medium-term notes.

Submitters were generally supportive of a regulatory perimeter that focused on 'banking-like' services, rather than capturing all lenders funded via retail debt securities. Feedback from finance companies suggested they did not see their business model aligning well with a regulatory regime for deposit takers and that at least some finance companies would stop seeking retail funding if doing so required them to be licensed as deposit takers.

However, further discussions with stakeholders highlighted the need to retain some level of prudential regulation of finance companies. Concerns focused on the risks inherent in finance companies' business models and the difficulty for retail investors in assessing underlying credit, liquidity and operational risks through disclosure alone. In the December 2019 Cabinet paper the Minister of Finance indicated that his initial view was that finance companies should continue to be prudentially regulated. The Phase 2 Review Independent Expert Advisory Panel also recommended that finance companies continue to be subject to some level of prudential regulation.

This consultation seeks further feedback on the approach to the prudential regulation of finance companies under the Deposit Takers Act, in particular whether a separate restricted licence category should be established for finance companies.

Options for regulation

***Option 1:** establish a restricted licence category that would permit finance companies to issue uninsured retail debt securities, but not to take insured deposits or offer transactional facilities. Disclosure requirements, minimum term lengths and restrictions on what these debt securities could be called would seek to differentiate them from insured deposits.*

This option would maintain prudential regulation of this sector but provide a specific licence category for finance companies that issue retail debt securities but do not wish to take insured deposits. As outlined in Chapter 8, bonds, debentures and other more complex debt securities are not proposed to be covered by the deposit insurance scheme.

Under this approach, these finance companies would:

- be prudentially regulated and licensed by the Reserve Bank, but have a separate licence category and not be described as 'deposit takers'
- not be permitted to offer insured deposits or transactional facilities
- be subject to prudential standards set by the Reserve Bank, although these could differ from those applying to deposit takers
- be subject to full FMC Act governance and disclosure requirements
- be subject to requirements intended to further differentiate their debt securities from insured deposits, such as minimum term lengths (e.g. a minimum maturity period of 31 days) and a prohibition on describing these products as 'deposits'
- continue to be prudentially supervised by a licensed financial markets supervisor (FMS), with the Reserve Bank's role being focused on licensing and broader systemic risk management. Alternatively, the Reserve Bank could undertake frontline prudential supervision, as is proposed for other deposit takers
- not be subject to the resolution provisions in the Deposit Takers Act. Instead any resolution would be dealt with under the provisions of the Companies Act, the Receiverships Act 1993 or the Corporations (Investigations and Management) Act 1989 (CIMA).

Under this option a finance company could still apply to become a full deposit taker if it wished to take insured deposits or offer transactional facilities, but most would not need to do so to carry on their current business models.[16]

Introducing a separate restricted licence category for finance companies would:

- more clearly distinguish finance company debt securities as investment products from insured deposits
- seek to better tailor the regulatory regime's focus on the risks that are most relevant to the finance company sector

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[16] Currently one finance company, Christian Savings Limited, issues on-call debt securities. If Option 1 is adopted it would have the option of either restricting its product offering in order to qualify for the restricted licence category, or seeking a full deposit taker licence.

- avoid potential moral hazard risks associated with finance companies being able to take insured deposits
- enable a more proportional regulatory environment that maintains financial sector diversity.

Prohibiting finance companies from providing transactional services or issuing products that appear very similar to insured deposits would limit the potential for investor confusion and regulatory arbitrage. Similar limitations have been imposed in Australia, where RFCs are exempted from the requirement to obtain an ADI licence.[17]

While many of the Deposit Takers Act's core provisions could apply to finance companies, these companies would not need to be subject to provisions that are less relevant to their business model. In particular, there does not appear to be a need for finance companies to be subject to the Deposit Takers Act's crisis management and resolution provisions. While the failure of a finance company could cause losses for investors, the fact that it would not offer on-call or transactional services would limit the immediate hardship impacts and disruption costs. Receivership or liquidation would appear to be sufficient in the event of a failure, supported by statutory management under CIMA in the event of fraudulent or reckless conduct.

The current approach to finance company supervision could be retained, whereby licensed FMSs would supervise the companies' compliance with both prudential and conduct requirements. Alternatively, the Reserve Bank could prudentially supervise finance companies, with the licensed FMS's role limited to the supervision of FMC Act compliance.

Establishing a separate licence category for finance companies would also more easily enable differential treatment of finance companies and deposit takers under other legislation. In particular, it would allow for disclosure and governance requirements under the FMC Act to be applied to finance companies, but not to other deposit takers types (see section 3.3).

***Option 2:** require finance companies to be licensed as deposit takers to issue any type of retail debt securities.*

Under this approach, the Deposit Takers Act would not draw a distinction between finance companies and other types of deposit taker, requiring them to be licensed as full deposit takers in order to issue any retail debt securities. While the Reserve Bank could choose to treat finance companies as a class of deposit taker – issuing different standards on some matters or granting exemptions from requirements that are not relevant or necessary – the bulk of the regulatory regime would likely be similar to that applying to other deposit takers.

The most significant benefits of this approach are that it would:

- avoid the complexity associated with providing for two licensed entity types under the Deposit Takers Act

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[17] The exemption for RFCs prohibits them from: using the words 'deposit' and 'at-call' (or other restricted words such as 'bank'); issuing retail debentures with maturity periods under 31 days; and providing transaction facilities, such as ATM access to accounts or EFTPOS facilities. APRA imposed these restrictions in 2013 in response to concerns about the blurring of distinctions between RFCs and ADIs causing confusion for investors – particularly in relation to which products were protected by Australia's deposit insurance scheme. The restrictions sought to draw a sharper regulatory boundary between ADIs and RFCs, and were a recognition that disclosure alone was not an adequate tool to resolve these issues.

- create a consistent regulatory framework for all lenders that borrow money from the public
- potentially provide for greater regulatory oversight of the sector (depending on the standards and supervisory approach that are applied to finance companies as a deposit taker class)
- remove any residual risk that retail investors would confuse finance companies with licensed deposit takers.

The challenges associated with this option primarily relate to whether regulatory requirements could adequately manage the risk of a finance company being able to take insured deposits, while still being compatible with finance companies' higher risk and return business models and the desirability of maintaining financial sector diversity.

To the extent that finance companies decide to take insured deposits and are able to maintain relatively high returns from engaging in higher-risk lending, this would raise significant moral hazard issues. Investors would be incentivised to take advantage of these higher (risk free) returns, creating the potential for significant in-flows of funds to the sector.

Barriers to entry, prudential standards, supervision and risk-based insurance pricing could seek to address these moral hazard issues. However, this would likely require finance companies to adopt a risk- and return-model similar to that of other deposit takers, potentially reducing the availability of credit to higher risk ventures and the diversity of investment opportunities available to retail investors.[18]

Even if some finance companies were prevented from taking insured deposits (for example through licence conditions), there is a risk that the label of 'licensed deposit taker' (as opposed to 'licensed finance company' or similar) would create a perception that finance company debt securities are insured and would ultimately be protected by the government in the event of failure, despite any disclaimers in disclosure documents.

There may be other areas where it would be problematic to treat finance companies in the same way as other deposit takers. In particular, the proposed exclusions for deposit takers from the governance and disclosure requirements of the FMC Act would not necessarily be appropriate for finance companies. As noted above, the resolution regime discussed in Chapter 7 also appears less necessary in relation to finance companies funded by longer-dated debt securities.

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[18] The Office of the Auditor General's report on the operation of the Crown Retail Deposit Guarantee Scheme explored the challenges faced managing moral hazard issues in relation to that scheme, particularly in relation to finance companies.

Table 3.1 summarises an initial assessment of the impacts of the two options.

Table 3.1: Options for prudentially regulating finance companies

Option 1: Restricted licence	
Pros	**Cons**
▪ Allows for a more differentiated and proportionate treatment of finance companies ▪ Manages risks to the insurance scheme by preventing finance companies taking insured deposits ▪ Restrictions on the scope of finance company products and how they are labelled, along retention of FMC Act disclosure, reduce the scope for public confusion	▪ Additional legislative complexity and separate regulatory standards ▪ Potential complexity of different supervision model ▪ Residual risk of public confusion
Option 2: Licensed as a deposit taker	
Pros	**Cons**
▪ Less legislative complexity than option 1 ▪ Higher prudential requirements and more intensive supervision may reduce risks to investors	▪ Challenges managing the moral hazard risks associated with deposit insurance while maintaining financial sector diversity ▪ Potential for public confusion on what financial products are insured ▪ Does not allow for differential treatments of finance companies in relation to resolution or under the FMC Act

Questions for consultation

3.I Do you agree that prudential regulation should be retained for finance companies funded via retail debt securities?

3.J Would you support the approach of creating a restricted licence category for finance companies funded via retail debt securities (option 1)? What do you think would be the benefits and costs of this approach?

3.K Under option 1, what restrictions should be placed on the services that a licensed finance company could offer without becoming a full licensed deposit taker?

3.L Should licensed financial market supervisors undertake the frontline supervision of finance companies under this model? If not, what approach would you suggest?

3.M Alternatively, would you support requiring finance companies to have full deposit taking licences to issue retail debt securities (option 2)? What do you think the benefits and costs of this approach would be?

3.3 Approach to 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 mutual credit unions and building societies (the regulation of finance companies is discussed in section 3.2).

Consultation Document 2A 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. Consultation Document 2A noted that a differential approach could be created by either classifying deposit takers into tiers or providing exceptions from particular rules for deposit takers that meet specific criteria. The design of deposit insurance settings (such as risk-based levies for deposit insurance) would also need to take into account the impacts on small deposit takers – see Chapter 8.

A number of submissions on Consultation Document 2A highlighted:

- the risk that small deposit takers, particularly credit unions and building societies, could struggle to meet the compliance burden associated with a 'bank-like' level of prudential regulation. In particular, they noted that these entities are of an entirely different scale from banks and often have very limited dedicated compliance resources
- the importance of ensuring that prudential requirements for small deposit takers reflect their less complex business models. For example, stakeholders commented on the complexity of banks' capital and liquidity requirements and the compliance challenges of applying those requirements to NBDTs. Stakeholders also emphasised that the substance of these requirements would not necessarily be appropriate for NBDTs, which are significantly smaller than any of the registered banks
- the role of credit unions, building societies and other small deposit takers in contributing to broader Government policy objectives, such as by promoting 'financial inclusion'. These entities often offer services in underserved areas and to populations that may otherwise struggle to access 'banking' services, such as people who lack permanent accommodation.

Regulatory approach

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 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.

Proposed approach 3.4: *the Reserve Bank has the flexibility to calibrate its regulatory approach to small, less systemically significant deposit takers. 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.*

The flexibility provided to the Reserve Bank in calibrating standards and using exemption powers (as discussed in section 4.3) should enable it to establish regulatory requirements that are both proportionate to different deposit taker classes and responsive individual deposit taker's business models.

It is important that the Deposit Takers Act's purposes, the Reserve Bank's decision-making principles and the Remit (as outlined in Chapter 2) appropriately guide decisions on the design of the framework for small deposit takers.

Purposes of the Act

The Deposit Takers Act's proposed purposes include "promoting the safety and soundness of deposit takers". This seeks to ensure that an appropriate focus and resources are dedicated to these entities' regulation, and acknowledges the substantial potential impacts of a small entity's failure on individual depositors and particular places or sectors.

It is important that the Reserve Bank does not take an overly risk-averse or high-cost approach to achieving this purpose. The use of the word 'promote', rather than 'ensure', in relation to safety and soundness avoids the implication that the Reserve Bank should run a zero-failure regime.

Decision-making principles

Four of the proposed regulatory principles, as discussed in Chapter 2, are particularly relevant to small deposit takers.

The desirability of minimising unnecessary costs of regulatory actions, taking into account the benefits of the outcomes to be delivered

This principle will require the Reserve Bank to assess whether the benefits of particular regulatory requirements outweigh the costs to small deposit takers. For example, there may be requirements that are either more difficult or more costly (in relative terms) for small deposit takers to introduce than they are for large deposit takers, or where the benefits associated with the requirements – whether at a systemic or an entity level – are not as clear for small deposit takers as they are for large deposit takers.

Taking account of this principle, the Reserve Bank may choose to either apply less stringent or different requirements to small deposit takers, or exempt certain small deposit takers completely from particular requirements.

The desirability of taking a proportionate approach to regulation and supervision, and ensuring that similar institutions are treated consistently

As outlined in Chapter 2, the Reserve Bank must consider proportionality in its regulatory and supervisory approach, particularly given the wide range of entity sizes and business models in the sector. An appropriate response to risks presented by systemically important institutions may not be justifiable for small deposit takers.

The need for a proportionate approach applies to the licensing thresholds that the Reserve Bank expects entities to meet, the prudential standards that the Reserve Bank applies to different classes of deposit takers and the intensity of its supervisory approach.

The consistency component of this principle is also relevant to small deposit takers, encouraging the Reserve Bank to set applicable regulatory requirements rather than rely solely on case-by-case exemptions.

The desirability of sectors regulated by the Reserve Bank being competitive, taking account of the size of the market

Small deposit takers can have an important role in promoting the deposit-taking sector's competitiveness, as they compete with each other and with banks for customer deposits and for lending to various sectors. New entrants also have the potential to disrupt the deposit-taking market through innovative new products and services that benefit consumers.

Taking a regulatory approach that facilitates effective competition includes removing unnecessary barriers to entry and minimising barriers to growth for small deposit takers. A number of jurisdictions have sought to promote entry to the deposit taking market by providing graduated licensing pathways or creating regulatory 'sandboxes'.[19] In the UK, the Prudential Regulation Authority has recently shifted its competition focus from enabling the entry of new challenger banks to ensuring that the regulatory environment allows small players to grow, without undermining financial stability.[20] Part of this focus has been on reducing the complexity of its prudential rules, including proposals to simplify its capital requirements for credit unions.

Consideration of the practice by relevant international counterparts carrying out similar functions, as well as guidance and standards from international bodies

Internationally, recent reforms have focused on the regulation of small deposit takers and the interaction with objectives such as competition and financial inclusion. In Australia, for example, APRA has focused on reducing the regulatory burden on small ADIs, including by:

- simplifying the capital adequacy framework for ADIs with assets under AU$15 billion

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[19] A regulatory sandbox is a framework set up by a financial sector regulator to allow small scale testing of innovative business models in a controlled environment (operating under a special exemption, allowance, or other limited, time-bound exception) under the regulator's supervision.

[20] See this 2019 speech for an outline of the PRA's approach.

- providing for longer transitional periods for new regulatory requirements
- lowering supervisory intensity for small ADIs.[21]

APRA's Restricted ADI licence framework allows small new-entrant firms to conduct a limited amount of banking business for up to two years while they seek to meet the requirements of the full prudential framework. Restricted licences allow small entities with limited banking experience to develop and test their systems, processes and business models and seek the investment necessary to obtain full ADI licences and operate full banking businesses.

Financial Policy Remit

The Financial Policy Remit provides an opportunity for the Minister of Finance to set out matters that the Reserve Bank should take into account in pursuing its financial stability objective.

For example, the Remit could set out the Minister's risk appetite in relation to the financial system, which could influence the Reserve Bank's risk tolerance in relation to small deposit takers. They could also choose to highlight other policy objectives that the Government is looking to achieve, such as ensuring that all New Zealanders can access the financial system, as articulated in its recent Safer Credit and Financial Inclusion Strategy.[22]

The Reserve Bank would need to take these matters, and the principles, into account in seeking to promote financial stability. To that end the Remit will influence the level of risk the Reserve Bank is willing to tolerate, how it seeks to mitigate these risks and how it prioritises its resources.

Alternative approaches

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

One option for establishing this tiering would be to link it to any restrictions on the use of the word 'bank' (as discussed below). The use of 'bank' as the basis for tiers would effectively continue the current regulatory approach, albeit with a more consistent approach to rule-making, supervision and enforcement powers. Because deposit takers would decide whether or not to become 'banks' under this model, separate licence categories would be maintained for 'bank' and 'non-bank' deposit takers.

A benefit of this approach is that it would use the existing distinction between 'banks' and other deposit taker types, and could help to communicate to depositors the regulatory intensity levels for the different entity classes. However, it is unclear whether the public has a clear understanding of the distinction, or whether it is necessary given the introduction of deposit insurance. The distinction would also not necessarily stop a 'non-bank' deposit taker becoming systemically significant (without, for example, also limiting the size of NBDTs).

Alternatively, separate tiers could be established according to institutions size, with a size threshold set through regulations. This approach is taken in IPSA, which exempts insurers with annual gross premium income below a prescribed amount from particular solvency, credit rating, financial

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21 See this 2019 speech by APRA Chair Wayne Byers, and this 2018 Discussion paper.

22 The Basel Committee on Banking Supervision has also published guidance on the application of its core principles to the regulation and supervision of the financial institutions engaged in reaching the financially unserved and underserved.

statement and statutory fund requirements. Similarly, under the NBDT Act, small NBDTs are exempt from the requirement to obtain credit ratings.

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.

Questions for consultation

3.N Do you support the proposed approach to small deposit takers, under which the Reserve Bank would be expected to calibrate its regulatory approach in light of the proposed purposes, the decision-making principles, and the contents of the Remit? If not, what changes would you suggest?

3.O Alternatively, would you support creating a separate tier in legislation for small deposit takers? If so, how would you suggest drawing this distinction?

Use of the word 'bank' by small deposit takers

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.[23] 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 ADIs (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".[24]

In 2018, the Australian Government passed legislation that removed the need for ADIs to hold AU$50 million in capital before they could call themselves 'banks'.[25] Under the new rules, any ADI, regardless of size, can call itself a bank unless APRA expressly prohibits it doing so because it lacks the ordinary characteristics of a bank, such as stored-value payment facilities. This change was made on the basis that it would remove barriers to entry in the banking sector and provide a more level playing field among ADIs. The International Monetary Fund's (IMF's) 2019 Financial Sector Assessment Programme (FSAP) for Australia noted the risks associated with this change and that APRA was managing those risks by ensuring that all ADIs had the capacity to meet prudential capital requirements.[26]

This consultation is seeking feedback on the preferred approach to any restrictions on which deposit takers can use the words 'bank', 'banker' and 'banking'. Potential options include:

1. Permitting all licensed deposit takers to use the word 'bank', 'banker' and 'banking'

   Under this option the Reserve Bank could be provided with a power to prohibit a particular deposit taker from using 'bank' because it lacks the ordinary characteristics of a bank for similar reasons (in line with APRA's powers).

2. Requiring deposit takers to get Reserve Bank approval to use 'bank', 'banker' and 'banking' words in their names and requiring non-approved deposit takers that use any use of these words in advertising to accompany them with a disclaimer statement.

   Under this option, approval could be based on minimum capital or assets, or on an assessment of risk management systems and capabilities. Any assessment of systems implies the creation of higher regulatory standards for banks as a class, compared to other deposit takers.

3. Establishing separate licence categories in legislation for 'bank' and 'non-bank' deposit takers, with different regulatory treatment (as discussed above).

Question for consultation

3.P Do you think the use of the words 'bank', 'banker' and 'banking' should be restricted to a subset of deposit takers? If so, what criteria would be appropriate for their use?

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[23] Credit unions are currently required under the Friendly Societies and Credit Unions Act 1982 to include the term 'credit union' in their name.

[24] Australian Productivity Commission (2018) Competition in the Australian Financial System, No. 89, June, page 123.

[25] Treasury Laws Amendment (Banking Measures No. 1) Act 2018 (Cth) – see here.

[26] See the recent IMF FSAP for Australia, page 68.

FMC Act requirements for small deposit takers

The FMC Act establishes governance, supervision and disclosure requirements for issuers of financial products such as debt securities. These requirements seek to ensure that investors are well placed to assess the risks associated with their investments and that issuers' ability to meet their obligations to investors is supervised in accordance with trust deeds.

Registered banks are currently excluded from these requirements in relation to debt securities. This means they are not required to:

- comply with the FMC Act's trust deed requirements,
- prepare product disclosure statements for basic deposit products
- be supervised by licensed FMSs.

This exclusion reflects an assessment that prudential regulation and supervision under the Reserve Bank Act sufficiently addresses the conduct risks that these FMC Act requirements are intended to address. Registered banks are also required to publish six-monthly disclosure statements under the Reserve Bank Act (as discussed in Chapter 5).

NBDTs do not have a similar exclusion from the FMC Act, as their prudential requirements are generally applied through trust deeds and FMSs supervise compliance with both the NBDT Act and the FMC Act. The NBDT Act also does not impose disclosure requirements on NBDTs (unlike the Reserve Bank Act). However, NBDTs are subject to simplified FMC Act disclosure requirements in relation to basic deposit products.

As noted in the introduction to this chapter, the in-principle decision to establish a single regulatory framework for deposit takers is premised on the Reserve Bank prudentially supervising all deposit takers. However, some stakeholders have queried whether all deposit takers would have the same exclusions from the FMC Act as currently apply to banks, and be subject to similar disclosure requirements under the Deposit Takers Act.

In response to the second round of consultation, some NBDTs expressed a preference for retaining disclosure under the FMC Act instead of having a similar regime to that which applies to banks. They stated that these disclosures were more useful for their customers and that a 'bank-type' approach could increase compliance costs. However, some NBDTs have also argued in the past for similar treatment to banks under the FMC Act.

Proposed approach 3.5: *all deposit takers should have equivalent treatment under the FMC Act and be subject to similar disclosure requirements.*

Under the proposed approach, all deposit takers would be subject to the same exclusions under the FMC Act. This would be consistent with the creation of a single licensing regime and similar treatment under the Deposit Takers Act on matters such as disclosure.

In relation to disclosure, this would likely mean that NBDTs that become deposit takers would be required to publish disclosure statements periodically, but would be exempt from the requirement to provide their customers with disclosure statements in relation to basic deposit products. Risks arising from depositors having less disclosure of the risks associated with their deposits would also be mitigated by the creation of a stronger regulatory regime and the introduction of deposit

insurance. Other disclosure requirements, such as the provision of information for the Reserve Bank's 'Bank Financial Strength Dashboard' could also apply.

The proposed approach would mean that NBDTs such as credit unions would no longer be supervised by FMSs. The role and duties of an FMS under the FMC Act focus on protecting the interests of investors, for example by representing the interests of prospective investors in the approval of new product offerings. The Reserve Bank's role as prudential regulator involves a broader set of interests (as outlined in Chapter 2) and is not solely focused on the interests of investors.

The rationale for the current exclusion for banks would apply equally to all deposit takers under the new regime, with strengthened prudential regulation and supervision addressing any risks associated with the removal of FMC Act governance and supervision requirements. The new conduct licensing regime being introduced through the Financial Markets (Conduct of Institutions) Amendment Bill will also provide the FMA with a greater degree of oversight over deposit takers and assurance that they are treating consumers fairly.

As noted in section 3.2, if a restricted licence category were established for finance companies, these exclusions would not apply to entities licensed as finance companies. Finance companies would therefore continue to be subject to FMC Act governance, supervision and disclosure requirements.

Questions for consultation

3.Q Should current NBDTs have the same supervision, governance and disclosure exemptions from the FMC Act as banks? If not, what approach would you suggest?

3.R Should current NBDTs be subject to a disclosure regime that is similar to that for banks? If not, what approach would you suggest?

3.4 Perimeter flexibility

Consultation Document 1 and Consultation Document 2A both sought feedback on the introduction of tools for monitoring entities outside the regulatory perimeter and for adjusting the regulatory perimeter if necessary. Most submitters supported the introduction of these tools, although some noted concerns about overlaps with other regulatory regimes, such as the Credit Contracts and Consumer Finance Act.

Further feedback is being sought on the proposed approach to these tools. Chapter 5 discusses the concept of a 'distinct macro-prudential perimeter' and proposes allowing the Minister of Finance to extend (via regulations) the Reserve Bank's reporting and macro-prudential standard-setting powers to other lender types.

Perimeter monitoring

Consultation Document 2A sought feedback on providing the Reserve Bank with an 'enhanced perimeter monitoring' role, in order to promote an ongoing focus on the adequacy of the formal regulatory perimeter. It noted that additional reporting or registration requirements for non-deposit-taking lenders could support this role. Submitters were generally supportive of strengthening the Reserve Bank's role in this area.

The perimeter monitoring role aligns with the agreed functions of the Reserve Bank under the Institutional Act (see this Cabinet paper), which will include:

- monitoring financial sector developments, including the collection and analysis of information and the publication of statistics relevant to the main objectives
- acting as prudential supervisor, including by monitoring compliance with and investigating conduct that constitutes or may constitute a contravention of, and enforcing, any requirements imposed on entities under or pursuant to prudential legislation.

Proposed approach 3.6: *The Deposit Takers Act should empower the Reserve Bank to monitor other lender types for financial stability risks and/or instances of unlicensed entities engaging in restricted activities or regulatory arbitrage, with scope to introduce further reporting requirements in future.*

The Reserve Bank's broader financial stability and compliance functions will require it to monitor the activities of non-deposit-taking lenders for financial stability risks and/or instances of unlicensed entities engaging in restricted activities or regulatory arbitrage. This monitoring would support:

- advice to the Minister of Finance on the appropriate maximum level of New Zealand liabilities for excluded wholesale lenders (see section 3.1)
- advice to the Minister of Finance on extending the Reserve Bank's ability to set reporting and/or lending standards for prescribed types of non-deposit-taking lenders (see Chapter 4)
- the identification of instances of regulatory arbitrage that may appropriately be dealt with using the Reserve Bank's designation power (outlined below)
- the identification of breaches of the Deposit Takers Act by unlicensed entities.

Information-gathering powers in the Institutional Act and/or the Deposit Takers Act would need to be sufficiently broad to support this monitoring function (see Chapter 6). As discussed in section 4.3, there is a proposal to extend the Reserve Bank's ability to set reporting standards for prescribed categories of non-deposit-taking lenders. Any such extension would need to consider the reporting costs to lenders and the extent of any benefits compared to the use of the Reserve Bank's information-gathering tools.

The Reserve Bank's monitoring functions could also be supported by a requirement for lenders to provide additional information through the Financial Service Providers Register. This information could potentially be limited (for example, to lenders' services) or be extended to include basic information on total lending volumes, which would not necessarily be publicly available. This information would provide the Reserve Bank with a more comprehensive picture of total lending activity in New Zealand and could allow for better targeting of detailed information requests. Changes to the information collected through the Register could be made through regulations and be progressed later if considered desirable.

These tools would need to be supported by effective coordination and information-sharing with other regulators. In particular, the Council of Financial Regulators, which is co-chaired by the Reserve Bank and the FMA, has an important role in identifying and monitoring issues, risks and gaps in the financial system. The proposed mandate for the Council under the Institutional Act should strengthen and support this role.

Question for consultation

3.S Do you support the proposed approach to perimeter monitoring? If not, what approach would you suggest?

Designation powers

Proposed approach 3.7: *the Deposit Takers Act should empower the Reserve Bank to designate an entity as a deposit taker where the services it provides have the same economic substance as borrowing and lending.*

The Reserve Bank should be able to designate 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. As discussed in Consultation Document 2A, the designation power may be less appropriate for dealing with emerging financial stability risks, which would more appropriately be dealt with through a flexible legislative design, minimising the legislative change required should any new sectors be added in the future. The Minister of Finance could also address financial stability risks by adjusting the prescribed size threshold at which a wholesale-funded lender would be required to be licensed as a deposit taker (see section 3.1).

Given that designation notices would alter the application of the Deposit Takers Act, it would be appropriate to classify them as secondary legislation under the Legislation Act 2019 (consistent with the FMA's designation powers under the FMC Act). This would provide for parliamentary oversight via the Regulations Review Committee as well as publication requirements. Natural justice requirements, such as for the Reserve Bank to give reasons for exercising this power to affected entities and to consider their responses before proceeding, would also apply.

Question for consultation

3.T Do you support the proposed designation power? If not, what approach would you suggest?

Exemption powers

Given the broad range of business models that may need to operate under the Deposit Takers Act, it is unlikely that every requirement in either the Act or standards is going to be appropriate for every regulated entity. It is therefore important that the Reserve Bank have sufficiently broad and flexible exemption-making powers.

Proposed approach 3.8: *the Reserve Bank should have a broad power to exempt an entity or class of entity from requirements under the Deposit Takers Act and subordinate legislation (including standards), subject to enforceable terms and conditions determined by the Reserve Bank.*

The proposed exemption-making power would enable the Reserve Bank 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. 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.

One risk with a broad exemption power is that it introduces excessive complexity into the regime, and results in prudential regulations being set by a series of exemptions (and associated terms and conditions) rather than being necessarily reflected in the core standards. In his report on the prudential regulation of banks, James Every-Palmer QC recommended the introduction of an explicit exemption power, while noting that it should be subject to the following safeguards:

- Provide that the power to grant exemptions must be exercised consistently with the purposes of the Reserve Bank Act and the rest of the prudential framework.
- Set out the criteria to be applied by the Reserve Bank in determining whether to grant an exemption. The criteria should provide a threshold that ensures exemptions do not become so numerous that the accessibility of the law is impaired.
- Require the Reserve Bank to give reasons for its decision to grant or decline to grant an exemption and that these reasons be published on the Reserve Bank's website.
- Provide that exemptions are subject to expiry dates to ensure regular review of the exemption unless, exceptionally, the nature of an exemption is such that it should be granted permanently.

Every-Palmer QC also recommended that decisions to not grant an exemption should be subject to appeal rights. However, this would not appear to be consistent with the fact that exemptions would likely have the status of secondary legislation under the Legislation Act 2019 (given that they would alter the application of primary legislation). Secondary legislation is not usually subject to appeal rights, although it could still be judicially reviewed and would be subject to scrutiny by Parliament's Regulations Review Committee. This approach would be consistent with the treatment of the FMA's exemption powers under the FMC Act.

Feedback is sought on whether these are appropriate safeguards for an exemption power, including on the criteria the Reserve Bank would use in assessing exemption requests. For example, the Reserve Bank's exemption power under the NBDT Act is limited to where:

- an exemption is consistent with the maintenance of a sound and efficient financial system, and
- compliance with the relevant requirement would be unduly onerous or burdensome, and
- the exemption is not broader than reasonably necessary.

In comparison, the FMA's exemption power under the FMC Act is not limited to where compliance with relevant requirements would be unduly onerous or burdensome.

While the Deposit Takers Act could provide for exemptions to be made via regulations (as per IPSA), empowering the Reserve Bank to issue exemptions is more consistent with the principle that prudential requirements should be set by the Reserve Bank as an independent regulator. It also supports the intent that the Deposit Takers Act be flexible and enabling in nature. This aligns with the approach under the NBDT Act and with the FMA's powers under the FMC Act.

It is important that the Reserve Bank be able to establish enforceable terms and conditions for any exemption. For example, terms and conditions may apply alternative requirements that deliver on the intent of the provision that the entity is being exempted from, or may include requirements that better enable the Reserve Bank to monitor and assess any risks associated with an exemption. A breach of a term or condition would be treated as a breach of the underlying requirement from which the entity has been exempted.

Questions for consultation

3.U Do you support the proposed exemption power? If not, what changes or alternative approaches would you suggest?

3.V What should the criteria be for the Reserve Bank granting an exemption? What other limitations or safeguards should be placed on the power?

Summary

This chapter has outlined a proposed approach to defining who would be regulated under the Deposit Takers Act, including the treatment of wholesale-funded lenders, bank branches, finance companies and small deposit takers.

The proposed approach aims to allow for proportionate application of regulatory requirements that respond to the underlying risks that justify prudential regulation, while promoting public understanding of the regulation and protection associated with different providers and products. The scope of deposit insurance, as proposed in Chapter 8, is an important factor.

The chapter has also considered how the regulatory perimeter can respond flexibly to changing business models and financial stability risks.

Chapter 4: Standards and licensing

Introduction and progress to date

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.

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. 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 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.

This chapter seeks feedback on the proposed scope of this standard-setting power, in terms of:

- the matters to which standards could relate
- who standards could apply to
- how standards could be flexibly applied to accommodate different business models
- the procedural requirements that would apply to the use of the standard-setting power.

Finally, this chapter seeks feedback on the proposed licensing framework, including procedural requirements and protections, and the role of licence conditions.

Chapter 4 Overview

- ✓ Standards as the main tool for imposing prudential requirements
- What kinds of standards could be set?
- How should macro-prudential standards be dealt with?
- What process should the Reserve Bank go through in setting standards?
- How should the licensing process for deposit takers work?

✓ Key decisions taken by Cabinet

▪ Key remaining issues to be covered in the current consultation

4.1 Scope of standards

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 in section 4.2).

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 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 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.[27] 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.

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 macro-prudential 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. This desire for clarity will need 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 GFC (under the 'risk management systems and

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[27] See the assessment of the Reserve Bank's compliance with the core principles in the Detailed assessment of observance - Basel core principles for effective banking supervision, May, 2017.

policies' provision in the current Reserve Bank Act).[28] The scope should also be broad enough to enable standards to be set in relation to all the relevant BCPs.

It should be noted that internationally, prudential regulators are often given broadly defined authorities to set prudential rules in relation to matters that they consider relevant to financial stability or the soundness of a regulated entity. This approach would be highly unusual in the New Zealand context.[29] 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
- flexibility should be balanced against the importance of maintaining the legitimacy of the law.

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.

Proposed approach 4.1: *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 in Table 4.1*

Table 4.1: Indicative scope of prudential standards

	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

[28] See this Reserve Bank Bulletin article for a discussion on the liquidity policy and its introduction.

[29] It should also be noted that institutional settings and oversight of rule-making in other jurisdictions can differ significantly from those in New Zealand. For example, the Australian Parliament periodically disallows delegated legislation for policy reasons, rather than technical reasons. While this is rare in the prudential context, it provides an additional degree of Parliamentary constraint on rule-making.

	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 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 pre-positioning.
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
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 8.4).	

	Intended scope	Current Banking Supervision Handbook equivalents
Lending standards in relation to mortgages	See section 4.2	▪ 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	

In general, the proposed approach would cover the range of matters currently provided for via CoRs, but with more clarity and specificity 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 BCPs, should it choose to do so. The rationale for the proposed scope of macro-prudential standards (e.g. lending standards) is discussed in section 4.2.

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 4.5, the requirement for directors and senior managers to be fit and proper persons (and the associated procedural protections) would be directly provided for in the Deposit Takers Act. Standards relating to fit and proper requirements (i.e. suitability) could establish procedures and policies designed to provide assurance of the ongoing fitness and propriety of deposit takers' directors and senior managers, as well as a requirement for Reserve Bank approval of new appointments. The Reserve Bank could remove directors and senior managers who it determines are no longer fit and proper persons.

As discussed in section 4.5, 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 – see section 3.1).

Prudential standards will be developed and set independently by the Reserve Bank, subject to the procedural requirements outlined in section 4.4. 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. 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 (and potentially for 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 discussed in Chapter 1, with enough time for deposit takers to adjust to any changes and proceed through the final licensing process.

Question for consultation

4.A Do you agree that the proposed scope of standards is appropriate? If not, what changes would you suggest?

4.2 Macro-prudential policy

As described in Chapter 2 of Consultation Document 2B, macro-prudential policy is an approach to prudential regulation that emphasises the risks to the financial system as a whole, rather than focusing solely on the stability of individual institutions. Since the GFC, many countries (including New Zealand) have added a macro-prudential overlay to their approach to prudential regulation, and many have used new tools – such as LVR restrictions and capital buffers – to help prevent the build-up of systemic financial risks.

As well as being novel, some macro-prudential tools can generate significant 'distributional' consequences that raise questions about whether prudential regulators like the Reserve Bank should have sole authority to use them. For example, while bank capital requirements may affect loan pricing, LVR restrictions can effectively stop certain borrowers being able to obtain credit. The key questions raised in Consultation Document 2B focused on the *extent* of the Reserve Bank's powers to conduct macro-prudential policy and whether using the powers should require additional consultative or approval processes (relative to standard prudential powers).

Stakeholder feedback

Most submissions to Consultation Document 2B that addressed macro-prudential policy in detail were supportive, including on the use of LVRs. Many also recommended that debt-to-income ratios (DTIs) be empowered as a macro-prudential tool. A number of submitters agreed that macro-prudential policy should involve more consultation and oversight than 'standard' prudential tools. Others suggested that additional oversight or consultation (e.g. involving the Minister of Finance or the Treasury) is particularly desirable for tools such as LVRs and DTIs that have high distributional consequences.

Some stakeholders advocated applying LVRs and DTIs more aggressively than they have been to date, and others suggested making current settings permanent. One theme that motivated this was concern at the extent of private credit creation in recent decades, and the focus of that private credit on residential property lending.

In December 2019, the Minister indicated to Cabinet that under the Deposit Takers Act the Reserve Bank would be expected to be able to regulate lending standards (e.g. LVRs and DTIs) for systemic reasons. However, noting that these tools also have distributional consequences and can affect other Government objectives such as housing affordability, further consultation was proposed on whether the suggested framework would lead the Reserve Bank to have sufficient regard to wider Government priorities in the housing area when formulating controls on lending standards. This informed the recommendations below (and the discussion on the Deposit Takers Act's purposes in Chapter 2).

Proposed approach 4.2: *macro-prudential powers should be subject to the same general framework as other standard-setting powers. This framework should specifically empower lending-standard tools in relation to property lending (e.g. LVRs and DTIs), and allow for additional tools to be introduced via regulations.*

As described in Consultation Document 2B, where a central bank is the prudential regulator (as in New Zealand), it is normal for it to set macro-prudential policy. While there are arguments for involving other agencies (particularly with lending standards such as LVRs and DTIs that have significant distributional consequences for individual borrowers), this can be achieved without creating a bespoke standard-setting power for macro-prudential policy. In other words, the prudential powers being assigned to the Reserve Bank for macro-prudential purposes (such as LVRs) can simply be listed within the allowed scope of standards discussed earlier in the chapter.

The current Reserve Bank Act sets the matters that can be considered when setting CoRs, including 'risk management systems and policies'. As described earlier in this chapter, it is desirable for these empowering provisions to be more specific. For example, the list of matters could include a provision that allows the Reserve Bank to set lending standards such as 'lending conditions related to the income of a mortgage borrower, and collateral provided by the borrower'. This would enable the Reserve Bank to set LVRs or serviceability tools like DTIs. The power would most likely be used for residential mortgage restrictions, but as drafted could be used in the future for restrictions on rural and commercial property lending. Alternatively the power could be restricted to residential mortgage lending so that restrictions on farm or commercial property mortgages could only be made after the Minister of Finance had agreed to an empowering regulation (see below).

Macro-prudential policy is evolving rapidly, and it is possible that new approaches will become mainstream (either as well as, or instead of, current approaches) in coming years. The proposed mechanism to expand the scope of the standard-setting power would accommodate this. This avoids delegating too broad a power to an independent regulator, while allowing powers to be extended without the burden of amending primary legislation. A similar mechanism also seems appropriate for extending the entity types to which lending standards could apply (as discussed in section 4.3).

Consultation Document 2B noted that, internationally, it is fairly common for central banks with macro-prudential powers to participate in multi-agency consultation processes to guide their use of those powers. These multi-agency 'councils' may be used to test policy proposals by the central banks, such as by endorsing actions, or recommending complementary actions by other member agencies.

Interagency consultation appears worthwhile for the reasons noted above (gathering multiple-agency support and considering complementary actions). However, it does not seem necessary to provide for specific requirements for macro-prudential standards, above and beyond the general interagency

consultation requirement for standards discussed in section 4.4. An obvious multi-agency body to consult is the Council of Financial Regulators, although a wider set of agencies may need to be consulted for some macro-prudential tools such as those related to residential mortgages.

The more clearly defined scope of macro-prudential powers and the role of the Remit in setting out matters that the Reserve Bank should take into account in setting standards address the issues dealt with by the 2013 MoU. For the avoidance of doubt the Minister and the Reserve Bank should make clear that the MoU has been superseded and is no longer in force.

Question for consultation

4.B Do you agree with the proposed power for the Reserve Bank to set lending standards (such as LVRs and DTIs) in relation to mortgages? If not, what changes to the scope or additional safeguards would you suggest?

4.3 Flexibility of standards

The regulatory regime for deposit takers needs to be adaptable to their individual business models and the risks presented by particular deposit takers, taking into account the need to maintain financial stability while also considering the importance of competition in the sector (see Chapter 2 and 3). Consultation Documents 2A and 2B suggested a flexible approach to setting prudential requirements, allowing for the differential treatment of different deposit taker types, and providing enough supervisory discretion to allow for prudential requirements to be calibrated to the risks that individual entities present.

Standards for deposit taker classes

Proposed approach 4.3: *the Reserve Bank should have the flexibility to calibrate appropriate standards for different deposit taker types or classes.*

The Reserve Bank should have broad scope to set differing standards for the various classes of deposit taker, to reflect the risks they present and to accommodate the broad range of deposit takers' business models. A class of deposit taker could consist of a single deposit taker that has a sufficiently different business model from those of other deposit takers to justify unique regulatory requirements.

This approach will allow the Reserve Bank to take a regulatory approach consistent with the proposed decision-making principle that emphasises "the desirability of taking a proportionate approach to regulation and supervision, and ensuring that similar institutions are treated consistently". The application of this approach to small deposit takers and to bank branches has been discussed in the previous chapter.

Supervisory adjustment

As discussed in Consultation Document 2B, many prudential regulators have the discretion to calibrate specific requirements within a prudential standard, often referred to as a 'supervisory adjustment'. It allows the supervisor to respond to an identified increases in the risk profile of a particular regulated entity in order to manage this risk. It might be achieved by adjusting

requirements such as capital buffers. In the current framework, CoRs enable the Reserve Bank to exercise supervisory discretion in relation to matters such as capital requirements.

For example, as part of its supervisory oversight a prudential regulator may identify shortcomings relating to guidance it has issued that raises the regulator's assessment of an entity's risk profile. If these shortcomings are not addressed, the regulator could choose to mitigate this risk by, for example, imposing a larger institution-specific capital buffer. The use of discretion is typically supported by a more detailed set of rules and guidance that provide regulated entities with transparency on the supervisor's expectations for good practice.

Proposed approach 4.4: *enable standards to provide for the calibration of specific prudential requirements to reflect the circumstances of an individual entity (supervisory adjustment).*

The Deposit Takers Act should specifically empower the Reserve Bank to make standards that enable it to exercise administrative discretions on matters and within ranges specified in the standard. In order to mitigate the risks associated with the scope of this power, the Reserve Bank should be required to give reasons to an affected entity and to consider its response before exercising its discretion. These adjustments would be given effect via notices issued to the relevant entity.

The ability to exercise such discretion is significant and unusual in the New Zealand context, given the potentially significant business impacts of these decisions. However, internationally it is seen as an appropriate and effective part of a prudential regulator's toolkit. As such, it would enable the Reserve Bank to better align with a rule-making and supervisory approach that is consistent with the BCPs.

It is also important that this power be supported by clear guidance on the circumstances in which the Reserve Bank would seek to use supervisory adjustments, and the thresholds at which matters would instead be dealt with under formal enforcement powers (see Chapter 6). Cabinet has agreed that the Institutional Act will include a requirement for the Reserve Bank to publish information about its regulatory approach. It is expected that this will include a clear articulation of:

- the thresholds for the use of supervisory adjustments vis-à-vis formal enforcement tools
- the factors it considers in assessing risk and determining its response
- its approach to promoting transparency in the use of these adjustments (where this does not otherwise risk undermining financial stability).

Stakeholder feedback is sought on the procedural requirements and protections that should apply to the exercise of this discretion. As a general rule, it is expected that the Reserve Bank would be required to give notice (and reasons), and provide the regulated entity with the opportunity to respond, before deciding to exercise its discretion. However, there may be circumstances where this discretion needs to be exercised urgently, in which case these requirements would not necessarily apply. Given that an adjustment would be fundamentally based on the supervisor's assessment of risk, it is expected that appeals would be limited to judicial review.

Application of standards to other non-deposit-taking lenders

Proposed approach 4.5: *the Deposit Takers Act should allow the Reserve Bank to set reporting and lending standards in relation to prescribed categories of non-deposit-taking lenders.*

The Deposit Takers Act should allow the Reserve Bank's standard-setting power to be expanded via regulations, enabling it to apply both reporting standards and macro-prudential lending standards to prescribed categories of non-deposit-taking lenders. As discussed in Consultation Document 2A, this would:

- provide an additional tool to bolster the Reserve Bank's ability to monitor these lenders for financial stability risks
- provide flexibility to address the risk of lending standards being undermined by significant levels of lending shifting outside the formal regulatory perimeter.

This is similar to the approach recently taken in Australia.

Under this proposal, extending the scope of these standard-setting powers beyond licensed entities would require the Minister of Finance to prescribe relevant lender categories in regulations, on the basis that lending in the relevant sector has been identified as contributing to risks of instability in the financial system. This would ensure an appropriate check before the perimeter of these standards is extended, and support the framing of this power as a 'reserve power' that would only be used where specific risks have been identified. Once a category of lenders had been prescribed, the Reserve Bank would set any standards independently, according to the normal process.

Questions for consultation

4.C Do you agree that the Reserve Bank should be able to issue differing standards for different entity classes? If not, what approach would you suggest?

4.D Do you agree that the Reserve Bank should be able to make standards that enable it to exercise supervisory discretion on matters and within ranges specified in the standards? If not, what approach would you suggest?

4.E What procedural requirements and protections should apply to the Reserve Bank's use of supervisory adjustment?

4.F Do you support the proposed approach to allowing the Reserve Bank to set reporting standards and lending standards in relation to categories of non-deposit-taking lenders that have been prescribed via regulations? Why or why not?

4.4 Procedural requirements for standards

As noted above, the proposed standards-based approach would delegate significant policy-making decisions to the Reserve Bank, independent of ministers. It is important for the legitimacy of the regime that there are both appropriate accountability mechanisms in the Reserve Bank's institutional design (as outlined in its proposed new institutional legislation) and appropriate procedural safeguards in its decision-making process.

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.

Proposed approach 4.6: *the following procedural requirements would apply to the use of the Reserve Bank's standard setting power:*

a. A requirement to prepare a regulatory impact analysis.

The Institutional Act would continue to require the Reserve Bank to assess the expected regulatory impacts of any policies that it intends to adopt, and to publish these assessments and provide them to the Minister of Finance. This requirement would apply to both new and amended prudential standards. The Reserve Bank would also need to outline its proposed approach to monitoring and evaluating the impacts of the proposed standard.

b. A requirement to consult with relevant government departments and Crown agencies.

Depending on the scope and subject matter of a prudential standard, it may have implications for other areas of government policy. This would particularly be the case in relation to standards that have distributional consequences (such as macro-prudential standards – as discussed in section 4.2) or where there are interactions with other regulatory regimes (such as financial markets conduct legislation). In these instances the Reserve Bank should consult the government departments and Crown agencies that it assesses as relevant to the standard in question, and take their feedback into account as part of the standard-development process. This requirement would only apply to the development of new standards (or material amendments to existing standards).

c. A requirement to consult publicly on standards in most instances.

The Reserve Bank should generally be required to consult publicly on the introduction or amendment of a standard, given the significant policy decisions involved and the potentially broad impacts of those decisions. This consultation would include the proposed rationale for the standard and the Reserve Bank's initial assessment of its impacts (for example, by publishing a draft of its regulatory impact analysis). This requirement would not apply to minor amendments to standards; in these cases the Reserve Bank could limit consultation to substantially affected persons.

d. Public notification in the Gazette and on the Reserve Bank's website.

Standards would be publicly notified in the Gazette and published on the Reserve Bank's website in order to promote awareness and accessibility.

e. Parliamentary oversight, including scrutiny by the Regulations Review Committee scrutiny and potential disallowance.

As a form of secondary legislation under the Legislation Act, standards would be subject to scrutiny by the Regulations Review Committee. The Committee examines all secondary legislation after it is made and in relation to any complaints it receives, and considers whether there are grounds for drawing it to the attention of Parliament, such as where the secondary legislation trespasses unduly on personal rights and liberties, contains matter more appropriate for parliamentary enactment, or appears to make some unusual or unexpected use of the standard-setting power.[30] The Committee does not concern itself with matters of policy and limits itself to technical scrutiny of secondary legislation.

If members of the Committee give a notice of motion to disallow a standard, Parliament would have 21 sitting days to dispose the motion; otherwise the standard would be disallowed. While parliamentary disallowance is very rarely used, the process of parliamentary scrutiny provides an important check on the Reserve Bank as an independent decision-maker.

f. Appeals against the Reserve Bank's decisions on standards would be limited to judicial review.

As outlined in Consultation Document 2B, standards are not well suited to merits-based appeal rights, given their status as secondary legislation, the need for certainty, and the technical subject matter. Instead, parliamentary oversight and procedural requirements provide more appropriate safeguards.

Appeals on these decisions should therefore be limited to judicial review, which would allow applicants to challenge whether the Reserve Bank, in setting standards, acted within its powers and consistently with the legal framework. This is consistent with the current approach to CoRs and other types of secondary legislation, as well as LDAC's Legislation Guidelines.

Questions for consultation

4.G Do you agree that the proposed procedural requirements for standards are appropriate? If not, why not? Should any other requirements be considered?

[30] The full grounds for drawing attention to a regulation are set in Standing Order 319(2).

4.5 Licensing

Under the proposed regulatory perimeter, any entities offering deposit-taking or finance company services would need to obtain relevant licences from the Reserve Bank.

***Proposed approach 4.7**: the following procedural requirements would apply to licensing under the Deposit Takers Act:*

a. *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).

b. *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.

As discussed in section 4.1, 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).

c. *The Reserve Bank would be required to consult the FMA before granting or declining a licence.*

Given that the Government has announced that banks and other deposit takers will be required to be licensed under the FMC Act in relation to conduct matters, and that a number will already hold other licences granted by the FMA (for example in relation to financial advice), it is important that the Reserve Bank consult the FMA as part of its assessment of any new licence application before it grants (or declines) that application.

d. *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.

e. *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.

As discussed in section 3.1, 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.

f. *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.

Under the Deposit Takers Act, decisions on whether directors or senior managers are fit and proper persons would be subject to full appeal rights, allowing those persons to seek a

rehearing of the decision in the High Court. This is an important protection given the impacts of these decisions on the rights of natural persons.

The appropriate scope of appeal rights in relation to other licensing decisions is less clear. On one hand, licensing decisions affect the rights of an individual entity, suggesting that appeal rights should be available. Licensing decisions under the FMC Act are subject to appeal to the High Court on their merits.

On the other hand, a court may not be well equipped to revisit licensing decisions under the Deposit Takers Act, as they may involve a significant degree of complexity and judgement.[31] The ability of applicants (who may be very well resourced) to appeal licensing decisions may also make the Reserve Bank more risk averse in its licensing process and in the setting of licence conditions. Narrower appeal rights, such as appeals limited to points of law, would present fewer concerns from this perspective.

Questions for consultation

4.H Do you support the proposed licensing test for deposit takers? If not, what approach would you suggest?

4.I Are the proposed procedural requirements for licensing appropriate? If not, why not? Should any other requirements be considered?

4.J What scope of appeal rights should be provided for in relation to licensing decisions and why?

De-licensing

Deregistering a bank under the current Reserve Bank Act requires the Minister of Finance to direct the Reserve Bank to cancel the registration, on the Reserve Bank's recommendation. Under the Deposit Takers Act, Cabinet has made an in-principle decision to remove the Minister of Finance's role in the de-licensing process. This supports an increase in the Reserve Bank's operational independence and aligns with more modern legislation such as IPSA, as well as with international standards. Given this decision, the criteria for de-licensing need to be considered.

Proposed approach 4.8: *the criteria for de-licensing a deposit taker broadly cover similar criteria to those found in section 30 of IPSA and parts of section 21 (d-f and h) of the NBDT Act, with additional specific thresholds of a more disciplinary nature.*

The criteria for de-licensing insurers under section 30 of IPSA are largely tied to the insurers no longer effectively carrying on insurance business in New Zealand.

The relevant criteria under section 21 of the NBDT Act are:

- that the requirements for independent directors are not being met
- that the licence holder is no longer an NBDT

[31] Licensing and other administrative decisions by both the Prudential Regulation Authority in the UK and APRA in Australia are subject to appeal to specialist tribunals.

- that the licence holder has been wound up, dissolved or otherwise ceased to exist
- that the licence holder has requested cancellation and that the Reserve Bank is satisfied that it no longer requires a licence.

It is envisaged that additional thresholds for de-licensing of a more disciplinary nature will be included in the Deposit Takers Act. These would include:

- the deposit taker having been licensed on the basis of false information provided by the deposit taker and not having begun taking deposits
- a change in the controlling interest of the deposit taker that has left it materially weaker
- a change in the controlling interest of the deposit taker that means it is no longer undertaking any deposit taking business (in order to prevent the on-selling of the licence at a future date)
- material breaches of a prudential standard or licence condition, where all other regulatory measures have been exhausted and there is no reasonable prospect of compliance.

Tied to de-licensing powers, the Act should also include:

- a direct power to stop an entity taking deposits, lending, or growing its business
- the ability to place a deposit taker, including branches, into resolution (in this regard, see limb (c) of the 'non-viability' test for resolution in Chapter 7).

Another consideration will be interactions with other licensing regimes, such as the new 'fair conduct' licensing regime for deposit takers (and insurers) that will be administered by the FMA following amendments to the FMC Act. This will create a dual-licensing regime for deposit takers, i.e. they will be licensed under both prudential and conduct regulatory regimes. It is expected that the Reserve Bank and the FMA would coordinate on both licensing and de-licensing decisions.

Question for consultation

4.K Do you agree with the proposed approach to de-licensing? If not, what changes would you suggest?

4.6 Transparency requirements

One of the criticisms of the current CoR-based approach is that it can be difficult to determine the requirements applying to a particular bank. An interested party needs to review the bank's six-monthly disclosure document, which cross-references parts of the Banking Supervision Handbook. It is not obvious in this disclosure whether any special conditions have been imposed and there is no central register of other administrative decisions that may be relevant to the entity (such as notices of non-objection).

Proposed approach 4.9: *a new Reserve Bank register of licensed deposit takers should set out the standards applying to each deposit taker, along with certain administrative instruments and decisions such as licence conditions and exemption notices.*

This approach would build on other elements of the Deposit Takers Act and Institutional Act that promote transparency and would align with Every-Palmer QC's recommendation that the Reserve Bank be required to maintain a central register of the particular conditions that have been imposed on particular banks. Given the relatively small number of licensed entities, the register would not necessarily need to be sophisticated, although it should link to broader information on entities' entries in the Financial Service Providers Register.

Under a standards-based approach, the register could also be the mechanism by which standards are applied to a particular entity. This would make the register entry the definitive record of the regulatory requirements that an entity must comply with. While standards could alternatively be applied via licence conditions, this approach has proved administratively complex under IPSA.

Question for consultation

4.L Do you agree with the proposed use of the register to record and apply standards and other requirements on deposit takers? If not, what approach would you suggest?

Summary

This chapter has outlined the proposed scope of the Reserve Bank's power to set prudential standards under the Deposit Takers Act, including in relation to macro-prudential requirements such as LVRs. It also seeks feedback on the procedural requirements that should apply when the Reserve Bank sets standards. The proposed approach seeks to balance providing the Reserve Bank with the scope, flexibility and independence to respond to financial stability risks, and providing clarity on the scope of its powers and assurance in relation to the decision-making process.

The chapter also seeks feedback on the approach to licensing under the Deposit Takers Act, including the grounds for granting and revoking licences and the procedural requirements that should apply as part of the licensing process.

Chapter 5: Liability and accountability

Introduction and progress to date

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.

The current Reserve Bank Act has a somewhat disproportionate emphasis on criminal penalties. The new Deposit Takers Act will need to strike an appropriate balance in using these penalties as sanctions for deposit takers as corporate entities, and for individuals.

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 tied to promoting financial stability. This individual accountability reinforces any sanctions that can be applied to the entity itself.

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.

Consultation Document 2B considered a number of options to improve the current approach to liability and accountability.

Following that consultation Cabinet made an in-principle decision to increase the accountability of deposit takers' directors by imposing various positive duties upon them, with civil pecuniary (monetary) penalties as the primary redress (see the December 2019 Review Update). This 'strengthened director accountability' regime will improve the status quo by sharpening the incentives for directors to manage risk.

Cabinet has also 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 will 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. A separate cross-agency process will be established, and the terms of reference and timeframe for the work will be published in due course. That said, this work will build on the Review's efforts at strengthening the accountability regime for directors of deposit takers.

Chapter 5 Overview

- ✓ Director accountability for deposit takers should be enhanced
- ✓ Accountability requirements should be extended to senior executives of deposit takers and insurers*
- ▪ What types of penalty should apply to breaches of requirements?
- ▪ What should the enhanced duties for directors look like?

** This will be progressed outside the Phase 2 Review*

✓ Key decisions taken by Cabinet

▪ Key remaining issues to be covered in the current consultation

The remainder of this chapter outlines some of the high-level issues for consideration in specifying the liability and accountability regime for both individuals and deposit takers. They include:

- the appropriate balance between civil and criminal penalties
- the role of 'deemed liability' for directors
- a tiered structure for penalties.

The chapter's main focus, however, is on proposals designed to improve the accountability framework for directors in the new Deposit Takers Act.

5.1 Civil and criminal liability

The current Reserve Bank Act has a heavy emphasis on (criminal) offences, including circumstances where breaches of regulatory requirements may not involve any reckless intent or deceptive-type behaviour on the part of the registered banks or their directors.

As outlined in Consultation Document 2B, the emphasis on criminal liability for rule breaches in the Reserve Bank Act is arguably disproportionate to the nature of the underlying conduct the Act seeks to address. In most cases criminal enforcement action is not the most suitable regulatory response.

In addition, the Reserve Bank has not taken any formal enforcement action against a registered bank or its directors to date, suggesting that criminal liability is a very high threshold for action. All stakeholders who provided feedback on this issue supported a shift to a more proportional liability framework, which limits criminal liability to deliberate or reckless conduct.

***Proposed approach 5.1**: criminal liability for breaches of the Act should generally be limited to undertaking deposit-taking activity without a licence, purporting to be a deposit taker or otherwise using restricted words, non-compliance with the Reserve Bank's supervision and resolution powers (such as a failure to comply with directions), and knowing or reckless breaches of other provisions.*

LDAC's Legislation Guidelines note that criminal offences are used to punish, deter and publicly denounce conduct that society considers to be particularly blameworthy and harmful. However, offences are just one mechanism available for achieving compliance with legislation and should not be seen as the default response to breaches.

As a general rule, the Review is proposing that the Deposit Takers Act place less reliance on criminal sanctions than the current Reserve Bank Act, and that criminal offences have a *mens rea* element (i.e. intent or knowledge of wrongdoing) or relate to obstruction of the Reserve Bank's supervision and resolution powers, or affect the overall integrity of the regulatory regime. This approach is also reflected in the proposed approach to penalties outlined in section 5.4.

***Proposed approach 5.2**: breaches of standards should generally give rise to civil liability, including a monetary penalty, with criminal liability generally limited to knowing or reckless breaches.*

LDAC's Legislation Guidelines note that civil pecuniary (i.e. monetary) penalties are an appropriate alternative to criminal offences when a monetary penalty would deter breaches of a regulatory regime and "the nature of the offending conduct does not warrant the denunciatory and stigmatising effects of a criminal conviction or imprisonment".

Civil monetary penalties should be the primary penalty for breaches of standards – the secondary legislative instruments that will replace CoRs in the new Act – on the basis that:

- the purpose of a penalty is primarily to incentivise compliance rather than punish wrongdoing
- a breach may relate to technical compliance rather than significant harm to individuals, property or the financial system
- the complex nature of evidence may make it difficult to prove a breach to the criminal standard of proof
- monetary penalties form part of a graduated range of penalties and offences.

The retention of criminal liability for knowing or reckless breaches reflects the significance of some of the matters that will be dealt with via standards, and the potentially serious consequences of a breach to the broader financial system. It also reflects the importance of maintaining public confidence in the regulation of deposit takers, as part of promoting a stable financial system.

The proposed approach to maximum criminal and civil penalties is discussed in section 5.4.

Question for consultation

5.A Do you agree with the general categorisation of the contraventions that should give rise to criminal and civil liability in the Deposit Takers Act?

5.2 Director accountability

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 Act. Directors are criminally liable for any false and misleading attestations in banks' disclosure statements. 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 issues with this attestation regime as outlined in Chapter 1 of Consultation Document 2B:

- The Reserve Bank has no guidance for banks on what constitutes 'adequate risk management'.
- There is limited verification by the Reserve Bank that attestations are correct.
- Criminal liability can be disproportionate to the 'crimes'.

Consultation Document 2B asked stakeholders to consider three options that could potentially improve the individual accountability and liability framework for registered banks (and by extension the new deposit-takers regime given Cabinet's in-principle decision). The three options were: an enhanced status quo; a reframed attestation regime, and; a senior managers regime that extends the accountability framework beyond directors to include other office holders in deposit-taking institutions.

Stakeholder feedback

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.

Cabinet in-principle decision

As outlined in the introduction to this chapter, 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) outlined in Chapter 1 of Consultation Document 2B.

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
- 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).

Proposed approach

Proposed approach 5.3: *introduce a new strengthened director accountability regime for deposit takers, incorporating the key features of the reframed attestation regime from the June 2019 consultation.*

Table 5.1 summarises the key elements of this new model.

Table 5.1: Features of a strengthened director accountability regime

	Status quo	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 (see BS10)	▪ Framework for fit and proper requirements outlined in primary legislation, detail provided for in a prudential standard (see Chapter 4)
Obligations	▪ Generic obligations on directors under the Companies Act 1993 ▪ Specific attestation requirements tied to signing of disclosure statements	▪ Positive duties imposed on directors (in addition to existing duties) – see Table 5.2 ▪ These duties supported by clarification/guidance from the Reserve Bank
Sanctions	▪ Criminal sanctions on directors for contraventions of attestation 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)	▪ 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

Director obligations

The Review proposes a set of positive duties or obligations for directors that are owed to the Reserve Bank (acting on behalf of society at large). These obligations will be modelled on some of the obligations developed by accountability regimes internationally for both directors and senior executives (see Table 5.2). Because the strengthened director accountability regime only covers directors, the obligations will be more general than the role-specific duties some regimes impose on senior executives (e.g. chief executive officer, chief operating officer etc.).

Under the proposal, a director will be required to:

- 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
- deal with the Reserve Bank in an open and honest manner.

The general specification of these obligations ensures that directors are not unduly constrained in the performance of their strategic and oversight roles on behalf of their institutions and their shareholders/owners. However, it also makes it difficult to determine whether directors are meeting their obligations. The Reserve Bank may wish to issue guidance on what is expected of directors, including what 'taking reasonable steps' means and the Reserve Bank's expectations of 'prudent risk management'.

To verify that directors are meeting these obligations, the Reserve Bank could formally require deposit takers to report privately the minutes of board meetings and associated committees, and other relevant information on a regular basis.

The changes proposed here remove the tight link between director obligations and market disclosure (directors attesting in six-monthly disclosure statements), shifting the focus instead to how a director actually discharges their duties. In this sense director obligations can be thought of as continuous obligations rather than point-in-time duties that apply when directors sign disclosure statement.

Note, this does not dilute the important role of 'market discipline' in helping to support the statutory objective of financial stability. Disclosure requirements will remain (although these will shift from Orders in Council to standards as the secondary legislative mechanism – see Chapter 4). Moreover, it is envisaged that directors will still be expected to sign disclosure statements, and that penalties will be imposed on directors for false and misleading disclosures (see the discussion of 'deemed liability' in section 5.3).

This positive accountability framework would provide a direct legislative mechanism for holding directors to account for any breaches or contraventions incurred by entities, e.g. non-compliance with regulatory standards such as capital requirements. Directors would be able to defend themselves on the grounds that they took all reasonable steps to ensure the entities were being run in a prudent manner.

This suggests a more limited role for 'deemed liability' – where if an entity has contravened a relevant provision or regulatory requirement, the directors are treated as having also contravened that provision or requirement (see section 5.3).

Table 5.2: Individual duties and obligations – international comparison

	Common obligations*
New Zealand's deposit takers director accountability regime *(Proposed director duties)*	▪ Act with honesty and integrity, and with due skill, care and diligence ▪ Deal with the Reserve Bank in an open and honest manner ▪ Take reasonable steps to ensure that the deposit taker is being run in a prudent manner
Australia's Banking Executive Accountability Regime (BEAR)** *(Accountable persons' obligations)*	▪ Act with honesty and integrity, and with due skill, care and diligence ▪ Deal with APRA in an open, constructive and cooperative way ▪ Take reasonable steps in conducting those responsibilities to prevent matters from arising that would adversely affect the prudential standing or prudential reputation of the authorised deposit-taking institution
UK's Senior Managers and Certification Regime (SMCR) *(Individual conduct and senior manager conduct rules)*	▪ You must act with integrity ▪ You must act with due skill, care and diligence ▪ You must be open and cooperative with the Financial Conduct Authority, the Prudential Regulation Authority and other regulators ▪ You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively ▪ You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system
Ireland's Senior Executive Accountability Regime (SEAR)*** *(Common conduct standards and senior management standards)*	▪ Act honestly, ethically and with integrity ▪ Act with due skill, care and diligence ▪ Be open and cooperative with the Central Bank and other regulators and deal with them in good faith ▪ You must take all reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively ▪ You must take all reasonable steps to ensure that the business of the firm for which you are responsible complies with relevant regulatory requirements

* Note the table only shows related duties/obligations in the four regimes. Additional duties/obligations apply in the UK and Ireland.
** The Australian Treasury is currently consulting on a financial accountability regime (FAR) that will extend BEAR to all APRA-regulated entities and provide joint administration to the Australian Securities and Investments Commission as the financial market conduct regulator. There is one new obligation for accountable persons being proposed under FAR: "taking reasonable steps to ensure that the entity complies with its licensing obligations".
***This is progressing through the legislative process following the introduction of an amendment Bill in mid-2019.

Interaction with Companies Act duties

One issue that requires attention is the relationship between the new obligations being proposed here and the duties that directors owe to their institutions and their owners under the Companies Act 1993.[32]

The Companies Act aims to "encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power". It does so in part by imposing a set of duties on directors (see sections 131-138A). A director must:

- act in good faith and in what the director believes is the best interests of the company
- exercise their powers for a proper purpose
- not act or allow the company to act in breach of the Act or its constitution
- not agree to allow, or cause the company to trade recklessly
- not agree to the company incurring obligations that it cannot perform
- exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances.

These duties are obligations of loyalty and fidelity owed primarily to a company and its shareholders, rather than to the public at large. In contrast, the new positive director duties envisaged under the proposed strengthened director accountability regime are obligations owed to society as interpreted by the Reserve Bank in its role as a prudential regulator with a statutory objective to protect and promote financial stability.

It is possible that the interface between the two regimes will create uncertainty and a lack of clarity, and a court will have to reach an interpretation in the case of legal challenge. However, in most cases the performance of the fiduciary obligations will align with the performance of those duties imposed by the Reserve Bank. For example, taking "reasonable steps to ensure the deposit taker is run in a prudent manner" should not generally conflict with acting in the "best interests of the company", except perhaps if directors prioritise the short-term interests of their institutions relative to longer-term outcomes.

Moreover, directors currently navigate both their duties owed to the institution and shareholders, and the broad set of prudential and other regulatory rules imposed on them. Regulatory requirements in general reflect the fact that the commercial incentives for, and the pursuit of private benefits by, a deposit taker and its office holders do not always align with the outcomes society would like to achieve from the financial system. The proposed additional positive duties for directors would help to address this misalignment.

[32] This issue was also raised by some stakeholders in the Australian context, given the director duties specified in the Australian Corporations Act and the accountable persons obligations under the BEAR framework.

Director indemnities and insurance

An important consideration for the individual liability framework will be whether there should be restrictions placed on a deposit taker's ability to indemnify or insure directors against personal financial loss that might arise from criminal or civil prosecution. This would include financial loss from the application of any pecuniary (monetary) penalties for non-performance of the new director duties outlined above. As noted earlier, in most cases these penalties will be civil in nature, with criminal conviction reserved for very serious cases of recklessness or intent.

At a conceptual level, indemnification and insurance may act to reduce the incentives placed on directors to fulfil their fiduciary roles to shareholders and company owners, and reduce their incentives to perform adequately any additional obligations or duties imposed by the regulator.

On the other hand, indemnity and insurance recognises that performing director duties carries personal financial risks for directors, and that in certain circumstances they should be adequately protected. Blanket restrictions may act to reduce the pool of potential candidates for director positions on the boards of firms including deposit takers. The ability to insure a director against a pecuniary penalty could also mean the penalty is paid without significant delay as opposed to a situation where the director fails to pay the penalty (or has 'hidden assets' complicating payment).

An insurance market for penalties may also act as another layer of external monitoring, as an insurance company may be disinclined to grant an insurance policy unless the director or the board is able to show that they have mechanisms in place to meet their obligations under company law or requirements imposed by the regulator. However, this likely overstates the ability of the insurance sector to provide an additional layer of scrutiny to directors.

Section 162 of the Companies Act permits a company to only:

- indemnify or insure a person for the cost of *successfully* defending a criminal proceeding
- indemnify or insure a person for civil liability and the cost of defending a civil proceeding (either successfully or not), except in the case of a breach of a director's duty to act in good faith and the best interests of the company (section 131).

The FMC Act follows this approach with respect to persons who are not New Zealand-incorporated companies but are licensed under the FMC Act, or who issue or offer financial products to retail investors (see sections 526-528). Similar restrictions are being proposed for persons who are not New Zealand-incorporated companies but act as operators of designated FMIs (see sections 155 and 156 of the FMI Bill).

Proposed approach 5.4: *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. Deposit takers will be able to indemnify and insure directors for the costs of successful defences in criminal proceedings generally, and successful criminal and civil defences of proceedings tied to the new positive duties. Successful and unsuccessful defences of civil proceedings not tied to the new duties will be able to be indemnified and insured.*

The proposed approach replicates the general approach in company law and other regulatory contexts. However, it makes it clear that pecuniary penalties applied to breaches of the new director duties cannot be indemnified or insured. Taken together, the three new director duties imposed for a prudential purpose mirror section 131 of the Companies Act – i.e. acting in good faith and in the

best interests of the company – so should be carved out from the deposit taker's ability to indemnify or insure against.

In the Australian context, section 37KF of the Banking Act 1959 prohibits an authorised deposit taking institution from indemnifying or insuring an accountable person under BEAR.

Table 5.3 summarises the proposed approach.

Table 5.3: Director indemnities and insurance

Action in respect of deposit taker directors	Can the deposit taker provide indemnity/insurance?
▪ Personal financial losses arising from breaching (or unsuccessfully defending proceedings tied to) the new positive duties.	✗
▪ Unsuccessful defences of criminal proceedings generally	✗
▪ Successful defences in criminal proceedings generally	✓
▪ Successful defences of criminal and civil proceedings tied to the new positive duties	✓
▪ Successful and unsuccessful defences of civil proceedings *not* tied to the new positive duties	✓

Fit and proper requirements

Fit and proper, or suitability, requirements help ensure that certain office holders in an institution, including directors, have the requisite skills, experience and integrity to perform their roles.

At present fit and proper requirements are imposed by way of a CoR, with the requirements set out in the Banking Supervision Handbook (BS10).

The Review proposes that the framework for fit and proper requirements and procedural protections be specified in primary legislation along the lines of that for insurers under IPSA (section 34), with the detail of the requirements specified in a prudential standard (see Chapter 4).

Executive accountability

As noted in the introduction to this chapter, Cabinet has made an in-principle decision that officials will work on developing an integrated prudential-conduct executive accountability regime for deposit takers and insurers. Given the potential scope of this regime, and the agencies responsible for financial market conduct regulation and supervision (the Ministry of Business, Innovation and Employment [MBIE] and the FMA), this work will take place outside the current Phase 2 Review.

Formalising an accountability framework that includes both directors and senior executives recognises that there are inherent limitations in the role played by directors in providing strategic direction and oversight of their organisations, while holding management to account. There is a 'principal-agent problem' in the relationships between management and directors, with the latter

acting as monitoring agents on behalf of shareholders/owners and management often acting according to short-term interests (tied to the way remuneration is structured, for example).

Therefore, vesting formal accountability for firm-specific outcomes on those office holders who are directly responsible for particular activities and decision-making can help to better align the incentives between management and directors, and better align the incentives of the firm with society's preferences (as proxied by the statutory objectives for both the prudential and conduct regulators).

The GFC highlighted the serious consequences of incentive misalignment. The UK's 2013 Parliamentary Commission on Banking Standards took the view that directors and senior executives "operated in an environment with insufficient personal responsibility. Top bankers dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making. They then faced little realistic prospect of financial penalties or more serious sanctions commensurate with the severity of the failures with which they were associated. Individual incentives have not been consistent with high collective standards, often the opposite" (see Changing banking for good – Parliamentary Commission on Banking Standards).

The insights from the GFC have led to the subsequent development of executive accountability regimes in the UK, Australia and a number of other jurisdictions.

The work on developing an executive accountability regime in the New Zealand context will complement (and significantly build on) the Review's particular focus on improving the accountability framework for directors of deposit takers. For example, the foundations of any new executive accountability regime will also rest on positive duties or obligations, albeit these will need to be developed to cover both directors and senior executives of deposit takers and insurers. That said, it is likely that the new positive duties for directors outlined above will provide the building blocks or starting points for a set of duties underpinning any new executive accountability regime.

Given the relationship between a strengthened regime for directors of deposit takers and the development of a wider executive accountability regime, the Phase 2 Review will work closely with the cross-agency group that will be tasked with progressing the policy development associated with the latter.

It is also expected that work on developing an executive accountability regime in New Zealand will be mindful of developments in Australia. The Australian Treasury is currently working on implementing recommendations from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, which will create an integrated prudential-conduct executive accountability regime covering deposit takers, insurers, superannuation funds, and potentially other financial service providers. This financial accountability regime builds on BEAR, which was introduced in 2018.

Question for consultation

5.B Do you agree with the specification of the new positive duties for directors of deposit takers? If not, why not?

5.C Do you agree that directors should not be indemnified or insured against loss in the performance of their duties?

5.D Do you see any specific issues with the relationship between the existing director duties in the Companies Act, and the new duties being proposed here?

5.3 Deemed director liability

As discussed in section 5.2, most individual director obligations proposed under the Deposit Takers Act will be met through positive duties, thereby encouraging directors to continually scrutinise their organisation's compliance. This suggests a more limited role for 'deemed liability', where an individual such as a director is deemed liable for their organisation's specific breaches of legislative and other requirements.

The importance of disclosure

Proposed approach 5.5: *directors should have deemed civil liability for false or misleading disclosure, with criminal penalties for knowing or reckless breaches, subject to appropriate defences.*

Internationally, disclosure is a key component in the prudential regulation of deposit takers. BCP 28 (Disclosure and transparency) states that a supervisor should require banks to regularly publish information that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies, and corporate governance policies and processes.

New Zealand has traditionally placed a greater weight on the importance of disclosure than some other jurisdictions, given the reliance on self- and market discipline in promoting the soundness of registered banks. Disclosure requirements seek to:

- strengthen the banks' incentives to maintain sound banking practices
- help depositors and other investors to make well informed decisions on where to put their money.

At present, a bank director (or chief executive officer in the case of a bank branch) is required to attest in a six-monthly disclosure statement that:

- the disclosure statement contains all the required information, and is not false or misleading
- all the bank's CoRs were complied with during the accounting period of the disclosure statement
- credit exposures to 'connected persons' were not contrary to the interests of the bank in that period

- the bank had systems in place to monitor and control adequately the material risks of the banking group.

Banks and their directors commit a criminal offence if a disclosure statement (and therefore attestation) is false or misleading, although directors have a defence if they had reasonable grounds to believe the information was true.

Given the introduction of an individual liability framework in the form of positive duties for directors (see section 5.2), the Reserve Bank will need to assess whether there is any merit in retaining formal 'attestation requirements' in disclosure statements tied specifically to compliance matters, credit exposures and bank systems.

However, deemed liability may need to be retained in relation to *false or misleading* disclosure statements. This would emphasise the ongoing importance of accurate disclosures in promoting self- and market discipline, and align with the FMC Act's approach to deemed liability for disclosure breaches. Unlike the broader positive duties for directors, disclosure duties exist at a specific point in time and are therefore better suited to a deemed liability approach.

This deemed liability approach also addresses a problem with the current attestation process, whereby a director could avoid a sanction for breaches of regulatory requirements they were aware of but did not address by choosing to not sign a disclosure statement.

If the Deposit Takers Act were to follow the FMC Act's general liability framework for disclosure, directors would have defences, including that they made all reasonable enquiries and after doing so believed on reasonable grounds that a statement was not false or misleading. Under this approach, deemed criminal liability would be limited to knowing or reckless breaches.

Question for consultation

5.E Do you agree that deemed liability should be retained for false and misleading disclosure? If not, what approach would you suggest?

5.4 Penalties

Penalties for offences under the current Reserve Bank Act range from $25,000 to $2 million in relation to a body corporate, with maximum fines for individuals ranging from $10,000 to $200,000 alongside imprisonment terms of up to 18 months. While breaches of the prudential requirements for banks generally incur the highest penalties, there is not always a clear correlation between the relative seriousness of an offence and the associated penalty level.

A more consistent approach to penalties, reflecting the risks involved in the contravention and providing effective deterrence, is needed to support the more graduated framework of civil and criminal liability discussed in section 5.1.

Purpose and impacts of penalties

Penalties play an important part in deterring non-compliance in relation to corporate misconduct, although they may have other goals such as punishment or compensation for loss. While civil and criminal penalties form only part of the enforcement framework under graduated approaches to enforcement, these approaches rely on regulators possessing a credible threat in the background.[33]

In the context of prudential regulation, the size of a penalty needs to take into account the very significant social costs associated with a loss of financial stability. In theory, if penalties are sufficient to reflect the size of these costs and the risks to financial stability presented by a breach, they should result in parties internalising the social costs of a breach, incentivising potentially liable parties to invest in precautions against a breach of law at socially optimal levels.[34] Deterrence theory also suggests that where there is the prospect of an entity making a gain (or avoiding a loss) from a breach, deterrence will only be achieved if the expected penalty exceeds the expected gain or avoided loss, taking into account the likelihood of detection.[35]

The desirability of incentivising precautionary behaviour on the part of regulated entities and providing adequate deterrence needs to be balanced against the risk that if penalties are set too high they drive a disproportionate response, incentivising firms to completely eliminate risks that naturally arise in the conduct of their business rather than prudently managing those risks. An overly risk-averse response to penalties may also reduce the appetite for innovation in the sector, while overly high penalties for individuals may discourage otherwise suitable people from taking on these roles.

In reality, it is difficult to assess the impacts that penalty levels have on the behaviour of regulated entities. While studies of the impacts of enforcement actions against banks show evidence of deterrence, with improvements in the stability of other banks in the sector, these studies do not generally seek to compare the levels of the penalties involved.[36] The impacts of penalties on deterrence should also take into account the range of other consequences that may be associated with breaches of prudential requirements, such as supervisory adjustments of capital requirements (see Chapter 4,) licensing consequences for the entities, and remuneration and employment consequences for any individuals involved.

Very significant maximum penalties are often provided for in relation to breaches of prudential regulation in other jurisdictions. Table 5.4 provides a comparison of a number of international penalty systems with penalties in other New Zealand corporate legislation.

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[33] For example, see Robert Baldwin and Julia Black's 2007 paper Really Responsive Regulation.

[34] This basis for prudential penalties is discussed in the comparative research on fines for banking misconduct produced for the European Parliament's Economic and Monetary Affairs Committee.

[35] Reputational penalties associated with an offence can also influence the overall damage to an entity from a breach. However, while research suggests that reputational penalties where investors or customers are directly harmed by a breach can be very significant (on average nine times the regulatory penalty), it suggests that reputational penalties are very limited where other third parties or the public interest at large are harmed, as is often the case for prudential breaches. See Armour *et al* (2017) 'Regulatory sanctions and reputational damage in financial markets', *Journal of Financial and Quantitative Analysis*, Vol. 52, No. 4, August.

[36] For example, Caiazza, S *et al* (2014) Bank stability and enforcement actions in banking.

Table 5.4: Comparison of maximum penalties

	Reserve Bank Act (Part 5)	Commerce Act	FMC Act	Banking Act (Australia)	EU Single Supervisory Mechanism
Maximum criminal penalty *(corporate)*	$2m	$1m	$5m	$210,000	N/A
Maximum criminal penalty *(individual)*	$200,000 and/or 18 months imprisonment	$200,000, no imprisonment	$1m and/or 10 years' imprisonment	$42,000 and/or five years imprisonment	N/A
Maximum civil penalty *(corporate)*	N/A	$10m, or three times any benefit, or 10% of annual turnover	$5m or three times any benefit	*Current:* Large bank: $210m Medium: $52.5m Small: $10.5m *Proposed:* $10.5m, or three times any benefit, or 10% of annual turnover	Two times benefit, or up to 10% of annual turnover
Maximum civil penalty *(individual)*	N/A	$500,000	$1m or three times any benefit	Proposed: $1.05 million or three times any benefit	N/A

Civil pecuniary penalties

As discussed in section 5.1, the proposed approach in the Deposit Takers Act is to provide for civil pecuniary penalties in relation to most breaches of prudential standards. Civil penalties have lower burdens of proof than, and operate under different procedures from, criminal trials, but do not result in criminal convictions.

Body corporate civil pecuniary penalties

Proposed approach 5.6*: adopt maximum civil pecuniary penalties 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.*

The significant risks to financial stability presented by the most serious breaches of prudential standards, and the very substantial costs to the economy and broader society of a financial crisis, suggests that maximum penalties should be significant if they are to incentivise a socially efficient level of precaution on behalf of a deposit taker. The potential for significant gains in relation to some

contraventions also supports the need for significant maximum penalties to provide a sufficient deterrent.

It is difficult to quantify the risks and costs that would be associated with a breach of prudential standards in the abstract. However, given that the maximum penalty should reflect the worst possible case, it seems reasonable to suggest that a breach by a large deposit taker could meaningfully increase the risk of a financial crisis. While there are high degrees of uncertainty around the likely cost of a financial crisis, the Reserve Bank estimates that the cumulative present value of output lost due to a crisis equates to 63 percent of GDP.[37] Similarly, non-compliance with prudential requirements such as capital ratios could result in substantial gains for large deposit takers (even if the non-compliance was unintentional).

In terms of the specified dollar penalty, a relatively significant amount in the order of those imposed under the Commerce Act 1986 and the FMC Act would seem to be appropriate. This would both signal the overall seriousness of a contravention and reflect the fact that a serious breach by a small deposit taker may have outsized impacts on financial stability if it undermines confidence in the overall financial system.

A relatively common feature of the penalty regimes outlined in Table 5.3 is maximum penalties that either relate to a multiple of the gain made (or loss avoided) or relate to the size of the entity involved in the contravention. These maximum penalty types ensure that the penalties can exceed the benefits of contraventions and reflect the substantial risks to financial stability presented by large deposit takers, while maintaining proportionality in relation to smaller deposit takers. The Law Commission, in its guidance on the design of pecuniary penalties, acknowledges the usefulness of these penalty types in delivering deterrence, while expressing reservations that maximum penalties based on the size entities may exceed the amounts that would be imposed for the worst classes of contraventions.

Stakeholder feedback is sought on whether these maximum penalty types would be appropriate in the Deposit Takers Act and, if so, what specific metrics or amounts should be considered.

The large maximum penalties would only be suitable for the most serious breaches of prudential requirements. While the Deposit Takers Act could provide guidance to a court on how to determine the amount of penalties in specific cases (such as taking into account the nature and extent of the breach and the risks that it presented to financial stability), it may be disproportionate to open up deposit takers to potential liabilities of this scale in relation to more minor contraventions. It may therefore be appropriate to establish a lower tier of civil penalties for contraventions of standards that do not adversely affect deposit takers' prudential standing.

[37] The central estimate in the Reserve Bank's Regulatory Impact Assessment and Cost Benefit Analysis for the Capital Review.

Individual civil pecuniary penalties

***Proposed approach 5.7**: provide for lower maximum civil pecuniary penalties for individuals, up to a specified dollar amount.*

As discussed in sections 5.2 and 5.3, breaches of proposed director accountability duties and deemed liability for false or misleading disclosures would generally be subject to civil pecuniary penalties. Civil penalties for individuals tend to be significantly lower than those applying to bodies corporate (on the basis that lower amounts are needed to achieve deterrence) but differ significantly across legislation. While some legislation, such as the FMC Act, also provides for penalties for individuals based on a multiple of gain, the scope for individual gain would appear to be lower in relation to breaches of prudential requirements than it would for conduct requirements.

Stakeholder feedback is sought on the level at which maximum civil penalties for individuals should be set to provide sufficient deterrence without deterring otherwise appropriately qualified individuals from taking on director roles.

Criminal penalties

As discussed in section 5.1, criminal offences will be retained for other breaches of the Deposit Takers Act where the breaches have been knowing and reckless (or in some instances where there are no reasonable excuses for the breaches).

***Proposed approach 5.8:** provide for moderate monetary penalties for criminal offences relating to the obstruction of more routine supervisory powers.*

The Deposit Takers Act will provide for a number of offences for obstructing the Reserve Bank's routine supervisory powers, such as information-gathering and on-site inspection powers. While this conduct is generally considered sufficiently 'morally blameworthy' to be a criminal offence, it does not present immediate risks to financial stability or allow for financial gain on behalf of the offenders. This suggests that the maximum penalty should be lower than it is for more serious offences (without an imprisonment term for an individual), although sufficient to influence the behaviour of a large financial institution. The FMA Act provides for a maximum penalty of $300,000 for a body corporate and $30,000 for an individual for these sorts of breaches. The FMI Bill provides for $500,000 for a body corporate and $50,000 for an individual.

***Proposed approach 5.9:** provide for more significant monetary penalties and for potential imprisonment for criminal offences relating to more serious breaches of the Deposit Takers Act.*

It is proposed that more serious criminal offences, such as operating a deposit-taking business without a licence, failing to comply with a direction or knowing or reckless breaches of prudential standards, be subject to more significant maximum penalties, including a term of imprisonment for individuals who are party to the offences.[38] An increase in the maximum imprisonment term from 18 months to two years would reflect the fact that criminal penalties would be limited to more serious

[38] While breaches of prudential standards would typically be undertaken by a body corporate, the Crimes Act 1961 provides that any persons who are party to an offence (e.g. by aiding or abetting the offence) are also guilty of that offence. Individuals may therefore be prosecuted for criminal offences committed by the body corporate.

breaches of the Deposit Takers Act and would result in the offences being categorised as more serious offences under the Criminal Procedure Act 2011.[39]

The maximum monetary penalty for these offences should also be significant, reflecting the fact that these breaches may present a risk to financial stability and involve a higher degree of culpability than civil contraventions of standards. This suggests that the maximum monetary penalties for the most serious criminal offences should be comparable to the highest civil penalties, noting that the use of penalties based on the extent of benefits or the size of an entity would be unusual in the criminal context.[40]

Questions for consultation

5.F Do you agree with the proposed approach to maximum civil penalties on bodies corporate, including the use of maximum penalties based on the size of the institution or any benefit gained (or loss avoided)? If so, what specific metrics or amounts should be considered for these penalties?

5.G Should a lower tier of civil penalties be established for some contraventions, for example, those that do not adversely affect the deposit taker's prudential standing?

5.H What maximum level of individual civil penalty should be provided for and why?

5.I Should criminal offences relating to the obstruction of routine supervisory powers be subject to monetary penalties, but not imprisonment terms for an individual? If so, what level of maximum penalty would be appropriate and why?

5.J What monetary and imprisonment penalties should be considered for more serious criminal offences and why?

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[39] Offences with a maximum penalty of two years imprisonment or more are category 3 offences under the Criminal Procedure Act 2011, which has an impact on trial procedures.

[40] There is not a consistent approach across legislation to the relative amounts of civil vs criminal monetary penalties. In some legislation (such as the Commerce Act) civil penalties are greater than the equivalent criminal penalties, on the basis that a criminal conviction and the potential for imprisonment provide a significant additional deterrence. In other legislation criminal monetary penalties are higher, on the basis that the offending in the case of a criminal conviction has been more serious and that a higher burden of proof has been met. When the Law Commission examined this issue it did not come to a conclusive finding on which approach was more appropriate.

Summary

This chapter has outlined a proposed approach to improving the liability and accountability framework for directors of deposit-taking institutions that will be within the new regulatory perimeter. The framework rests on new positive duties, including an obligation to take reasonable steps to ensure an entity is run in a prudent manner.

The chapter has also considered the more general question about the nature of the liability that pertains to both directors and entities as a whole – that is, the appropriate balance between criminal and civil penalties. It proposes a tiered approach to the specification of criminal and civil penalties to better align the contravention of a legislative provision or prudential requirement with its seriousness.

Stakeholder feedback is also sought on the maximum penalties that should apply to civil contraventions and criminal offences in order to reflect the seriousness of the breaches and provide appropriate levels of deterrence.

Chapter 6: Supervision and enforcement powers

Introduction and progress to date

Chapter 3 of Consultation Document 2B outlined the Reserve Bank's approach to supervision and enforcement – tasks undertaken by the regulator that involve:

- monitoring the health of regulated entities
- verifying information provided by those entities
- assessing the entities' compliance with formal prudential rules
- taking corrective action in the event of non-compliance
- addressing emerging risks and concerns.

The Reserve Bank's approach to supervision is somewhat unusual in the international context. It has traditionally taken a less intensive approach than other prudential regulators, reflecting a long-standing emphasis on self- and market discipline to achieve its statutory objectives for prudential policy. Underpinning this light-handed approach is the absence of 'on-site' inspections to independently test and verify information provided by banks and other regulated entities, or to check compliance.

The second consultation canvassed a number of options for greater verification by the Reserve Bank as prudential supervisor, premised on more baseline funding for its supervision function together with a legislative provision enabling it to undertake some form of business-as-usual (BAU) or routine on-site inspections of regulated entities.

Following this consultation Cabinet made an in-principle decision that the Reserve Bank would be empowered to undertake on-site inspections as part of its supervisory activities (see the December 2019 Review Update). This change was to be supported with an increase in funding. This consultation tests the scope of that power.

'Enforcement' in the broadest sense involves taking corrective action if regulated entities or certain individuals do not comply with prudential requirements, or to address emerging risks well before any formal non-compliance.

Robust enforcement frameworks typically have a broad suite of both supervisory and formal enforcement tools that can be used in proportionate and tailored ways to respond to contraventions, or effect desired behavioural change.

Chapter 6 Overview

✓ There will be an 'on-site inspection' power
✓ Wider range of formal enforcement powers

- Scope of on-site powers
- Confirmation of additional enforcement tools
- How will breaches of requirements be reported?

✓ Key decisions taken by Cabinet
- Key remaining issues to be covered in the current consultation

Chapter 3 of Consultation Document 2B outlined the Reserve Bank's current powers and noted that formal enforcement powers were largely confined to court-based criminal sanctions. The chapter argued that the enforcement framework could be improved by expanding the formal toolkit to include other tools such as statutory public notices, enforceable undertakings, infringement notices and civil penalties.

The chapter also noted that removing a requirement for Ministerial consent to the issuance of directions would remove the current high threshold for using this particular tool to take corrective action.

Cabinet has made an in-principle decision to broaden the suite of formal enforcement tools available to the Reserve Bank under the new Deposit Takers Act.

This chapter seeks feedback from stakeholders on which tools should be added to that toolkit.

Cabinet has also made an in-principle decision to remove the Minister of Finance's role in consenting to the issuance of directions to an entity under the new Deposit Takers Act. This change removes the high threshold for using this enforcement tool under the Reserve Bank Act and aligns with modern legislation such as IPSA, as well as with the IMF's recommendations from its 2016/17 FSAP for New Zealand.

No follow-ups are required on this decision in the present consultation.

6.1 On-site inspections

Most stakeholders who responded to the second consultation supported a more intensive supervision approach, coupled with an increase in the resources necessary to achieve the accompanying improvements in capacity and capability.

Stakeholders emphasised a number of problems with the current model, including:

- a lack of assurance from the bank director attestation process that banks are managing their risks appropriately
- a lack of a thorough understanding of regulated entities' business among Reserve Bank supervisory staff
- the Reserve Bank's inability to respond in a timely manner to approval and authorisation requests from regulated entities
- a lack of alignment with international standards.

A key legislative dimension supporting the transition away from a light-handed supervisory approach, to one that enables the Reserve Bank to become a much more challenging and sceptical regulator, is the ability to conduct on-site inspections.

On-site inspections involve supervisors going to regulated entities' premises. They are used to:

- obtain independent verification that the entities have adequate policies, procedures and controls and are complying with regulatory requirements
- promote compliance with the law in the financial sector, as non-compliance can result in serious harm to the economy and financial harm to individuals
- determine that information reported by the entities is reliable
- obtain any additional information and take possession of documents (for copying) as appropriate, including for a proper understanding of the operations of the entities, and the entities' risks and how they are managed
- monitor how entities are addressing any risks and other concerns expressed by the regulator and any instances of non-compliance.

Cabinet has agreed, in principle, to the Reserve Bank being empowered to undertake on-site inspections as part of its supervisory activities. This change will be supported by an increase in funding.

Alignment with international standards and practice

Cabinet's decision will help to better align New Zealand's supervisory framework with both international standards and supervision practice in most other jurisdictions.

BCP 9 (Supervisory techniques and tools), for example, requires supervisors to use a suitable mix of on-site and off-site supervision. There is a parallel requirement in the International Association of Insurance Supervisors' Insurance Core Principle 9. The on-site power is justified on the basis that the entities are carrying out activities in a regulated sector, and regulation should come with an expectation of their being monitored and assessed for compliance in a rigorous manner. It recognises:

- the impacts that failures of regulated entities can have on the financial system
- that the entities are in positions of trust in relation to various stakeholders' financial wellbeing
- that public confidence in both the regulated sector and the regulator helps to support financial stability.

Most jurisdictions have embedded the international standards into enabling legislation, thereby empowering the relevant prudential authorities to undertake on-site inspections (see Table 6.1).[41] Most of these prudential authorities have been given fairly broad and enabling powers to go 'on-site', often framed in terms of access to business premises at 'reasonable times'. This power typically sits alongside other powers such as more general 'access to information' powers and obligations for

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[41] Australia is an interesting exception. In the normal course of discharging its supervisory functions APRA conducts on-site inspections of regulated entities with the consent of those entities. However, legislation such as the APRA Act 1998 and the relevant sectoral legislation (e.g. the Banking Act 1959) do not expressly provide for a formal on-site power. To date this has not led to any significant issues, partly because APRA has other powers it can call on where it is difficult to obtain information from or gain access to regulated entities' premises (powers of investigation and examination).

regulators to preserve the confidentiality of information gained via on-site inspections and examinations.

The IMF 2016/17 FSAP for New Zealand, which assessed the Reserve Bank's supervisory model against the BCPs and Insurance Core Principles, found that the Reserve Bank's approach was in conflict with the international requirements in a number of areas. The Reserve Bank received a number of 'materially non-compliant' grades for the BCPs in light of the absence of independent testing of prudential information and the risk management practices of registered banks via on-site inspections. At the margin, these ratings may negatively affect the broader international perception of New Zealand's prudential framework.

Table 6.1: On-site powers of prudential authorities – international comparison

	On-site powers
APRA (Australia)	▪ No formal on-site inspection powers in legislation
Bank Negara Malaysia	▪ "The Bank may examine, without any prior notice, the business and affairs of the [various] persons…and examine any director, officer or controller of persons…" (Financial Services Act 2013, section 146) ▪ Provisions for the delegation of inspections to auditors/actuaries, and inspections by home authorities
EU national authorities	▪ "The competent authorities shall, at least annually, adopt a supervisory examination programme for the institutions they supervise" (Article 99[1] Directive 2013/36EU) ▪ Provisions for increasing the number or frequency of on-site inspections, permanent presence of competent authority at an institution, and thematic examinations
European Central Bank (ECB)	▪ "…the ECB may in accordance with Article 13 and subject to prior notification to the national competent authority concerned conduct all necessary on-site inspections at the business premises of the legal persons referred to in Article 10(1)… Where the proper conduct and efficiency of the inspection so require, the ECB may carry out the on-site inspection without prior announcement to those legal persons" (Council Regulation [EU] No 1024/2013 of 15 October 2013, Article 12)
Federal Deposit Insurance Corporation (US)	▪ "The appropriate Federal banking agency shall, not less than once during each 12-month period, conduct a full-scope, on-site examination of each insured depository institution" (Federal Deposit Insurance Act 1950, section 10[d][1]) ▪ Provisions for alternate annual inspections if inspections carried out by a State authority, 18-month rule for certain 'small institutions', coordinated exams (given multiple regulatory agencies) and separate examinations by multiple regulatory agencies
Monetary Authority of Singapore	▪ "The Authority shall, from time to time, inspect under conditions of secrecy, the books of each bank in Singapore and of any branch, agency or office outside Singapore opened by a bank incorporated in Singapore" (Banking Act 1970 section 43[1]). "The books…shall not be required to be produced at such times or at such places as would unduly interfere with the proper conduct of the normal daily business of that bank or subsidiary" (Article 44A) ▪ Provisions for delegation of on-site inspection powers to an auditor, and inspections by home authorities
OSFI (Canada)	▪ "The Superintendent, from time to time, but at least once in each calendar year, shall make or cause to be made any examination and inquiry into the business and affairs of each bank that the Superintendent considers to be necessary or expedient to determine whether the bank is complying with the provisions of this Act and whether the bank is in a sound financial condition and, after the conclusion of each examination and inquiry, shall report on it to the Minister" (Bank Act 1991, section 643[1])

Domestic regulatory regimes

There are a number of regulatory regimes in New Zealand that confer powers on the regulator to undertake BAU on-site inspections aimed at pre-emptive monitoring and compliance assessment. These include the regimes for AML/CFT, food safety, workplace health and safety, civil aviation and maritime safety, and Fire and Emergency New Zealand's role.

A 'reasonableness' test (e.g. accessing premises at a 'reasonable time') is often tied to these regimes. For example, New Zealand Food Safety inspectors must give reasonable notice of inspections, but this rule can be circumvented if giving notice would defeat the purpose of a visit. Different requirements are often in place for searches of private dwellings and marae, where such searches require either consents or warrants.

The AML/CFT regime has a provision preventing self-incrimination by any employees, officers or agents of reporting entities who answer questions as part of inspections.

Other regimes confer on-site inspection powers in respect of defined incidents, such as investigating accidents (the Transport Accident Investigation Commission) and investigating specific breaches of relevant legislation (e.g. the Commerce Commission and Electricity Authority), the latter usually with the assistance of warrants.

On-site powers in New Zealand legislation must be specified in ways consistent with New Zealand's legal and constitutional principles. On-site powers typically require strong justification and careful design to ensure they balance rights and freedoms.

A robustly designed on-site inspection power needs to:

- identify the purpose clearly
- state clearly who the power applies to
- be clear about the protection of information and confidentiality
- consider relationships with other supervisory powers, such as powers of investigation that require warrants[42]
- specify if information gained through an inspection can be used for a different purpose, and shared with a different body.

Chapter 21 of LDAC's Legislation Guidelines states that warrantless inspections without notice may be suitable for a regulatory regime if it can be established that this is an effective way of ensuring that regulatory requirements are being adhered to. But, "regardless of the content, all search powers must be proportionate to their objectives and all searches must be carried out by properly authorised and trained officers".

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[42] For example, if during a routine on-site inspection evidence of a potential contravention of a regulatory requirement is uncovered, does this allow inspectors to gather evidence at the time, or must they cease the inspection and return with a warrant?

Proposed approach

Proposed approach 6.1: *on-site powers should be designed in a way that is consistent with international standards, which implies a fairly broad power. This can be achieved by placing the on-site inspection power in the new Institutional Act, broadly modelled on the on-site power provided for in the Anti-money Laundering and Countering Financing of Terrorism Act 2009 (AML/CFT Act).*

Legislative location

Making on-site inspections a generic power in the Institutional Act is an efficient and elegant way of enabling the power to be applied to the various industry sectors the Reserve Bank regulates (deposit takers, insurers and FMIs). A counterpart to this option is the consolidation of related supervisory tools and powers such as information gathering and sharing, and investigatory powers in the Institutional Act (see below).

Alternatively, these powers could be provided for separately in the relevant sectoral Acts.

Scope of the power

The on-site power in New Zealand's AML/CFT legislation provides a useful template for a similar power for the Reserve Bank's prudential responsibilities.

Section 133 of the AML/CFT Act states that "an AML/CFT supervisor may, at any reasonable time, enter and remain at any place (other than a private dwelling or a marae) for the purpose of conducting an on-site inspection of a reporting entity". This reasonableness test is in lieu of any formal notice of inspection. An AML/CFT supervisor (e.g. the Reserve Bank in the case of banks, NBDTs and life insurers) may appoint any employee to exercise on-site inspection powers (section 141). The on-site inspection function itself may be delegated to another person who is suitably qualified to perform this function (section 134).

The AML/CFT Act (section 76) confers protections on the supervisor and its staff when exercising on-site powers (unless the person concerned acted in bad faith). The new Institutional Act will have a broad protection power for Reserve Bank staff that will provide similar protections for the exercise of on-site powers by staff.

The purpose of on-site inspections in the AML/CFT Act is synonymous with the overall purposes of that Act, which are to: detect and deter money laundering and the financing of terrorism; maintain and enhance New Zealand's reputation by adopting international standards; and contribute to public confidence. In the prudential context, an on-site power is justified by the social harm caused by the failure of a regulated entity, or indeed a financial crisis – which aligns with the overarching financial policy objective for the Reserve Bank to protect and promote financial stability.

Other features of the AML/CFT Act worth emulating include an ability to use information gained from on-site inspections for other functions and responsibilities, and an ability to share information with other agencies for other purposes – which for the Reserve Bank could be with the FMA for market conduct purposes. This would be facilitated through the broader information-sharing provisions, specified in either the Institutional Act or the relevant sectoral Act (see section 6.2).

In general, Reserve Bank staff (or any persons given delegated authority) who will be carrying out on-site inspections for prudential purposes should have relevant expertise and understand the scope

of their on-site powers and their specific obligations (including the protection of confidential information etc.). The requirement to appoint or authorise specific staff to undertake inspections could include a provision that staff be well-trained, or authorisation could be taken to imply that such staff meet this criterion.

It is also envisaged that if during the course of undertaking an on-site inspection evidence of non-compliance is uncovered, the inspection can continue without recourse to a search warrant. This follows the approach in the Health and Safety at Work Act 2015 (section 174).

In summary, the justification for what is a fairly intrusive power is:

- the social harm that can arise from imprudent risk-taking by regulated entities
- and international standards such as the BCPs that state that a prudential regulator can only adequately achieve its statutory mandate by undertaking on-site inspections that pre-emptively test and scrutinise regulated entities' adherence to regulatory rules, as well as their risk management and control systems.

The proactive and pre-emptive nature of these inspections implies that they need to be undertaken without warrants or the consent of the entities (in the New Zealand regulatory context warrants are typically issued for formal investigations when there is evidence, or suspicion of actual non-compliance). The absence of a notice provision is to ensure that the regulator has sufficient flexibility to turn up and inspect where urgency may be required, and possibly where advance notice may 'tip off' the entity.

In practice though, most on-site inspections will be a regular and routine part of the supervisory cycle, with the frequency of inspections of individual entities tied to the Reserve Bank's risk assessment methodology (i.e. generally the larger, more systemically important entities will be inspected at a higher frequency). These BAU inspections will therefore be well signalled to regulated entities, effectively under de facto notices of inspection. Although it will likely be general practice to issue de facto notices of inspection, the ability to exercise an on-site power without a notice may act to further reinforce incentives for entities to comply with regulatory requirements.

Protections that balance this proposed power with the rights and freedoms of regulated entities include:

- the scope being limited to accessing business premises at a 'reasonable time'
- the authorisation or approval of persons carrying out inspections (and these persons being well-trained and having requisite expertise)
- confidentiality protections for information gained from inspection.

Alignment with the financial market conduct peak

FMA's inspection powers

Consideration of the Reserve Bank's on-site inspection powers also raises questions about the regulatory powers of the FMA. This is because the Reserve Bank and the FMA often regulate the same entities under New Zealand's 'twin peaks' regulatory system, and increasingly carry out joint or coordinated supervisory and monitoring activities.

Status quo

The FMA carries out a range of monitoring and supervision activities. It currently has powers under the FMA Act to:

- require a person to supply information, documents, or to give evidence (section 25)
- enter and search a place, vehicle or thing (section 29).

The FMA's power under section 25 to request information or documentation requires the FMA to pre-specify the nature and scope of information to be supplied, and the time and place for viewing. As found in a 2012 High Court decision, this power cannot be exercised on-site to request information to be provided "immediately", and if any information is out of scope of a section 25 request, the FMA must provide another section 25 request.

The FMA's power under section 29 to enter and search places requires either the consent of the occupier or a court-ordered warrant before it can be exercised. A warrant may be issued if there are reasonable grounds to believe that a person has been or is engaging in conduct that contravenes a financial markets regulatory obligation, and that the search will produce evidential material.

Should the FMA have the ability to conduct on-site inspections without warrant or notice?

As noted above, the FMA currently carries out a range of monitoring and supervision activities, including off-site information requests and on-site visits. On-site visits generally rely on the consent of the entity. While these types of monitoring and supervision activities are sufficient in many situations, there is a question about whether an additional, broader ability to proactively and pre-emptively monitor and verify entities' compliance with their regulatory obligations would be helpful and appropriate. As noted above in the Reserve Bank context, such an ability may also help detect and deter misconduct.

Broader powers would enable on-site inspections in all of the FMA's regulatory areas, but would be relevant particularly in the following areas where the FMA is taking on new mandates:

- the licensing of financial advice providers under the Financial Services Legislation Amendment Act 2019
- the licensing of financial institutions (banks, insurers and NBDTs) under the Financial Markets (Conduct of Institutions) Amendment Bill
- the designation and supervision of FMIs under the Financial Market Infrastructures (FMI) Bill.

An example of when warrantless and noticeless inspection powers might be needed is to verify whether a recently licensed Financial Advice Provider (FAP) under the new financial advice regime does in fact have the processes and compliance staff in place that they said they would get in place in their licence application. In this situation, the FMA may not have evidence or reason to believe the FAP was breaching a regulatory obligation so would not have grounds to obtain a warrant. However, the ability to verify compliance could nevertheless be valuable.

The international practice of market conduct regulators with inspection powers is that in most cases prior notice of the inspection is given to the regulated entity (for example, to arrange an appointment with relevant staff). However, the ability to conduct an inspection on-site without prior notice ensures the regulator can have sufficient flexibility to turn up and inspect in appropriate circumstances. Providing prior notice of the inspection could also result in a markedly different picture of compliance.

Another question is around whether, from a regulatory coordination perspective, aligning the FMA's on-site inspection powers with what is proposed for the Reserve Bank would be desirable. Aligning the regulators' power could facilitate joint inspections where they are considered necessary, such as in the above areas, whether of individual institutions or on a thematic basis. Joint monitoring visits could potentially be efficient and reduce regulatory burden on entities. Joint monitoring plans could also flow into facilitating streamlined FMA and Reserve Bank licensing processes for new entities.

A broadened on-site power for the FMA would also align with the international standards for securities regulators set out in the International Organization of Securities Commissions' (IOSCO's) Objectives and Principles of Securities Regulation. Principle 10 states that "the Regulator should have comprehensive inspection, investigation and surveillance powers". IOSCO's assessment methodology (May 2017) sets out specific requirements tied to Principle 10:

> *The regulator should also have the power to carry out inspections of regulated entities on their premises without prior notice, when it believes it is appropriate to verify compliance with regulatory requirements.*
>
> *The suspicion of a breach of law should not be necessary to enable the regulator to require information from or conduct inspections of regulated entities* (page 65).

As with the on-site power proposed for the Reserve Bank, a broadened on-site inspection power for the FMA could mitigate reputational risk to New Zealand's financial markets associated with the regulatory regime's non-compliance with international standards, including when assessed through future FSAPs.

Scope of power

As for the Reserve Bank, it would be important that any expansion of the FMA's inspection powers be justified and proportionate in the financial markets regulatory context. The same design principles discussed in the context of the Reserve Bank's new power apply equally for the FMA.

The FMA regulates a broad range of entities, from banks and insurers to financial product issuers and crowdfunding platforms. These entities raise different types of risks and are subject to different supervisory and monitoring approaches. There is a question about whether a broad warrantless and noticeless on-site inspection power is necessary and appropriate for *all* FMA-regulated entities and

in all circumstances, or whether it should be available only for certain entities/circumstances, e.g. in high-risk circumstances or for dual prudential-conduct regulated entities where there is a need for coordinated supervision between regulators.

Any expanded FMA on-site power should be subject to similar safeguards as the proposed Reserve Bank power. It should be exercised only by properly authorised and trained personnel and, at a minimum, should be subject to a requirement that it is only exercised at 'reasonable times' (as with the AML/CFT Act power).

Questions for consultation

6.A Do you agree that the on-site power for the AML/CFT regime is an appropriate comparator for a similar power for the Reserve Bank's prudential functions?

6.B Should this power be a generic power in the new Institutional Act, or specified in the Deposit Takers Act?

6.C Do you think any additional safeguards are necessary for the on-site power?

6.D Do you think the FMA's on-site inspection power should be expanded in the same way that is proposed for the Reserve Bank?

6.E Should an expanded FMA on-site inspection power apply in all circumstances and to all FMA-regulated entities or only some (e.g. in high-risk circumstances or for dual prudential-conduct regulated entities)?

6.2 Other supervisory powers

Proposed approach 6.2: *the Deposit Takers Act maintains and modernises the Reserve Bank's other supervisory powers and obligations, subject to a consideration of whether powers and obligations common to the Reserve Bank's regulatory regimes are better located in the Institutional Act.*

As noted in section 6.1, a legislative design choice needs to be made on where certain supervisory powers and obligations are best located – in the Institutional Act or the new Deposit Takers Act. These powers and obligations, in addition to the new on-site power, include those to gather and share information, protect confidential information and conduct investigations.

The Review's starting point is that these related powers and obligations should be located in the Institutional Act, and in doing so reflect a degree of consolidation of similar powers in other legislation such as IPSA and the FMI Bill.

The Review team will undertake further work on this question, and engage closely with the Parliamentary Counsel Office during the drafting stage to determine the most appropriate legislative framework for these powers.

Question for consultation

6.F Do you have any comment on the appropriate legislative location of supervisory powers such as information gathering and sharing, on-site inspections, and other related powers? Do you see merit in consolidating similar powers from sectoral Acts into the Institutional Act?

6.3 Breach reporting

Background

An important element of any supervision and enforcement regime is the way contraventions of prudential requirements are identified in the first place. The Reserve Bank does undertake compliance assessments, but the off-site supervisory approach and limited independent verification mean it largely relies on information provided by regulated entities.

While the ability to undertake on-site inspections will help the Reserve Bank to identify potential breaches in a more timely way (it will be better able to 'second guess' and verify information provided by regulated entities), there is still a key role for individual entities in self-reporting breaches or potential breaches to the Reserve Bank.

Chapter 1 of Consultation Document 2B provided some information on the Reserve Bank's current approach to registered banks' reporting of (potential) breaches.

While breaches of prudential requirements by banks are criminal offences under the Reserve Bank Act, the Reserve Bank, like any prudential regulator, has significant discretion in addressing any non-compliance.

One peculiarity of the current arrangements is that banks are not compelled to report breaches of CoRs to the Reserve Bank (although the Reserve Bank expects them to). Instead, under current disclosure rules, they must publish details of the nature and extent of any breaches in their six-monthly disclosure statements.

Up until March 2018, banks were required to produce disclosure statements every quarter. However the development and introduction of the Bank Financial Strength Dashboard led to the Reserve Bank deciding to extend the formal disclosure and associated attestation requirements to six monthly.

With no formal requirement for banks to report breaches to the Reserve Bank and the longer interval between disclosure statements, the current framework is at risk of undermining the Reserve Bank's ability to make proactive and timely use of its regulatory tools to effect corrective action.

New breach-reporting framework

The Reserve Bank has recently undertaken a consultation process on a new approach, under the current legislative framework, that would require registered banks to undertake public and private reporting of breaches, subject to a 'materiality threshold' (the identification of more serious and significant breaches).

The consultation aimed to enhance the market discipline effects of prompt breach reporting and publication, while considering a materiality threshold to reduce a focus on relatively minor breaches that could divert directors' attention away from more important areas.

The new framework will use a standing section 93 (of the Reserve Bank Act) 'supply of information' notice to require banks to report any cases where they have breached, may have breached or are likely to have breached regulatory requirements. Banks will have to report material breaches to the Reserve Bank as soon as possible, and immaterial breaches in a compendium every six months. The compendium will help the Reserve Bank to assess whether the banks are drawing the distinction between material and immaterial breaches appropriately, and provide the basis for discussions with banks on borderline cases. It will also enable the Reserve Bank to monitor minor related breaches that might cumulatively be material.

The Reserve Bank would subsequently display actual and material breaches on a new webpage.

The new framework is due to take effect from 1 April 2020.

Proposed approach

***Proposed approach 6.3:** 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.*

It is proposed that a breach-reporting framework be empowered more directly in legislation, replacing the more indirect section 93 approach that will apply to registered banks until the Deposit Takers Act takes effect.

The Deposit Takers Act would have a specific requirement for licensed deposit takers to report all breaches of prudential requirements to the Reserve Bank. The Reserve Bank would have the flexibility to decide which breaches needed to be reported immediately, based on 'materiality' criteria, and which could be reported less frequently in the compendium of minor breaches. It is anticipated that the Reserve Bank would issue guidance to deposit takers on the boundary between material and immaterial breaches.

The publication of material breaches on the Reserve Bank's website could be provided for under a new statutory public notice provision (see section 6.4), rather than requiring an exception from a confidentiality provision (which is the way this information will be published from April under the new policy via an exception to section 105 of the current Reserve Bank Act).

Alternative options

An alternative approach would be to use the information gathering power in the Deposit Takers Act or the Institutional Act (see section 6.2). This approach might enable some additional flexibility for the Reserve Bank, as the Reserve Bank would have more scope to alter reporting requirements on a temporary or permanent basis.

A section 93-type notice could also sit alongside a statutory provision for breach reporting in order to meet demands for flexibility. However, this would be somewhat cumbersome, as breach-reporting requirements would be spread across both the Act and a notice.

One relevant factor for the legislative design of a breach-reporting framework would be the different legal consequences of a contravention of a direct breach-reporting requirement and a contravention of an information-gathering notice.

Another legislative design choice is whether to specify a generic breach-reporting requirement in the Institutional Act, rather than locating it in the Deposit Takers Act. The requirement would then apply to all sectors the Reserve Bank regulates. This approach would be consistent with locating a number of other generic supervisory powers in the Institutional Act, such as information-gathering and on-site inspection powers (see section 6.2).

Question for consultation

6.G Should a breach-reporting requirement be directly provided for in legislation? Should this be provided for in the Deposit Takers Act, or located in the Institutional Act as a requirement for all entities regulated by the Reserve Bank?

6.4 Enforcement powers

Background

Cabinet has made an in-principle decision to expand the suite of formal enforcement powers available to the Reserve Bank. Broadening the toolkit will give the Reserve Bank more credible options to change firm’s behaviour, helping to address non-compliance with more formality and a greater sensitivity to individual circumstances. Formal enforcement actions also serve a wider deterrence purpose, as they are generally public and can therefore help to set expectations for the industry as a whole.

However, no decision has been made on which additional tools should be specifically included in the Reserve Bank’s enforcement toolkit.

The second consultation in June 2019 outlined four possible tools:

- **Statutory public notices**: notices that provide a legislative basis for issuing public warnings
- **Infringement notices**: notices for a subset of criminal offences that do not result in criminal conviction, typically used for minor compliance-type contraventions (e.g. a failure to lodge particular documents with the Reserve Bank)
- **Enforceable undertakings**: commitments given to and accepted by the Reserve Bank that are enforceable in court
- **Civil penalties**: non-criminal monetary penalties applied under the civil standard of proof.

In addition, Cabinet’s decision to remove the requirement for the Reserve Bank to get consent from the Minister of Finance to issue directions helps to support improvements in the use of this existing tool.

Stakeholder feedback

There was widespread agreement among stakeholders that the Reserve Bank needed a broader suite of enforcement tools, with a relative de-emphasis on the role of criminal penalties. However, only a handful of submitters had views on the specific merits of the four additional tools proposed in the consultation document. For example, a couple of submissions questioned the efficacy of infringement fees as a sanctioning tool.

A number of submissions discussed enforcement in the context of the potential sanctions tied to options for improving the individual liability provisions of the Reserve Bank Act (see Chapter 5).

Proposed approach

Broadening the enforcement toolkit would put the Reserve Bank's regulatory powers more in line with the toolkit of the FMA as New Zealand's conduct regulator and with those of overseas prudential regulators. It would also align them with international standards such as BCPs for effective banking supervision, which require supervisory authorities to apply a range of enforcement actions "in accordance with the gravity of the situation" (BCP 11 – Corrective and sanctioning powers of supervisors).

Similarly, LDAC notes that "creating a fully developed compliance model that is effective in dealing with the many forms of non-compliance often requires a combination of options. The combination of options should form an effective system, and each option should be proportionate to the form of non-compliance it is intended to address" (see Chapter 22 of LDAC's Legislation Guidelines).

Broadening the toolkit also serves to positively affect voluntary compliance among regulated entities. That is, the availability of a wider set of tools to the Reserve Bank can help in developing a more cooperative relationship between the regulator and regulated entities, although this can only work if the new regime is seen as credible and threats of more punitive action are followed up where escalation is warranted.

The new Deposit Takers Act should include enforceable undertakings and civil pecuniary (monetary) penalties, with the latter reflecting a more general rebalancing away from the current Reserve Bank Act's emphasis on criminal penalties (see section 5.1 of Chapter 5 for the proposed approach).

The merits of including statutory public notices and infringement notices in the Deposit Takers Act are more finely balanced. The Review is therefore seeking further comment from stakeholders on the pros and cons of adding these tools.

In addition to seeking feedback on the four tools identified in the second consultation, the Review is seeking feedback on the merits of including remedial notices and/or actions plans as statutory tools.

Enforceable undertakings

Proposed approach 6.4: *the Deposit Takers Act should provide for enforceable undertakings as a statutory tool. The tool would be modelled on a similar power being proposed under the FMI Bill, and include procedural requirements and consequences for the Reserve Bank in accepting the undertakings.*

Enforceable undertakings are a fairly common tool among regulatory regimes. They are also being proposed for the new regulatory regime for FMIs, which itself is closely modelled on sections 46-47 of the FMA Act.

Enforceable undertakings would allow the Reserve Bank to agree certain outcomes with a deposit taker (such as particular remedial actions to address non-compliance or an area of emerging concern). This agreement would allow a degree of flexibility and tailoring, and would not carry the same punitive (criminal) sanctions associated with contravening a direction, for example. It would also enable escalated enforcement action to be taken (i.e. through the courts), in the event the undertaking is breached.

In terms of the legislative prescription, the power would:

- enable the Reserve Bank to accept a written undertaking from a deposit taker in relation to any matter in which the Reserve Bank is performing or exercising its functions
- outline the scope of the undertaking, including the payment of compensation or an amount in lieu of a monetary penalty.

The consequences for the Reserve Bank would need to be spelled out, including its inability to undertake subsequent criminal and civil proceedings for the same issue. The undertaking's enforcement would also be detailed in legislation, including the factors a court would need to consider in issuing an order to the deposit taker.

Question for consultation

6.H Do you agree that the Deposit Takers Act should provide for the Reserve Bank to accept a voluntary undertaking from a deposit taker that is enforceable in court?

Statutory public notices

Currently, the Reserve Bank can issue an informal public notice or warning to signal to the public that an entity may have breached a prudential requirement, but that the Reserve Bank does not consider it appropriate to take further formal action at the time. This creates a reputational consequence for the entity, and can prompt swift remediation. Public warnings can also have a more general deterrence role in helping to influence wider industry behaviour. Informal notices carry some protections for regulated entities in that the notice can be judicially reviewed.

Formalising public notices in legislation may sharpen the reputational effects on regulated entities, while helping to normalise and legitimise their use by the Reserve Bank. The notice provision in the Deposit Takers Act could also provide a legislative basis for the publication of 'material' breaches by deposit takers on the Reserve Bank's website, without relying on exceptions to any confidentiality provisions in the Deposit Takers Act tied to the reporting of private information (see section 6.3).

In addition, the issuance of statutory public notices:

- ensures that a regulator's statutory indemnities, immunities and qualified privilege apply to that public notice

- provides a clear statutory framework for the notice-giving, including rights of response and appeal processes
- can provide for warnings to be disclosed in a number of places, such as an entity's (or related party's) website, disclosure documents, or advertisements.

Statutory public notices are found in the regulatory regime for AML/CFT and in sections 9 and 49 of the FMA Act for financial market conduct.

On the other hand, given the existing ability to issue warnings and notices informally, there may be limited practical value in adding this tool to primary legislation. As with any formal enforcement tool, there are costs to the regulator, including those associated with, for example, appeal processes.

Question for consultation

6.I Should the Deposit Takers Act provide a statutory basis for the Reserve Bank to issue a formal notice to a deposit taker?

Infringement notices

Infringement notices can offer a relatively efficient way to incentivise compliance where breaches have minor impacts, are frequent and are relatively unambiguous. While a notice can be challenged in court, there is no need to go to court to issue a fine under an infringement notice. Infringement notices can also have some reputational effects for the regulated entities, despite the modest fines typically issued.

The Review is considering including an infringement offence in the Institutional Act for minor infractions by financial institutions of the provision to supply information required by the Reserve Bank (for non-regulatory purposes, e.g. the Reserve Bank's power to collect survey data from market participants). To the extent that the supply of information-type provisions for regulatory purposes (e.g. information to assess compliance with prudential requirements) will be consolidated in the Institutional Act, this may limit the need for an infringement notice power in the Deposit Takers Act.

Question for consultation

6.J Do you see any role for infringement notices in the Deposit Takers Act?

Remedial notices and action plans

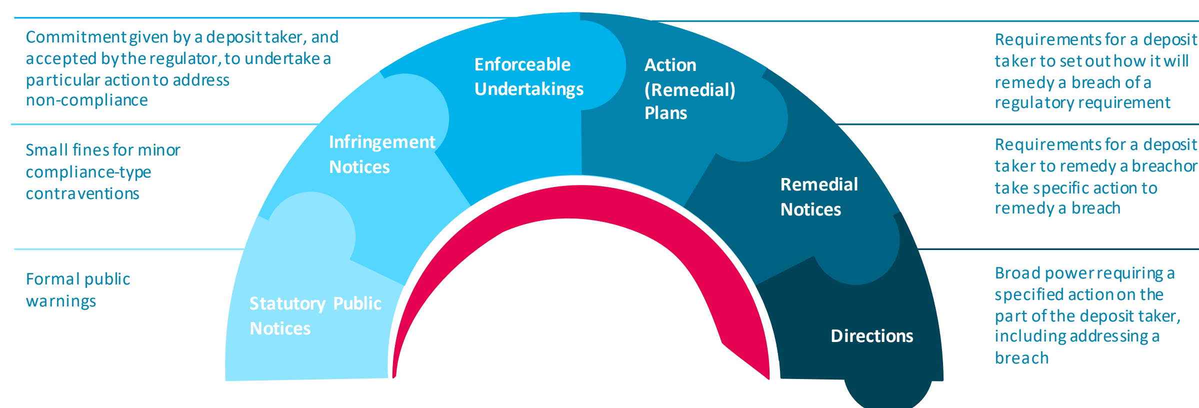
A **remedial notice** is a statutory tool that requires an entity to remedy a breach or take specific actions to do so. It is imposed on an entity rather than being voluntarily agreed to by the entity and the regulator, as is the case in enforceable undertakings.

Remedial notices are similar to, but not the same as, **action plans** (also called **remedial plans**). An action plan requires an entity in breach to prepare a plan setting out how the breach will be remediated. The plan typically has to be approved by the regulator, and amended and resubmitted for approval if the regulator is not satisfied with it. The regulator may issue a subsequent remedial

notice if the proposed action plan is inadequate or an approved action plan is not being complied with (if these tools are separately provided for).

Taken together, remedial notices and action plans are a class of statutory tool that complement other tools such as enforceable undertakings and the power to issue a direction to a regulated entity, together helping to complete the suite of formal enforcement powers (Figure 6.1).

Figure 6.1: Enforcement toolkit – potential new tools



Note: The power to issue directions is not a new tool per se. However, Cabinet has made an in-principle decision to remove the requirement for Ministerial consent.

Alternatively, a requirement to address a breach through a notice or action plan could be facilitated through a **direction** power. However, the threshold for issuing a notice or action plan is likely to be different from that for issuing a direction – a direction might only relate to a certain breach, while a remedial notice or action plan could relate to any breach. In addition, the liability for contravening a remedial notice/action plan may be different from that for contravening a direction, e.g. a civil versus a criminal penalty.

Separating the purposes of remedial notices and action plans from directions may more clearly signal that these tools are part of the BAU enforcement toolkit rather than crisis management powers (most, but not all, of the current criteria for issuing directions in the Reserve Bank Act are related to crisis situations).

In terms of precedents in other regulatory regimes, under IPSA and its provision pertaining to life insurers' statutory funds (subpart 3), the Reserve Bank may give a life insurer a written notice requiring it, within a specified period, to take the action specified in the notice to remedy a failure (section 106). A life insurer commits an offence if it fails to comply with the subpart, and is liable, on conviction, to a fine of up to $500,000 (section 118).

Under the FMI Bill, the joint regulators (the Reserve Bank and the FMA) may issue a remedial plan *and* a remedial notice to a designated FMI. If the regulators are not satisfied with a remedial plan, they may issue a remedial notice requiring the entity to take specified action(s) within a specified period. An entity that contravenes a remedial notice commits a 'level 4' criminal offence and is liable to a fine not exceeding $1 million.

The FMA has a power under section 417 of the FMC Act to require a person to submit an action plan to the FMA. A failure to submit, a rejection of, or a failure to comply with an action plan may result in censure, suspension or licence cancellation, or a civil penalty.

Question for consultation

6.K Do you see a useful role for remedial notices and/or action plans in the Deposit Takers Act?

Summary

This chapter has outlined a proposed approach to specifying an on-site inspection power for the Reserve Bank.

This power is enabling in scope, is subject to a reasonableness test and will provide the basis for the Reserve Bank to adopt a more intensive and challenging approach to the supervision of regulated entities. However, the power will need to be supported by substantial additional funding for the Reserve Bank to improve the supervision function’s capability and capacity.

‘Enforceable undertakings’ have been put forward in this chapter as a new formal enforcement tool for the Reserve Bank to effect corrective action, alongside a more general rebalancing towards civil penalties (as discussed in Chapter 4).

This chapter also:

- seeks feedback on the merits for the Deposit Takers Act of three other statutory enforcement tools: formal public notices, infringement notices and action plans/remedial notices
- proposes the provision of a breach reporting requirement in the Deposit Takers Act. This would replace the new self-reporting requirement for registered banks that will come into effect in April this year under the current legislative framework.

Chapter 7: Resolution and crisis management

Introduction and progress to date

Consultation Document 2B provided an overview of the existing legislative framework for crisis management for registered banks. As noted in that document, there are long-standing tools in New Zealand legislation (notably statutory management) that the Reserve Bank has used to develop a bank failure management strategy (Open Bank Resolution, or OBR) to help manage the failure of a large bank. However, crisis management regimes developed in other countries more recently and the IMF's analysis and recommendations for New Zealand's framework suggest there would be benefit in having a wider range of tools available.

Consultation Document 2B identified a number of areas where the framework could be enhanced and sought feedback on a number of proposals that would help set the direction for further work on a reformed legislative framework for both banks and NBDTs (in light of the decision to integrate these two sectors into a single prudential regime – see Chapter 3).

These fundamental elements of the review of the crisis management framework covered, among other matters:

- the role of the Reserve Bank in crisis management and resolution and the objectives it should seek to achieve in performing that role
- ensuring that a sufficiently wide range of tools is available to the Reserve Bank, as the resolution authority, for the orderly resolution of a failed deposit taker without severe systemic disruption and without relying on taxpayer support – recognising that, owing to the diversity of the deposit-taking sector, some resolution tools will be better suited to certain entities than others
- ensuring appropriate protections for deposit takers' creditors, including the principle that creditors should end up no worse off than they would be in an ordinary liquidation (known as 'no creditor worse off' or NCWO).

The proposals included in the second round of consultation were informed by the international experience during and since the GFC, the international guidance on bank resolution regimes that has emerged from that experience (principally the Financial Stability Board's (FSB's) 2014 Key Attributes of Effective Resolution Regimes for Financial Institutions, and the subsequent international policy work on and practical implementation of bank resolution regime reform.

Chapter 7 Overview

- ✓ Reserve Bank will be resolution authority, with clear objectives and functions
- ✓ Widen resolution powers (eg statutory bail-in powers)
- ✓ 'No creditor worse off' provisions

- Thresholds for using early intervention and resolution powers
- Liabilities to be subject to bail-in
- Statutory management advisory committee
- Resolving credit unions and building societies
- Whether deposit takers should remain subject to CIMA statutory management

** Other details of crisis management are being developed in parallel to the public engagement process*

- ✓ Key decisions taken by Cabinet
- ▪ Key remaining issues to be covered in the current consultation

Stakeholder feedback supported the proposed direction of reforms for crisis management, including the proposed introduction of bail-in powers and the establishment of creditor safeguards that aligned with international guidance and practice.

Following the second round of consultation, Cabinet made the following in-principle decisions on crisis management and bank resolution:

- Legislation will explicitly designate the Reserve Bank as the **resolution authority** for deposit takers and, as such, it will be responsible for ensuring resolution preparedness and exercising resolution powers in the event of a deposit taker failure.
- **The statutory objectives** to be achieved in performing the resolution authority function will focus on:
    - (i) enabling all deposit takers to be resolved in an orderly manner
    - (ii) avoiding significant damage to the financial system from the failure of a deposit taker
    - (iii) to the extent not inconsistent with (ii), minimising the cost of resolution and avoiding unnecessary destruction of value and interference with property rights, and protecting public funds, including by minimising the reliance on public funds to resolve a failed deposit taker.[43]
- Some crisis management powers (to be determined) currently available to a statutory manager can be **made directly available to the Reserve Bank.**
- The range of resolution options available to the Reserve Bank to restore solvency or to recapitalise a failed deposit taker will be increased by adding the power to **write down, or convert to equity, certain unsecured liabilities** ('statutory bail-in').
- Resolutions will 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 functions.
- A mechanism will be introduced to provide creditors with after-the-event **compensation** if a resolution results in their incurring losses greater than would have been incurred in an ordinary liquidation (NCWO).

The existing legislative framework for bank resolution is based on a failed or failing entity being first placed into statutory management.[44] In Consultation Document 2B, the Review proposed that key resolution powers be vested directly with the Reserve Bank as resolution authority, rather than a separately appointed statutory manager as is currently provided. This change would allow the Reserve Bank to exercise resolution powers directly, in addition to being able to appoint a statutory manager to exercise such powers. In the case of a small deposit taker, for example, the Reserve Bank may choose not to engage a statutory manager to undertake a resolution.

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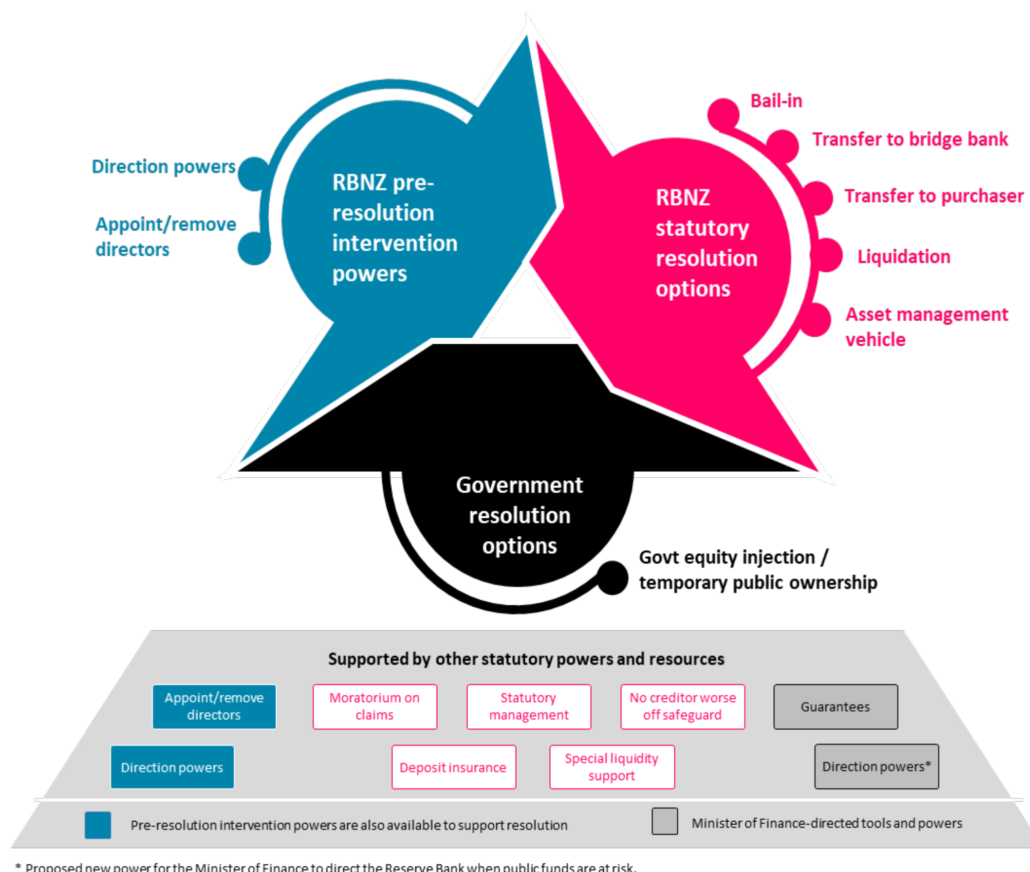
[43] The Review is still considering the merits of having 'protecting insured depositors' as an additional resolution objective.

[44] The existing legislative framework for NBDTs is limited to CIMA's statutory management provisions, which are overseen by the FMA.

The Review also envisages making a clearer distinction between pre-resolution intervention powers on one hand (e.g. the power to give directions and remove/appoint directors) and resolution powers on the other (e.g. bail-in, transfers of business, assets, and liabilities, and liquidation).

Figure 7.1 illustrates how the various elements of the wider crisis management and resolution framework would sit together (both proposed new elements and existing elements). No existing powers and tools (such as early intervention powers and statutory management) would be removed. However, the triggers for, and features of, those tools may be modified.

Figure 7.1: Proposed resolution and supporting powers framework



* Proposed new power for the Minister of Finance to direct the Reserve Bank when public funds are at risk.

The proposed framework can be summarised as follows:

- Key pre-resolution intervention powers will be available before a distressed deposit taker reaches the point where failure is deemed likely. These include direction powers that are currently contained in in section 113(1) and 113A of the Reserve Bank Act (which may need to be expanded to accommodate the Reserve Bank's resolution authority role).
- Once failure is deemed likely, the Reserve Bank will be able to access a range of statutory resolution options that are common in resolution regimes internationally. They include:
  - the ability to write down, or convert to equity, certain unsecured liabilities to help return a failed entity to a solvent and recapitalised state (statutory bail-in)
  - the ability to sell, or otherwise transfer, parts (e.g. insured deposits) or the whole of a failed deposit taker to a healthy acquiring entity

  - the ability to set up a temporary bridge bank and transfer to it parts of the failed deposit taker if a healthy acquiring entity is not available
  - the ability to transfer assets (likely poorly performing assets) to a special asset management vehicle
  - the ability to apply for a failed deposit taker (or the rump of one) to be placed into a normal court-appointed liquidation process.[45]

- The government would also still be able to use public funds to recapitalise and deliver a partial or full temporary public ownership of a failed deposit taker. However, the potential costs to taxpayers and moral hazard implications mean that the use of public funds in this way should be a last resort, used only if necessary to maintain financial stability or critical financial services, and potentially be recoverable from industry.

- A range of other tools would then be available to support a resolution strategy. These tools include direction powers, statutory management in order to take control of the failed deposit taker, the moratorium on claims that is currently attendant with statutory management, special central bank liquidity support (outside normal 'lender of last resort' facilities), and statutory safeguards for the treatment of creditors. Government guarantees would also still be an option for a government to directly support an open-bank type of resolution strategy. Government guarantees, however, raise issues similar to those for the use of public funds directly, so should similarly be employed with caution.

- Deposit insurance will be a key new feature of New Zealand's financial safety net. Deposit insurance may make it easier for authorities to contemplate resolution options that might otherwise see the majority of a deposit taker's depositors bear losses or lose access to their funds for an extended period of time. For example, an expectation that the deposit insurance scheme would pay out insured deposits promptly would make it easier to contemplate the closure and wind-up of a failed non-systemically important deposit taker.

- A pre-funded deposit insurance scheme could also offer a potential source of limited resolution funding where the chosen resolution strategy is not liquidation. Depositors' interests during a deposit taker's failure will generally be served best if access to their accounts can be maintained without interruption. This outcome is often achieved in other jurisdictions by transferring insured deposit accounts from a failed entity to a healthy acquiring financial institution, together with matching assets to which the insurer may legitimately contribute from the deposit insurance fund. The potential use of insurance funds in this way is discussed further in Chapter 8.

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[45] Receivership, voluntary administration, and the compromises regime remain options for dealing with going concern issues for distressed deposit takers. However, these insolvency regimes are not listed here as they would be instigated under other legislation (namely the Receiverships Act (receivership), Part 15A of the Companies Act (voluntary administration), and Parts 14 and 15 of the Companies Act (compromises). It is unlikely that the Reserve Bank would be in a position to instigate any of these regimes directly in respect of a distressed deposit taker.

There is no proposal to visit these other regimes as part of the Review, although it may consider the need for consequential amendments to the receivership regime and, possibly, the voluntary administration regime depending on the outcome of the regulatory perimeter discussion. The Reserve Bank will need to deal with the possibility of receivership, and potentially voluntary administration, as part of ensuring resolution preparedness and exercising resolution powers in the event of the failure of a small deposit taker.

A resolution strategy could comprise a combination of several of the above resolution powers and tools – in the same way that the Reserve Bank's existing OBR policy is based on the existing statutory management tool, the moratorium on claims and the ability to lift partially the moratorium and suspend payments, and government guarantees (all of which will continue to be available in the new framework).

Consultation Document 2B proposed rebalancing the role of the Minister of Finance in crisis management, with less involvement in early intervention processes where a Minister is less likely to be able to add value and the Reserve Bank may need to act quickly, and more involvement where a Minister has a stronger interest, such as being consulted on an impending resolution strategy, approving commitments of public funds, and having the power to direct the Reserve Bank when public funds are at risk. Further work on these proposals and a framework for the potential use of public funds in a resolution will be progressed in parallel with the current consultation.

Resolving different types of deposit taker

Not all deposit takers are alike. They can have different operating models, funding structures, and failure scenarios. A range of resolution options is required to meet a range of circumstances. Having the above range of resolution options and supporting tools in the Reserve Bank's resolution toolkit enables the Reserve Bank to develop resolution strategies suited to the circumstances of particular deposit takers.

For example, the failure of a small deposit taker may most effectively be dealt with through a liquidation process, with insured depositors either being paid out by the deposit insurer or having their accounts transferred to a healthy deposit taker for continuous account access.

On the other hand, placing a large, more complex deposit taker into liquidation may not be in the public interest due to the interconnectedness of the banking system (the insolvency of one bank can cause widespread problems in financial markets) and the range of essential services it provides to customers and other industries. Disruption to these services could have serious repercussions for the economy.

Instead, a large deposit taker may need to be resolved in an open state and using resolution tools that return it quickly to an appropriately capitalised and viable state. The addition of the statutory bail-in power to the resolution toolkit is intended to help the Reserve Bank resolve a large deposit taker by making use of the failed entity's own investor and creditor liabilities, reducing what would likely otherwise be a reliance on taxpayer support.

That said, credible reliance on statutory bail-in powers requires liabilities of an appropriate type and size to be available for bailing in, and bail-in will not be suitable for all deposit takers. The Reserve Bank will need to determine which resolution approach best suits each deposit taker.

Remaining issues and options

Many other elements of the crisis management framework, including details of some of the above in-principle decisions already made, remain to be worked through. Not all can be included in this consultation document. Some will be progressed with targeted stakeholder engagement where possible.

This document seeks views on the following further aspects of crisis management and bank resolution:

1) Conditions for placing a deposit taker into resolution
2) Liabilities that would be subject to statutory bail-in
3) The statutory management advisory committee
4) Resolving credit unions and building societies
5) The application to deposit takers of the CIMA statutory management provisions

7.1 Conditions for placing a deposit taker into resolution

Resolution involves the use of statutory powers that may interfere with normal shareholder and creditor rights. 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.

The Review is proposing that appropriate, internationally-recognised safeguards be put in place to protect creditor rights. Nevertheless, 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 or to address a material threat to financial stability. The special nature and purpose of resolution powers suggests 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.

Resolution is fundamentally about addressing non-viability. 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.

Proposed approach 7.1: *both a non-viability test and a necessity test should be met for a deposit taker to be placed in resolution.*

The Review proposes that resolution powers and tools should only be used when a deposit taker's viability or continued authorisation to operate is at risk. Resolution powers and tools comprise the statutory resolution options described in Figure 7.1, such as bail-in, transfer to a purchaser, a bridge bank, or an asset management vehicle, supported by other tools and resources such as statutory

management. Other tools are available to deal with prudential concerns that are not actual threats to a deposit taker's viability.

The FSB Key Attributes of Effective Resolution Regimes for Financial Institutions advises that:

> *Resolution should be initiated when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so. The resolution regime should provide for timely and early entry into resolution before a firm is balance-sheet insolvent and before all equity has been fully wiped out. There should be clear standards or suitable indicators of non-viability to help guide decisions on whether firms meet the conditions for entry into resolution.*

Exercising resolution powers should also be a last-resort intervention by authorities – to be employed only when it is not reasonably likely that any action outside resolution will be able to solve the problems presented by the deposit taker in a timely manner. The conditions for entry into resolution should strike a balance between avoiding placing the deposit taker into resolution before all realistic alternative options have been exhausted on one hand (e.g. the application of pre-resolution intervention powers and/or a private-sector solution), and the need to act swiftly and decisively (and potentially on limited information) to minimise losses and damage to the financial system and economy on the other.

The Review proposes that, in order to place a deposit taker into resolution, the Reserve Bank must be satisfied on reasonable grounds that both a non-viability test and a necessity test have been met:[46]

- **Non-viability** occurs when one or more of the following applies to the deposit taker —
    a. The value of the deposit taker's assets is or is likely soon to be less than the value of its liabilities
    b. The deposit taker is unable or likely to become unable to pay its debts as they fall due
    c. The deposit taker has contravened a condition with which it must comply, or failed to meet a criterion, to be a registered deposit-taker and, as a consequence, de-licensing by the Reserve Bank would be warranted

- The **necessity** condition is met when there is no reasonable prospect of the non-viable deposit taker being remedied outside resolution to the satisfaction of the resolution authority.

Part (c) of the non-viability test is intended to include circumstances where a deposit taker may be solvent but not considered viable for the purposes of maintaining its license to operate. The criterion also captures what might currently be captured by the Reserve Bank Act's section 113(1)(e) (that is, that the business has not been or is not being conducted in a prudent manner), but in a way that is more transparent and grounded in a rationale that warrants a deposit taker being placed into resolution. A deposit taker that faces de-licensing also faces exiting the deposit-taking business, in the same way that a deposit taker that fails financially might. Any scenario of an abrupt exit should

[46] A similar approach is taken in the UK. See, for example, The Bank of England's approach to resolution, 2017, p. 14.

trigger an intervention to ensure an orderly resolution process and to minimise risks to depositors and the wider financial system.

Where appropriate, the Reserve Bank could publish further guidance on the indicators that would likely lead to a determination of non-viability under part (c) above.[47]

The Review notes that the introduction of new statutory objectives for the Reserve Bank would replace the constraint on the exercise of resolution powers currently contained in section 68 of the Reserve Bank Act, particularly the requirement that powers conferred on the Reserve Bank shall be exercised for the purposes of "avoiding significant damage to the financial system that could result from the failure of a registered bank".

Rather than operating as a constraint on the use of powers, the new resolution objectives (as outlined in the introduction section of this chapter) will function more as outcomes that the Reserve Bank will be required to seek to achieve in using its resolution powers. The combined effect of the Reserve Bank's new statutory resolution functions and objectives would make it clear that the Reserve Bank would need to exercise its resolution authority function in the failure or expected failure of any licensed deposit taker, not just systemically important ones.

Question for consultation

7.A What are your views on the proposed triggers for placing a deposit taker into resolution and exercising resolution powers?

7.2 Liabilities that would be subject to statutory bail-in

Under the current legislative framework, the Reserve Bank has developed its OBR policy using a combination of existing resolution tools provided under the statutory management framework. This mechanism envisages some liabilities being partially frozen under the moratorium on claims and, through a combination of transfer powers and the eventual liquidation of the rump entity, losses being born by shareholders and the creditors whose liabilities were frozen. This mechanism provides a basis for an indirect (that is, through a liquidation process) write-down of creditor claims. However, there is currently no mechanism to write-down claims directly, nor is there a legal mechanism through which an entity can be recapitalised by the resolution authority using the bank's own resources.

Statutory bail-in is intended to address this gap by providing the Reserve Bank with the ability to write down or convert to equity certain unsecured liabilities. The objective of bail-in is to provide an option, under certain circumstances, for restoring the viability of a distressed deposit taker, enabling it to continue as an open and operating legal entity without relying on external capital or public funds. Bail-in therefore provides a mechanism to both impose losses on, and recapitalise an entity

[47] For example, the Reserve Bank's recent capital review decision notes that, if banks have total capital below 9 percent of their risk weighted assets, Tier 1 capital below 7 percent, or common equity capital below 4.5 percent, they will be in breach of their conditions of registration and may be deemed non-viable by the Reserve Bank. See Capital Review: Decisions 2019, Reserve Bank of New Zealand, p. 20.

using the resources of, the entity's investors and unsecured creditors, rather than taxpayers. Before bail-in would be executed, any outstanding losses would need to be absorbed by existing shareholders.

One of the goals of the review of the crisis management regime is to provide the Reserve Bank with a broad and flexible set of powers with which to formulate and execute robust resolution plans for all regulated deposit takers. As such, it is proposed that the legislation provide a high-level statutory power to bail-in (through write-down or conversion) liabilities of a failed deposit taker. It is recognised that this is a sweeping power, but its use will be restricted by the objectives of the resolution framework, and creditors will be protected by the introduction of the NCWO safeguard, with insured depositors protected by the deposit insurance scheme.

For bail-in to be a credible and orderly resolution option, it is essential that there is *ex ante* transparency on the scope of bail-in. 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 recommend that resolution regimes clearly define the scope of instruments and liabilities to which statutory bail-in could be applied.

It is proposed that the scope of statutory bail-in powers be specified in regulations made by the Governor-General (by Order in Council). The regulations are expected to be made soon after the Deposit Takers Act is enacted. This consultation seeks views on the general approach that should be taken in relation to the liability types that could be subject to statutory bail-in, including whether uninsured deposits would be included or excluded. Consideration of the scope of bail-in will inform related decisions such as whether to give insured depositors a preference in the creditor hierarchy ahead of other unsecured creditors.

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 UK and Canada. The UK takes what might be called a broad, 'negative list' approach, where all liabilities are included except those on a negative list. The UK's negative list can be summarised as:[48]

- 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.

[48] See section 48B(8) of the Banking Act 2009, as inserted by Schedule 2 of the Financial Services (Banking Reform) Act 2013 for the full description.

In contrast, Canada's approach is to specify a more targeted, relatively short positive list of liabilities subject to statutory bail-in. The list comprises:[49]

- 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).

The bail-in framework in Canada applies only to the six domestic systemically important banks.

In general, 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.

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 – but could potentially result in a very small pool of bail-inable liabilities unless the Reserve Bank required minimum issuance levels/amounts (e.g. through guidance or standards).

Treatment of unprotected deposits and depositors

The broad approach (such as that in the UK) technically makes uninsured deposits subject to statutory bail-in. However, the Bank of England's approach to ensuring that regulated entities meet the EU's 'Minimum Requirement for own funds and Eligible Liabilities' with sufficient and appropriately subordinated debt instruments means that uninsured deposits are, in practice, unlikely ever to be bailed in.

The targeted approach (such as Canada's) enables deposits – whether insured or not – to be unambiguously excluded from the scope of statutory bail-in.

Another approach is to have uninsured deposits technically available to be bailed in, but placed higher in the bail-in hierarchy so that, in practice – and where there are sufficient liabilities lower in the hierarchy – they are unlikely ever to be bailed in. Switzerland, for example, ranks categories of creditors for the purposes of statutory bail-in, and places uninsured deposits higher in the hierarchy (last in line for bail-in).

Excluding deposits from bail-in explicitly or rendering them difficult to reach through special placement in the bail-in hierarchy recognises the practical challenges that a resolution authority may

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[49] See Bank Recapitalization (Bail-in) Conversion Regulations, SOR/2018-57.

face in creating new shareholders out of a large number of retail depositors. In addition, many of these retail depositors may not be well-positioned to perform the role of new owners of a failed deposit taker.

On the other hand, including uninsured deposits on an equal basis with other unsecured liabilities theoretically creates a large potential pool of financial resources to recapitalise a failed deposit taker, but in practice this could make executing a bail-in-based resolution challenging for authorities.

This consultation seeks views on which approach would be best for New Zealand, noting 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 pay-out of insured deposits may be more suitable.

Other points to note on statutory bail-in

Financial institutions subject to statutory bail-in in both Europe and Canada (and other jurisdictions) are required to include in contractual documentation for relevant liability instruments terms that bind the liability holders to accept the domestic statutory bail-in powers and the jurisdiction of the domestic authorities. Such terms have become common internationally as a means to address the issue of having domestic bail-in laws recognised in respect of liabilities issued under foreign law. The Review will need to consider whether similar requirements are appropriate for New Zealand, and whether any such requirement should be mandatory under statute or subject to a Reserve Bank prudential standard on an as-required basis.

Recognising that statutory bail-in may make deposit takers’ debt products more complex for investors, the FMA and MBIE may need to consider new FMC Act disclosure requirements that would alert investors that such products could be bailed in. Any changes to FMC disclosure requirements would follow appropriate consultation once the scope of bail-in is clear.

A decision will also be needed on whether statutory bail-in should have retroactive application – that is, whether existing liabilities could be subject to bail-in or only those entered into after the enactment of empowering legislation. Retroactive application would mean that existing investors and creditors potentially subject to bail-in would not have been able to price the risk of bail-in into their decision-making at the time of making their investments. Non-retroactivity would enable all relevant investors and creditors to price the risk into their decision-making, but may mean that it will take longer for an adequate pool of bail-inable liabilities to be built up.[50]

Questions for consultation

7.B What should be the scope of statutory bail-in in New Zealand? What liabilities should be expressly included or expressly excluded? How should deposits be treated?

7.C Should statutory bail-in have retrospective application?

[50] Statutory bail-in in Canada did not have retroactive application. Only instruments issued (or amended/extended) on or after September 2018 – the date on which the relevant regulations were published – are eligible for bail-in.

7.3 The statutory management advisory committee

Under the current Reserve Bank Act (section 119), the Minister of Finance may, on the recommendation of the Reserve Bank, appoint an advisory committee when a bank or an associated person is subject to statutory management.

The Act has relatively little specification on the advisory committee's purpose. It states only that the committee is to advise the statutory manager on the conduct of the statutory management, including the exercise of powers conferred on the statutory manager by the Act.

The Act does not specify the advisory committee's composition, other than to provide for the Reserve Bank to determine the composition through a recommendation to the Minister of Finance.

In the context of the Reserve Bank being formally designated as the resolution authority for licensed deposit takers and responsible for exercising crisis management powers, and when a statutory manager has all the powers of an entity's management (including, presumably, the power to appoint advisers), the question arises whether there is still a need for statutory ministerial powers to appoint an advisory committee to a statutory manager.

If so, it may be desirable for legislation to be clearer on the purpose of the committee and, importantly, give guidance on its composition. This consultation seeks views on the statutory role and composition of the advisory committee.

Originally (under the Reserve Bank of New Zealand Amendment Act 1986), the committee was required to include relevant trustee representation to address the unease of some Members of Parliament with a statutory manager's ability to override creditor rights.[51] This suggests a creditor representation intention, which fell away by the time of the 1989 Act as the role of trustees in New Zealand's banking system became less mainstream. The resulting vanilla model has not been without criticism.[52]

On the other hand, the introduction of creditor safeguards through the availability of NCWO compensation may make redundant the need for creditor representation on the advisory committee, or at least provide, on balance, an adequate protection of creditor interests considering the complexities that would exist in ensuring meaningful creditor representation on the committee.

Questions for consultation

7.D Is there still a role for a ministerially-appointed advisory committee to a statutory manager? If so, should legislation be more specific about the purpose and the composition of that committee?

[51] New Zealand Parliamentary Debates, 1986, pp. 6068-6069.

[52] The Law Commission noted in 2001: "As an insolvency procedure, statutory management is neither transparent nor accountable. The decision making process whereby a corporation is placed in statutory management is confidential and interested parties are not entitled to be heard as of right; nor do they have a right to see the material on which the decision is based, nor are they able to challenge the decision except on the limited basis of judicial review." Law Commission, Insolvency Law Reform: Promoting Trust and Confidence, May 2001, p. 91. Members of the legal profession also raised this issue of advisory committee representation during the Review's recent stakeholder engagement.

7.4 Resolving credit unions and building societies

Under the proposed single deposit taker regime (where banks and NBDTs will be integrated into the same framework), the Reserve Bank will become the resolution authority for credit unions and building societies.

Mutual building societies and credit unions ('financial cooperatives') present particular resolution challenges because of their membership-based business and ownership models and the limitations these models can have on accessing external capital. In addition, the Building Societies Act 1965 and the Friendly Societies and Credit Unions Act 1982 impose particular procedural requirements in relation to mergers and transfers of engagements (and, in the case of building societies, conversion to a company). These procedural requirements can make it challenging to execute quick resolution solutions.

The in-principle decision to introduce deposit insurance, where depositors can receive prompt pay-outs of insured deposits, will make the use of a closed bank resolution option (such as a normal liquidation process for failing small financial cooperatives) more credible and feasible.

However, in cases where a closed bank resolution is deemed not suitable, special legislative powers may be required to deal with the failure or impending failure of a deposit taker that has a cooperative ownership structure and business model.

Proposed approach 7.2: *the Reserve Bank has the power to demutualise a failing credit union or building society.*

Authorities in a number of other jurisdictions have powers to demutualise financial cooperatives that have entered resolution. Demutualisation can occur through converting equity into investment shares. Under demutualisation, the financial cooperative ceases its cooperative structure and is converted to another form of ownership, such as a company, where shares and ownership benefits can be held by persons other than the previous members, such as creditors and external investors.

Demutualisation is most likely to be necessary when a statutory bail-in is the preferred resolution strategy for an ailing financial cooperative. In a statutory bail-in, creditors are generally written down and receive equity in the institution as compensation, giving them ownership stakes and rights to influence the direction of the firm post-resolution and claims on any future profits. Since financial cooperatives are owned by their members, they do not have equity in the same way that a company does, meaning that bail-in without some kind of demutualisation would not work in the same way (as there are no shares to redistribute).

The UK crisis management framework provides for two approaches to demutualisation (which applies only to building societies):

- Convert the building society into a company, and
- Transfer the building society's property, rights, and liabilities to a company, such as a bridge bank set up by the resolution authority.[53]

[53] See The Building Societies (Bail-in) Order 2014.

Both methods would be managed by the Bank of England through its resolution instrument. The instrument would also protect members' deposits by converting their shares into deposits with the successor company.

The UK regime also allows the Bank of England to transfer a building society or credit union to another financial cooperative (or to a company).

With respect to building societies and credit unions in New Zealand, further work would be needed on the details of a demutualisation power for the Reserve Bank. For now, the Review seeks feedback on whether, in principle, the Reserve Bank should have the power to demutualise a building society or credit union that meets the criteria for entering resolution.

Question for consultation

7.E Should the Reserve Bank have the power to demutualise a building society or credit union that meets the criteria for being placed into resolution?

7.5 The application to deposit takers of CIMA statutory management

Registered banks are currently subject to two statutory management regimes, both of which carry resolution powers and effectively put entities 'into resolution'. One regime is under the Reserve Bank Act and the other is under CIMA (which has general application to all corporations). NBDTs are currently subject only to CIMA but, under the Phase 2 reforms, they will be brought within the Reserve Bank's crisis management regime (subject to decisions on the treatment of finance companies that do not take insured deposits – discussed in Chapter 3).

Statutory management under the Reserve Bank Act

Section 118 of the Reserve Bank Act provides for the Reserve Bank to recommend that a registered bank be placed in statutory management if it is satisfied on reasonable grounds that one or more of the following circumstances exist:

- The registered bank or associated person is insolvent or is likely to become insolvent
- The registered bank or associated person is about to suspend payment or is unable to meet its obligations as and when they fall due
- The affairs of the registered bank or associated person are being conducted in a manner prejudicial to the soundness of the financial system
- The circumstances of the registered bank or associated person are such as to be prejudicial to the soundness of the financial system
- The business of the registered bank has not been, or is not being, conducted in a prudent manner
- The registered bank or associated person has failed to comply with a Reserve Bank direction

Statutory management under CIMA

Section 38 of CIMA provides for the FMA to make a recommendation to the Minister of Commerce and Consumer Affairs to place a corporation under statutory management. Section 8 states that the FMA can only make a recommendation in relation to a registered bank or NBDT after consulting with the Reserve Bank.

In summary, under section 39 of CIMA, the FMA can recommend statutory management to the Minister where the FMA is satisfied that, either:

a. the corporation is or may be operating fraudulently or recklessly and statutory management is desirable for the purpose of:

   - limiting or preventing the risk of further deterioration in the corporation's financial affairs, or
   - limiting or preventing the carrying out, or the effects of, any fraudulent act or activity, or
   - enabling the corporation's affairs to be dealt with in a more orderly or expeditious way

or

b. statutory management is desirable for the purpose of:

   - preserving the interests of the corporation's members, creditors, or beneficiaries, or the public interest, or
   - enabling the corporation's affairs to be dealt with in a more orderly or expeditious way, and
   - if those members, creditors, or beneficiaries or the public interest cannot be adequately protected under the Companies Act 1993 or in any other lawful way (see also section 4 CIMA).

Issues with the status quo

The Review considers that having two resolution regimes creates a degree of uncertainty as to the applicable regime for deposit takers, their investors, and their creditors (notwithstanding the requirement for the FMA to consult the Reserve Bank before recommending to its Minister that a deposit taker be put into statutory management under CIMA). Having two resolution regimes does not align well with the objectives of the review of the crisis management and resolution framework. These objectives include:

- providing greater clarity and certainty for stakeholders on how a failed or failing deposit taker would be dealt with by authorities, and
- ensuring that there is a clear resolution authority responsible for dealing with failed or failing deposit takers with clear resolution objectives.

According to some stakeholder feedback so far in this Review, the potential application of two separate statutory management regimes to New Zealand's prudentially regulated entities is not well understood internationally, especially by foreign banking counterparties.

In addition, statutory management under CIMA lacks crucial resolution tools that are recommended in the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions and will be available to the Reserve Bank. Banks and other deposit takers are now widely recognised as requiring resolution regimes that reflect their special nature in terms of their roles in the financial system and the potential destabilising effect of a disorderly failure. The lack of tools under CIMA may increase the probability of taxpayer support being required, which could carry substantial fiscal costs and undermine key prudential principles designed to reduce moral hazard risk.

Moreover, the statutory management and resolution of deposit takers are essentially prudential issues. It is not clear that there is a case for a conduct regulator to be able to invoke such measures if they are available to the prudential regulator. The prudential implications of CIMA statutory management are particularly apparent with the automatic close-out of financial contracts and the suspension from the payments system that would likely ensue.

Options

Given the Review's proposal to bring the Reserve Bank's crisis management and resolution regime into line with the international direction and guidance for resolving distressed financial institutions, the Review proposes that licensed deposit takers should not continue to also face the prospect of statutory management and resolution under CIMA overseen by a different regulator.

The Review has considered two options for creating a single statutory management and resolution regime for deposit takers under the Reserve Bank. The two options have the following common features:

- Registered banks and NBDTs would be removed from the scope of CIMA statutory management.
- The Reserve Bank would be responsible for making a recommendation to the Minister of Finance to place a licensed deposit taker into statutory management. The Minister of Commerce and Consumer Affairs would no longer have any functions.
- The FMA and the Registrar of Companies would continue to be able to exercise other powers under CIMA in relation to licensed deposit takers, including the powers to declare a corporation at risk (section 30), to give advice and assistance (section 32), and to direct a corporation declared at risk under section 30 (section 33) and appointing investigators (section 19).

The options would differ in the following ways:

Option 1: The existing grounds under the Reserve Bank Act would be the only grounds for placing a deposit taker into statutory management (subject to any wording adjustments necessary to reflect the purposes and objectives of the Deposit Takers Act).

Option 2: In addition to retaining the existing Reserve Bank Act grounds for statutory management, the Reserve Bank could place a deposit taker into statutory management under the CIMA grounds on the recommendation of the FMA.

An argument in favour of option 1 is that any conduct by a deposit taker that would be of sufficient gravity to warrant statutory management under either limb of CIMA's section 39 would likely necessarily also go to prudential soundness.[54] Such conduct will therefore also be of concern to the prudential regulator and likely captured by one of the existing criteria for Reserve Bank statutory management with the Reserve Bank motivated to intervene on prudential grounds.

An argument in favour of option 2 is that it may not be possible to ensure that the Reserve Bank criteria are sufficiently broad to cover the full range of circumstances provided for under section 39 of CIMA. There is, therefore, a risk under option 1 that the scope of the depositor, creditor, and particularly the broad public interest protections currently available under CIMA would be inadvertently narrowed. If that were the case, then under option 1 neither the FMA nor the Reserve Bank may have the power to deal with unusual and unexpected matters that are currently covered by the CIMA grounds. They could, however, be dealt with under option 2.

There remains a theoretical possibility under either option as well as under the status quo that, having exhausted its other existing tools, the FMA forms a view that grounds exist for placing a deposit taker into statutory management but the Reserve Bank does not share that view. However, New Zealand's deposit takers are regulated under the twin peaks model, where there is a prudential regulator (the Reserve Bank) and a market conduct regulator (the FMA). Accordingly, the FMA and the Reserve Bank cannot realistically act in isolation from each other. This is reflected in other aspects of the wider financial regulatory framework (for example, in relation to licensing decisions).

The Review seeks views on the general question of whether deposit takers should be subject to only one statutory management and resolution regime and on the two options set out above.

Questions for consultation

7.F Do you agree that deposit takers should only be subject to one statutory management and resolution regime?

7.G Do you favour option 1, option 2, or some other approach (including the status quo)?

[54] Placing an entity into statutory management under either regime would be a significant intervention and interference with property rights that would demand a correspondingly high threshold. A high threshold would be especially necessary in the case of a deposit taker due to the prudential consequences of statutory management, including the automatic early termination of financial contracts and the likely suspension of the deposit taker from the payments system.

Summary

This chapter has discussed and seeks feedback on a selected number of additional issues being considered in the development of a reformed crisis management and resolution regime. Other crisis management and resolution issues are being progressed in parallel with this consultation and will be the subject of targeted stakeholder consultation where possible.

Several of the issues presented here are important for ensuring that the new regime provides appropriate clarity and transparency as to when resolution powers will be triggered and by whom. In particular:

- the grounds for statutory management and being placed into resolution
- the scope of a new statutory bail-in power
- how a failing financial cooperative could potentially be resolved by the Reserve Bank outside its placement into liquidation.

Chapter 8: Depositor protection

Introduction and progress to date

The Government plans to introduce a deposit insurance scheme in New Zealand, with some **in-principle decisions** on its design announced in December 2019 (see the Review Update).

Under the scheme, deposits in New Zealand will be protected up to a total of $50,000 per depositor, per deposit taker. It is estimated that more than 90 percent of depositors will likely be fully covered by the $50,000 coverage limit; those seeking more insurance coverage will be able to acquire it by placing deposits at multiple deposit takers.

New Zealand's depositor protection regime will provide insured depositors with certain and prompt access to their funds in the event that their deposit taker fails. Deposit insurance will introduce an explicit promise of protection for these investments. There will be a clear boundary between insured products and other types of investment products that tend to offer both higher risks and higher returns (Figure 8.1).

The scheme's objective will be to protect depositors from loss, and in doing so, contribute to financial stability. The deposit insurance scheme will work together with the prudential regulation and resolution tools discussed earlier in the document:

- Deposit insurance will support public confidence in deposit takers, thereby improving the stability of the funding base of deposit takers. In turn, prudential regulation and supervision – such as minimum capital and liquidity requirements – reduces the expected cost of providing deposit insurance, by increasing the soundness of deposit takers. Prudential regulation and supervision can also help to manage any increase in risk-taking resulting from the introduction of deposit insurance.
- Deposit insurance contributes to the credibility of resolution tools, making it more likely that failed deposit takers will be resolved without taxpayer bailouts. Insured deposits will be protected regardless of whether the chosen resolution strategy is a liquidation, open resolution or purchase and assumption by a competitor. However, the choices of the resolution authority will affect both the timing and the scale of the deposit insurer's funding obligations.

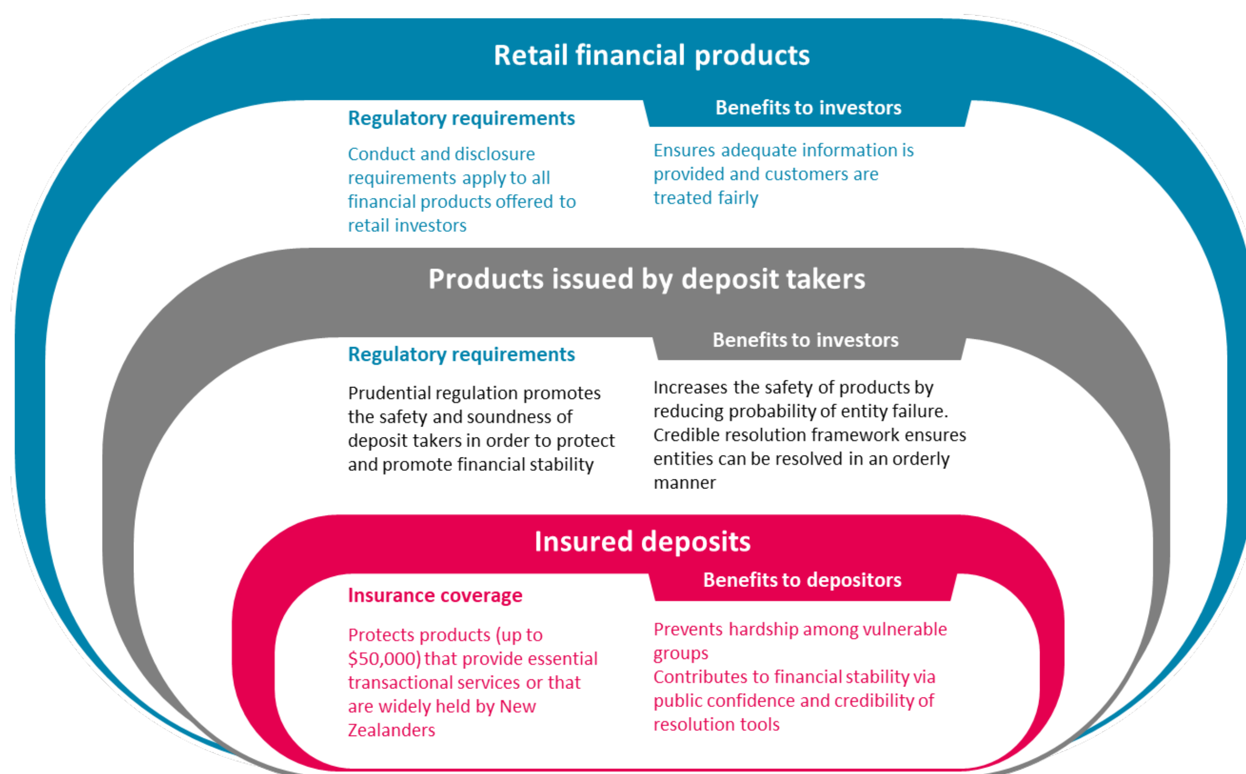
Chapter 8 Overview

- ✓ Formal deposit insurance with a **$50,000** limit
- ✓ Funded by a levy on deposit takers, with a Government backstop
- What products should be insured?
- How should insurance be funded?
- Who should administer the insurance scheme?
- What role should the insurer have?
- Should depositors have preference in resolution?

✓ Key decisions taken by Cabinet

▪ Key remaining issues to be covered in the current consultation

Figure 8.1: Regulatory and insurance protections applying to retail financial products



The first section of this chapter assesses whether deposit insurance should be complemented by a ‘depositor preference’, and the potential scope of such a preference regime. A depositor preference would mean that depositors’ claims on a failed deposit taker are paid out before the claims of other general unsecured creditors. Introducing depositor preference would increase the amount of money that the deposit insurer could expect to recover from a failed deposit taker, as it would assume the claims of depositors in liquidation. It would also have implications for the crisis management framework, including by increasing the losses that would be borne by other unsecured creditors in a failure.

The rest of the chapter focuses on design aspects of the scheme that require Cabinet approval before moving to legislative drafting:

- The **scope** of the financial products and institutions that should be covered by the scheme
- The **mandate and functions** of the deposit insurer once the scheme is in place
- How the deposit insurer should be **governed** in light of those functions and the degree of independence required from the government and the rest of the financial safety net
- The arrangements needed to ensure that the scheme can **fund** its potential deposit insurance payout obligations.

Deposit insurance will be developed and introduced alongside the other elements of the prudential framework discussed in this document, with full implementation currently 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.

Box A at the end of this chapter estimates the size of the insurance schemes exposures and its potential impacts on depositors and industry under a range of possible calibrations of the final scheme. While the scheme's final design has not yet been settled, the analysis in Box A will help stakeholders to better understand the questions that will be addressed in future consultation, and inform the regulatory impact statement that will accompany the scheme's creation in legislation.

8.1 Depositor preference

Option 1*: introduce a preference for insured depositors as part of the deposit insurance scheme*

Option 2*: depositors continue to rank equally with other unsecured creditors in the event of the liquidation of a deposit taker (the status quo)*

Depositor preference has already been discussed in previous consultation documents. However, the Government wishes to undertake further consultation on this issue given the apparent fine balance of the costs and benefits of introducing depositor preference relative to the status quo. While the introduction of depositor preference would increase the recoveries of the deposit insurer in liquidation and may increase the market discipline applied by providers of non-deposit funding, it could also increase the ongoing costs of non-deposit funding for deposit takers, which may be passed on to depositors and borrowers.

Depositor preference is achieved by altering the legal hierarchy of claims in a liquidation to rank depositors above other general unsecured creditors (depositors currently rank equally with these other general unsecured creditors). Under a depositor preference regime, depositors, or the deposit insurance scheme representing them, would receive the proceeds of liquidation before other general unsecured creditors and shareholders, who would rank below them in the creditor hierarchy. Depositor preference could be introduced by adding a new class of preferential creditors to Schedule 7 of the Companies Act (and, to the extent applicable, other relevant legislation).

In the wake of the GFC, a number of jurisdictions have reformed their depositor protection schemes, and this has included supplementing deposit insurance with depositor preference (for example, both the EU and the UK have introduced preference regimes). At the end of 2013, 62 of 99 deposit insurers reported to the International Association of Deposit Insurers (IADI) that they had some form of depositor preference in their jurisdictions.

Responses to previous submissions were fairly evenly divided on the merits of introducing depositor preference. Some of those in support of depositor preference mentioned that the depositors of credit unions already rank ahead of other unsecured creditors and a preference would enhance market discipline for other deposit takers. However, a number of banks and the New Zealand Bankers Association noted that depositor preference could significantly increase the cost of wholesale funding, particularly for small banks. Some submitters also said they were opposed to increasing the complexity of New Zealand's creditor hierarchy.

If depositor preference is introduced in New Zealand, it is proposed that it will only apply to insured depositors. The alternative options are to prefer both insured and uninsured depositors equally; or to prefer insured depositors above uninsured depositors and uninsured depositors above general

unsecured creditors. Limiting the scope to insured deposits would maximise the deposit insurer's recoveries in a failure (as insured depositors would rank above all other general unsecured creditors) and limit the risk of unintended impacts from the introduction of preference. For deposit takers that obtain the vast majority of their funding from deposits, preferring all deposits would produce little benefit for depositors (as these institutions have very few non-deposit creditors).

There are a number of factors to consider in assessing insured depositor preference relative to the status quo:

- **Deposit insurance scheme recoveries:** by increasing the deposit insurance scheme's recoveries in liquidation, a preference would reduce the need for exceptional levies on scheme members after a deposit insurance payout, when the surviving industry may also be under stress. However, under the status quo, the deposit insurer would still be able to fully recover the cost of any deposit insurance payouts in the long run given its power to levy premiums on scheme members.
- **Adding to market discipline:** by allocating losses more towards other unsecured creditors, who may be more sophisticated (institutional) investors, the introduction of depositor preference could increase the incentives for these investors to monitor the risk profile of deposit takers.
- **Reducing supply of non-deposit funding**: non-preferred investors may demand significantly higher compensation for this additional loss exposure, and could lose interest in such debt entirely if compensation were not provided. Some banks have noted that institutional investors are concerned about the impacts of depositor preference on the cost and availability of wholesale funding. This risk is especially relevant in light of the existence of covered bonds that reduce assets available in the event of a failure, and the planned introduction of residential mortgage-backed securities in the market.
- **Concentrating losses on non-preferred creditors:** the increased losses in a failure for uninsured creditors could create hardship for retail investors who have deposits above the $50,000 limit, potentially increasing the political economy challenge of resolving a deposit taker. There is also the risk of increased contagion during periods of financial stress as non-preferred creditors become more aware of the extent of losses that would be applied to them.
- **Impacts on small deposit takers:** a preference could create (or exacerbate) an uneven playing field between deposit takers that are more structurally reliant on deposit funding and those that aren't. Deposit-reliant institutions could find it even harder/costlier to issue wholesale debt, which could constrain their opportunities for growth.
- **Interactions with the resolution framework:** the introduction of depositor preference could add complexity by creating an additional class of creditors. On the other hand, introducing depositor preference could simplify resolution options that involve the transfer of deposits to a new entity, as this can be done without affecting the hierarchy of creditors in the failed entity. The nature of any preference for depositors would also have interactions with the potential bail-in framework and NCWO payments.

In summary, a preference for insured depositors has the benefit of increasing recoveries to the deposit insurer from a failed deposit taker and would potentially strengthen market discipline applying to deposit takers. However, the introduction of preference could reduce the supply of non-deposit funding, create additional risks associated with concentrating losses on non-preferred creditors, and disproportionately affect small deposit takers. In addition, the increase in recoveries to the deposit insurer under a preference might not be relevant in the long run because of the deposit insurer's ability to levy premiums on its members.

Questions for consultation

8.A What are your views on the benefits and costs of a preference for insured depositors compared to no preference?

8.B If a preference for depositors is introduced, do you agree it should only cover insured deposits (not all deposits)?

8.2 Scope of coverage

Cabinet has decided to limit coverage of deposit insurance to a maximum of $50,000 held by a depositor at a single institution. This section defines the financial products that will qualify for the deposit insurance scheme, with the aim of clearly differentiating these from uninsured products. The scope of products that are subject to deposit insurance will influence the range of products available to investors, and their levels of safety and returns.

As announced in the December 2019 Review Update, membership of the deposit insurance scheme will be compulsory for licensed deposit-takers. This means institutions that are able to offer insured deposits will be subject to a minimum level of prudential regulation and supervision, which may in turn help to monitor and limit any increase in risk-taking among licensed entities due to the provision of insurance. Chapter 3 discusses the boundary for which entities are licensed as deposit takers:

- Section 3.1 proposes that banks operating as branches be licensed as a class of deposit taker. However, the branches' provision of retail deposits could potentially create risks for depositors and the insurance scheme, especially where the existence of depositor preference in a branch's home jurisdiction would reduce recoveries in the event of failure.
- Section 3.2 discusses whether finance companies should be licensed as deposit takers. If finance companies are licensed as deposit takers (and are permitted to take insured deposits), the continuation of their current higher risk business model could potentially increase risks to the deposit insurer.

To the extent that some institutions with the ability to offer insured deposits pose risks to financial stability and/or the deposit insurer, there will be measures available to the Reserve Bank to mitigate such risks. These will range from applying more scrutiny to an entity's risk management processes as part of prudential supervision, to using licence conditions to place restrictions on its ability to take deposits (the latter approach is currently used to prevent some branches from taking retail deposits). The insurer can also help to manage the risk-taking of deposit takers by charging differential levies based on risk (this proposal is discussed in section 8.5).

Financial products covered

Proposed approach 8.1: *the deposit insurance regime should cover prescribed types of basic deposit products, such as transactional accounts, on-call savings accounts, term deposits and redeemable shares offered by financial cooperatives.*

This section discusses the financial products that should be treated as eligible deposits under the insurance scheme. 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. On the other hand, a model where higher-risk products are not insured may be less credible under a stress environment.

Deposits have unique features in that the deposit taking entity is required to repay the unpaid credit balance on demand or within a specified timeframe following that demand, and they are offered by entities that undertake maturity transformation (i.e. their lending has a much longer maturity than their deposit and other funding). For these reasons, investments such as KiwiSaver funds, equities and annuities are outside the scope of deposit insurance. Table 8.1 (overleaf) lists the main product categories that fit this definition, and their key features.

The case for including a financial product in the insurance regime depends on:

- **The degree of information asymmetries:** there is a stronger case for protecting investors if it is difficult to assess a product's underlying risk (for example, due to its complexity). Information asymmetries are particularly likely where products are offered to retail investors, who typically have fewer resources and financial capabilities to assess risk than wholesale investors.
- **Whether it is used for everyday spending:** some financial products provide transactional services that are necessary for customers' participation in the financial system and wider economy. The significant hardship that would be experienced by customers if these services were unavailable strengthens the case for their protection.
- **Its contribution to financial stability:** there is a stronger case for including products that are widely held by New Zealanders as they are more likely than other products to destabilise the financial system if they are subject to a 'run' by their depositors. A failure to protect widely held products could also undermine the resolution regime's credibility.
- **Its ease of measurement:** to implement deposit insurance, deposit takers will need to identify eligible deposits. A boundary that is readily measureable will significantly reduce the implementation costs for deposit takers. An easily identifiable boundary will also support public understanding of the regime.

There is a strong case that transaction and on-call savings accounts, redeemable shares offered by financial cooperatives and term deposits meet the criteria for inclusion in the deposit insurance scheme. These products can be easily opened by retail customers; are widely held by New Zealanders; can be readily identified and measured by deposit takers; and, with the exception of term deposits, are primarily used for everyday spending. PIE deposits would be eligible for

coverage on the basis that they are ultimately investments in the eligible products.[55] Making these products eligible for deposit insurance is consistent with the FMC Act, where these products are exempt from product disclosure requirements due to their lower risk and complexity.

Table 8.1: Comparison of financial products offered to retail investors

Product	Summary	Disclosure requirement	Typical return	Share of retail liabilities
Transactional accounts	Used to undertake everyday transactions; offered by banks, credit unions and building societies	Prudential requirements for entities offering these products*	Very low	Large
Redeemable shares offered by financial cooperatives	Similar to transactional accounts except they confer an ownership stake in the firm offering the shares	As above	Very low	Small
On-call savings accounts	Similar to a transaction account except that higher returns are provided if the money is not spent	As above	Low	Large
Term deposits	A retail savings product with a fixed term, where it is more difficult to withdraw before maturity.	As above	Medium	Large
PIE deposits	Tax efficient vehicles used by retail investors to enhance returns on deposits. The portfolio investment entity (PIE) invests in the deposits of the issuing entity	As above	Medium to high	Medium
Retail bonds, debentures and capital notes	Retail investment products that can be on-sold after purchase, and that may have more complex features such as different levels of security of subordination	Product disclosure requirements under FMC Act	Higher	Small

* Registered banks are required to publish disclosure statements covering their financial position and compliance with regulatory requirements. The Reserve Bank also publishes information on the financial position of individual banks on its *Financial Strength Dashboard.* Credit unions and building societies are currently subject to product disclosure requirements under the FMC Act, but this will likely change if they become licensed deposit takers (see chapter 3).

55 The detailed rules for coverage of PIE products will be covered in future consultation. The treatment of PIEs may "look through" the PIE structure to determine ownership of the individual deposit accounts held by the PIE. This approach would require deposit takers to be able to identify the ownership structure of their PIEs.

It is proposed that investments in other types of retail debt securities, such as bonds, debentures and capital notes, are not eligible for deposit insurance coverage. These debt securities are typically offered as higher-risk (and higher-return) products; excluding them from the insurance regime would allow them to continue to fulfil this role in the market. They also do not provide transactional services, are not widely held by the general public and can have complex features such as differing levels of security and subordination. It is also uncommon for these sorts of debt securities to be included in overseas insurance schemes.

Regardless of the specific boundary for insured products, public awareness of which products are and are not insured will be a critical determinant of the effectiveness of the scheme. The product disclosure regime will need to be reviewed prior to the introduction of deposit insurance, so that there is clear signalling to retail investors where t products are not insured, and the level of coverage available for products that are insured. This may require changes to the product disclosure requirements specified in the FMC Act, and additional requirements to make depositors' insurance coverage levels clear. As discussed in Chapter 3, public awareness could also be promoted by preventing products that are not insured being marketed as deposits. Finally, section 8.3 discusses whether the insurer should be made responsible for promoting public awareness of the scheme.

It is proposed that insured products be set out in regulations, so that the list of eligible products can be updated and adjusted to reflect changes to product offerings. Licensed deposit takers would be expected to notify the insurer when issuing new financial products, with the possibility of the deposit insurer engaging further with those deposit takers (if necessary) to understand the product features. The final drafting of the products eligible for deposit insurance will be consulted on when these regulations are developed. Future consultation will also look at the treatment of joint accounts, complex deposit types (such as accounts held by trusts), and customers who have temporarily high balances at the time of failure due to certain life events.

Questions for consultation

8.C Do you agree with the proposed prescribed product approach for coverage under the new scheme? If not, what approach would you suggest?

Exclusions from the deposit regime

Proposed approach 8.2: *foreign currency deposits, deposits held by related parties, and interbank deposits should not be eligible for deposit insurance.*

A key question is whether wholesale depositors (i.e. large/institutional depositors) should be able to access the $50,000 protection proposed for the future insurance scheme. Excluding wholesale depositors is consistent with the Government's intention to protect investors who do not have the resources to monitor their deposit taker(s) actively. In reducing the size of the insured depositor base, it would also reduce the dollar amount of levies and levels of fiscal risk associated with the scheme. However, excluding wholesale depositors would likely create complexity and additional costs for deposit takers, especially given that the industry currently has no standardised approach to identifying wholesale deposits.

At this stage, a simple and comprehensive treatment is the preferred option. Both wholesale and retail investors would be able to access insurance coverage by investing in the prescribed deposit products that are eligible for insurance. The exceptions would be deposit products that do not align

with the objectives of depositor protection and whose exclusion would not materially reduce the effectiveness of the deposit insurance scheme:

- Foreign currency deposits (these are not widely held and would give rise to foreign exchange risk for the insurer)
- Deposits held by related parties or connected persons as defined by the Reserve Bank's Connected Exposures Policy (BS8)
- Interbank deposits and deposits from other financial institutions, as they provide market discipline and are sophisticated enough to assess risks.

Questions for consultation

8.D Do you agree that both retail and wholesale investors in insured deposit products should be covered up to the $50,000 coverage limit? If not, what approach would you suggest?

8.E Is the list of excluded deposit products appropriate? If not, what approach would you suggest?

8.3 Mandate, powers and additional objectives

The mandate of the deposit insurer will determine the functions it is expected to undertake to achieve its objective. The deposit insurer should have powers commensurate with the scope of its mandate.

Narrow mandate

Proposed approach 8.3: *the deposit insurance scheme should focus on a narrow role of ensuring that protected depositors can access their funds promptly after a failure. The deposit insurer should not duplicate the supervision and resolution functions of the Reserve Bank.*

It is proposed that the deposit insurer have a narrow mandate focused on protecting depositors in the event of a failure, regardless of the resolution tool used. This would avoid a duplication of the Reserve Bank's functions as supervisor and resolution authority (notwithstanding that the deposit insurer could be located within the Reserve Bank).[56] Table 8.2 lists the functions that New Zealand's deposit insurer would be expected to undertake to fulfil the proposed mandate.

[56] Some deposit insurers directly supervise member institutions and have an active role in determining the most appropriate resolution tool to deal with a failed deposit taker, and in some cases also operate as the designated, sole, resolution authority.

Table 8.2 Deposit insurer powers and functions (fulfil the proposed mandate)

Before resolution (business as usual)	
1	Require member institutions to have the systems in place necessary to determine insured deposits at a single customer view level, and to test systems regularly.
2	Require member institutions to have systems necessary to transfer insured deposits to other deposit takers.
3	Share information with the supervisor/resolution authority, including supervisory reports on deposit takers.
4	Have deterrent/enforcement mechanisms that promote member compliance with requirements relating to deposit insurance.
5	Ensure adequate funding mechanisms. Collect member premiums and manage the deposit insurance fund (if ex ante funding exists), and have access to backup funding.
6	Provide advice/recommendations on the deposit insurance scheme, including the appropriate coverage limit and the target size for the deposit insurance fund (if ex ante funding exists).
7	Promote understanding of the scheme among depositors as part of contributing to financial stability (see proposed approach 8.5).
During and after resolution	
8	Ensure that insured depositors are protected regardless of the resolution tool used (e.g. a purchase and assumption by a competitor).
9	Assume the claims of insured depositors in liquidation (subrogation rights).

Question for consultation

8.F Do you agree with the proposed narrow mandate for the deposit insurer?

Role in supporting resolution tools other than liquidation

Proposed approach 8.4: *the deposit insurer should be able to provide funding for resolution options (other than deposit insurance payouts) that protect insured depositors. However, there should be adequate safeguards to ensure that the use of such funds is consistent with the scheme's objectives and that shareholders and other creditors bear losses as appropriate.*

The traditional role of deposit insurers has been to pay out insured depositors when deposit takers are closed and liquidated. However, liquidation is just one of the tools available to the resolution authority. Depositors will benefit from the protections committed to by the government regardless of the resolution tool used. For example, insured depositors would be fully protected if the Reserve Bank recommended that the deposit taker be resolved using its Open Bank Resolution (OBR) tool.

It is unlikely that the resolution authority would choose to liquidate and pay out depositors of one of the large, systemically important banks, given the enormous disruption this would cause to New Zealand's financial system and economy. It is also possible that liquidation would not be the

preferred option for resolving small and medium sized deposit takers. Ensuring that the deposit insurer has the ability to use funds to support resolution tools other than liquidation is one of IADI's Core Principles for Effective Deposit Insurance Systems (see principle 9).

Additionally, allowing the deposit insurer to contribute funds to support the use of resolution tools other than liquidation could result in better outcomes for all parties. For example, another deposit taker may wish to acquire the insured deposits and certain assets of a failed deposit taker. In such a case, the deposit insurer could provide cash or other assets to increase the likelihood of this transaction proceeding, potentially resulting in a seamless transition for insured depositors, at lower cost (than a deposit insurance payout) to the deposit insurer.

If it is decided that the deposit insurer can use funds for resolution tools other than a liquidation, it is suggested that appropriate safeguards be implemented to ensure that the use of these funds is consistent with the protection of insured depositors and enhancing market discipline. IADI's *Core Principles* contain a list of safeguards that could be introduced by the deposit insurance scheme, which include:

- the use of the deposit insurer's funds is transparent and documented, and is clearly and formally specified
- where a deposit taker is resolved through a resolution process other than liquidation, the resolution results in a viable, solvent and restructured entity, which limits the exposure of the deposit insurer to contribute additional funding in respect of the same obligation
- 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
- contributions are not used for the recapitalisation of resolved institutions unless shareholders' interests are reduced to zero and uninsured, unsecured creditors are subject to losses in accordance with the legal claim priority
- the use of the deposit insurer's funds is subject to an independent audit and the results reported back to the deposit insurer.

Giving the resolution authority an explicit objective to protect depositors and to use insurance funds in the most efficient way might also strengthen the safeguards. All else being equal, the objective would direct the resolution authority to use resolution options that deliver better outcomes for insured depositors.

Questions for consultation

8.G Do you agree that the deposit insurer should be able to provide funding for resolutions other than a liquidation?

8.H If yes, do you agree with the limit on the amount of funds that can be used? What are your views on the appropriate safeguards?

Decision-making authority and process for reviewing scheme settings

Feedback is sought on who should set the coverage limit, target fund size and levies for the insurance scheme, and on the process for reviewing these parameters over time. Elements of the deposit insurance scheme could be prescribed in legislation (under the control of Parliament), regulations (under the control of the minister), or be set at the discretion of the deposit insurer. The following principles are relevant when designing the decision authority:

- Decisions with significant distributional, fiscal or political consequences may be better suited to ministerial control, or even require parliamentary approval.
- The government should be making a credible and durable commitment to protect depositors up to the pre-announced level.
- There should be robust review processes to ensure the scheme's settings remain appropriate in light of changes to the financial system.

The appropriate degree of independence for the deposit insurer in delivering its day-to-day functions is discussed further in section 8.4.

The coverage limit is a key feature of the scheme that has significant impacts on protected depositors, uninsured creditors, and the Crown balance sheet. Any proposed changes to the coverage should therefore be subject to ministerial or parliamentary control. Placing the limit in legislation would create a more thorough process for changing the coverage limit, which would support the government to make a credible and durable commitment to protect depositors up to the prescribed level.

The target fund size and resulting levies on industry would have direct impacts on deposit taker profitability and pricing, and indirect fiscal implications. One model would be for these features to be set in regulations, similar to the approach used for funding the Earthquake Commission. To provide more certainty for industry around future premiums and reduce the risk of lobbying, the legislation could set out the criteria that should guide these decisions, and potentially direct the minister to have regard to the advice of the deposit insurer. An alternative model would be for the insurer to set the levies, and potentially even the target fund size, if the decision-making criteria can be specified tightly enough to justify delegating these powers to an independent regulator.

A robust process for review of the schemes parameters, and whether it is achieving its objective, would support the durability of the scheme. Regular reviews (e.g. every five or 10 years) could be required by legislation, with the agency tasked with stewardship of the scheme or the deposit insurer producing public recommendations. A transparent review process should reduce the uncertainty for investors associated with possible changes in the coverage limit.[57]

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[57] Increases in the coverage limit would have especially significant implications for uninsured creditors if deposit preference is introduced (higher coverage for insured depositors would reduce the assets available to these investors in the event of failure).

Questions for consultation

8.I What are your views on the appropriate decision authority for the coverage limit?

8.J If a deposit insurance fund is established, should changes to the target size and the levies be made by ministers via regulations or by the deposit insurer itself?

8.K Should there be a legislated requirement to review the deposit insurance scheme? If so, how often should it be reviewed (e.g., every five years)?

Additional guidance to support the deposit insurer's objective

Proposed approach 8.5: *a target timeframe for reimbursing insured depositors (or making insured deposits available) should be specified in regulation. The insurer is expected to promote public awareness as part of its objective of protecting depositors and thereby contributing to financial stability.*

The deposit insurer's objective is to protect depositors, and in so doing, contribute to financial stability. Additional guidance could be provided to the deposit insurer, possibly in regulation. For example, the deposit insurer could be provided with guidance to encourage prompt depositor reimbursement and promote public awareness of depositor protection.

Promptly reimbursing depositors: as continued access to banking services (funds) is a priority for ordinary depositors, it is essential that the deposit insurer reimburse them, or provide them with access to their funds, as soon as possible. Many schemes have reduced their target payout period in recent years in response to the lessons from the GFC.[58] Emerging international practice is for payment to be made in seven days or less in the event of liquidation, although there may be a transitional period required when the scheme is first put in place. The target payout could be set in regulation and updated (presumably shortened) in light of technological change. The Reserve Bank expects that funds would be available the following business day if its OBR tool were used.

Public awareness: depositors need to be aware of the existence of deposit insurance in order for it to deliver the expected benefits for public confidence and the credibility of the resolution regime. For this reason, the implementation of the scheme is expected to be accompanied by an extensive public awareness campaign. The objective of the insurer already provides it with an incentive to monitor and support public awareness on an ongoing basis (for example, by maintaining accessible public information on the products covered by the scheme). It appears unnecessary to task the insurer with a specific sub-objective to promote public awareness of deposit insurance. The insurer would be expected to work closely with existing agencies tasked with financial capability in fulfilling its public awareness role.

[58] Almost all schemes have targeted payout period. Canada aims for partial payment within five days and full payment of most accounts within 14 days. The US Federal Deposit Insurance Corporation has the shortest targeted period, with the ability to make full payments within the next business day. In the UK, the Financial Services Compensation Scheme has a target to repay the majority of depositors within seven days.

8.4 Institutional arrangements

***Proposed Approach 8.6:** the insurer is located within the Reserve Bank, given the high costs of setting up a stand-alone entity, the proposed narrow mandate of the insurer, and the synergies with the resolution, policy making and statistical functions of the Reserve Bank.*

This section considers appropriate arrangements for the deposit insurer's institutional location and governance. The arrangements will be considered in light of the insurer's narrow mandate, and its role as part of the wider financial safety net (see Figure 1 of the executive summary). Deposit insurance will need to work alongside other elements of the safety net – prudential regulation and supervision, resolution and lender of last resort – that will be the responsibility of the Reserve Bank Board.

Criteria for the deposit insurer's location

The insurer could be located in an existing organisation such as the Reserve Bank or the Treasury, or be a stand-alone entity. The choice of location should be guided by the following considerations:

- **Operational independence from government:** operational independence means the deposit insurer is able to fulfil its mandate without interference from external parties to. Although the decision rights for some foundational aspects of the scheme should remain with ministers (see section 8.3), it is desirable for the insurer's day-to-day functions to be executed at arm's length from ministers. Operational independence also enhances the regime's credibility because the functions delegated to the insurer can be executed rapidly in a crisis, without the influence of short-term political interests.

- **Cooperation within the safety net:** it is important that safety net players share information and cooperate, particularly in times of crisis. Arrangements must be designed to promote collaboration, given that the participants have different powers and tools to achieve their respective mandates.

- **Start-up costs and ongoing efficiencies:** the insurer should be able to execute its functions while minimising costs for the taxpayer, taking into account its narrow mandate and New Zealand's small size. The potential for synergies with functions performed by an existing institution should be considered. Costs can potentially be lowered by outsourcing some functions of the scheme to other organisations.[59]

- **Accountability and transparency:** the deposit insurer should be operationally equipped and ready to perform its role in resolution. Its accountability and transparency can enhance the likelihood that the insurer is adequately resourced and performs its functions effectively.

These considerations are in line with guidance from IADI, which states that the deposit insurer should be operationally independent, well-governed, transparent and accountable.

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[59] A *virtual team* could be created whereby the deposit insurer pre-positions formal arrangements with a pool of experts or external resources, for example in the areas of Information Technology, data analytics (for testing) and paying agents (processing of claims), that could be tapped as and when required in carrying out the deposit insurance function.

If the insurer is located within an existing entity, it is expected that there would be processes in place to allow separate financial reporting for the deposit insurer. In addition, the government may desire to introduce safeguards that ensure the deposit insurance function receives adequate attention and resourcing and that decision-making for levies (if the insurer has decision rights for levies) and the management of insurance funds is sufficiently independent of the rest of the organisation. One way to achieve this is to create a statutory officer with independent decision rights for deposit insurance. The statutory officer would be appointed, and removed if necessary, by the Board of the organisation.

There are many models used in overseas jurisdictions: the Australian deposit insurance scheme is hosted by the prudential regulator; both the US-Federal Deposit Insurance Corporation and the Canadian Deposit Insurance Corporation are standalone legal entities (both entities are also resolution authorities and the Federal Deposit Insurance Corporation has supervision responsibilities); and the deposit insurer in Sweden is located in the Debt Management Office of the Ministry of Finance, which is also the resolution authority.

Analysis of institutional arrangements

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.
- The model can be activated relatively quickly given the Reserve Bank's existing relationships with the deposit-taking sector, its understanding of the regulation drafting process and its knowledge of deposit takers' information systems.
- The Reserve Bank will be designated as the resolution authority, and co-location would support strong information flows to the deposit insurer in a crisis.

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 governance framework that is being implemented as part of the Phase 2 review. The Board could be required to 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.

New Zealand Treasury

The Treasury is a contender for housing the insurance scheme given the scheme's significant implications for public funds and the fact that the scheme's functions involve managing levies collected from industry. The Treasury already has expertise in managing the funding of other contingent liabilities of the Crown, such as those of Earthquake Commission, and it also operated the Crown Retail Deposit Guarantee Scheme during the GFC.

To undertake the deposit insurance function, the Treasury would need to receive information from the Reserve Bank, and would likely rely on the Reserve Bank in setting the mechanics to operationalise the scheme. These issues are discussed further in the analysis of the stand-alone entity model below.

Standalone entity

This is a fully resourced, operationally independent deposit insurer set up as a stand-alone entity of the Crown. The entity would have its own decision-making body, powers, accountability and transparency processes and staff. This model would maximise the focus of decision makers on the functions of the deposit insurance, and the accountability and transparency of the insurer in undertaking those functions.

However, a stand-alone entity would likely result in higher costs compared to housing the deposit insurer within an existing entity. This reflects the fact that there would be less scope for sharing functions (such as human resources and information technology) and additional costs for enhanced accountability and transparency (such as performance reporting). Given the insurer's narrow mandate and its likely need for fewer than 10 staff, it is questionable whether establishing a legally separate and fully resourced entity is warranted.

If all the functions of a deposit insurance scheme were housed within a separate standalone entity (or the Treasury), substantial work would be required to create an operational model for legislation. For example, legislation may need to consider:

- ensuring unfettered access to regulatory information including the right to request confidential information from the Reserve Bank and/or potentially industry
- an ability to set regulatory requirements for system and other changes such as formats for deposit insurance data
- an ability to require actions from the Reserve Bank such as the issuance of directions to preposition banks' IT systems.

Alternatively, relevant agencies may enter into agreements in lieu of or to supplement legislated provisions. The legally separate, stand-alone entity would need its own Act to establish its powers, and its decision-making, accountability and transparency processes. This could potentially slow the process for introducing deposit insurance in New Zealand.

The need to develop separate powers for the Treasury and/or a stand-alone entity could be limited by having the Reserve Bank maintain its responsibility for requiring deposit takers to provide accurate and reliable deposit information for the purpose of calculating insured deposits in accordance with regulation. However, this model carries risks in that it splits accountability for delivering deposit insurance and creates the potential for some important functions to slip between the cracks.

Summary of pros and cons

Table 8.3 summarises the pros and cons of the three models. The preferred option is to locate the insurer within the Reserve Bank, primarily due to synergies and better coordination with the Reserve Bank's existing functions. Creating a new stand-alone entity is inconsistent with the narrow mandate of the insurer and the Government's desire to reduce fragmentation in the public sector.

Table 8.3 Summary of pros and cons of different locations for the deposit insurer

	Reserve Bank	Treasury	Stand-alone Crown entity
Safety net cooperation and synergies (technical skills, experience, expertise)	++	-	-
Safety net conflicts	-	+	+
Operational independence from Minister	++	--	++
Start-up and ongoing costs; duplication of resources	++	--	--
Accountability and transparency	+	--	++

Questions for consultation

8.L Has the Review identified the appropriate criteria for assessing the best organisational form of the insurer?

8.M Do you agree that the insurer should be located within the Reserve Bank? If not, what approach would you suggest?

8.5 Funding framework

A core function of New Zealand's deposit insurance scheme will be to make timely deposit insurance payouts to the insured depositors of a failed depositor taker.

The Government has announced the following in-principle decisions related to the scheme's funding framework:

- The scheme will be fully funded by levies on deposit-taking institutions.[60]
- The Crown will provide the scheme with a funding backstop (Government guarantee), which will ensure that the scheme can meet its obligations to insured depositors.

[60] These levies will be sufficient to fund the deposit insurance scheme's operating expenses (e.g. staff costs, premises, office expenses) and make deposit insurance payouts. While the deposit insurance scheme may enter a deficit position from time to time, particularly following a deposit insurance payout(s), insurance premiums collected from scheme members will be used to eliminate this deficit "over time.

To further develop the scheme's funding framework, a number of additional key design decisions will need to be made, including:

- whether resources that would be used for a deposit insurance payout will be: collected in advance of a deposit taker failure through the establishment of a deposit insurance fund (ex ante funding); obtained after a failure has occurred (ex post funding); or obtained via a combination of both
- if ex ante funding is desired, whether the scheme's premium rates will be adjusted according to the risks that members are assessed as posing to the scheme (i.e. a risk-based, or 'differential' premium system)[61]
- on what base (dollar) amount the scheme's premium rates would be applied (e.g. total insured deposits or total deposits) and how often premiums would be paid (e.g. quarterly, bi-annually or annually)
- if ex ante funding is desired, the target amount of such funding (i.e., the fund's target size)[62]
- the operational approach for the Crown's funding backstop.

The existence and calibration of a deposit insurance fund

Proposed approach 8.7: *the insurer should use a combination of ex ante and ex post levies from deposit takers to fund the deposit insurance scheme's obligations.*

It is proposed that the deposit insurance scheme establish a deposit insurance fund in order to help promote depositor confidence in the scheme's ability to fulfil its payout obligations in the event of a member failure and to reduce the amount of funds the government may need to provide in a failure scenario. In addition, under an *ex ante* funding model, scheme members that ultimately fail and require deposit insurance payouts would have partially contributed to the cost of these payouts. By contrast, under an entirely *ex post* funding model, only the surviving deposit takers would incur the payout costs of a failed deposit taker. Finally, there may be practical limitations to how much and how quickly scheme members could pay premiums after a stress event, particularly if they are in poor financial condition themselves.

It is proposed that a 'target size' be established for the deposit insurance fund, and that the appropriate target size be subject to further consultation. It is envisioned that the factors used to determine the target size of the deposit insurance fund would include:

- the 'severe, but plausible' failure scenario that the Reserve Bank, as the resolution authority, believes the deposit insurance scheme should be prepared for (recognising that this scenario could involve the concurrent failure of several deposit takers of various sizes,

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[61] The distinction between a 'risk-based' and 'differential' premiums system is based on the extent to which one believes such a system is truly capable of measuring risk accurately. Some deposit insurers prefer to use the term 'differential' rather than 'risk-based' in order to acknowledge the limitations of truly being able to measure risk with such a system.

[62] Once the fund's target amount is reached, authorities would need to determine whether the scheme should continue to collect premiums from members to recover its operating costs or possibly to build the fund above its target. It is possible that, by that time, interest income earned on the fund will be sufficient to cover the scheme's operating costs. However, it may still be desirable to levy premiums on scheme members using a differential premium system to ensure fairness among members.

and that the size of the deposit insurer's obligation for each failed deposit taker would not necessarily depend on the amount of insured deposits of each deposit taker, but also on the resolution tool used to resolve each deposit taker[63]);

- the ability of the deposit insurer to obtain (borrow) funds, if and when needed (recognising that it may be more challenging for the deposit insurer to borrow large amounts quickly)[64];
- acknowledgement that funds held in the deposit insurance fund – which would most likely be held in either cash and/or low-yield government bonds – could otherwise be used by deposit takers themselves for more productive purposes, such as lending to the economy.

Box A shows the results of some initial modelling of the fund's required size under various assumptions, and how the target fund size could affect industry, the Crown and depositors.

Proposed approach 8.8: *the scheme should ultimately, but not immediately, use a risk-based (or differential) premium system to levy scheme member premiums.*

As scheme members will pose different levels of payout risk to the deposit insurer, it is proposed that the scheme adopt a differential premiums system (DPS) to assess member premiums. This approach would be consistent with the common insurance industry practice of pricing insurance according to risk. For example, auto insurance premiums are usually higher for young drivers than for older ones given that, historically, young drivers have been more likely than older drivers to be involved in automobile accidents.

While the scheme could also levy premiums using a single, flat premium rate, this would be unfair to members who pose lower levels of risks to the scheme (they would effectively be subsidising higher-risk members in funding the scheme). Alongside the prudential supervision of deposit takers, a DPS could help manage the moral hazard impacts of the scheme by discouraging the flow of insured deposits to high risk firms from other, safer deposit takers.

In practice, however, it is acknowledged that some level of cross-subsidisation of scheme members would occur even with a DPS, as the members would likely be grouped into a limited number of 'risk' categories (e.g. three to five categories). As such, it is possible that scheme members posing somewhat different levels of risk will be grouped into the same 'risk' category.

Given that the implementation of a DPS would require consultation prior to implementation, and the deposit insurance scheme is targeted to be operational in 2023, the specific approach to risk-based pricing will be subject to further public consultation.

Proposed approach 8.9: *levies should be based on each scheme member's insured deposits as a base, and member premiums should be levied annually.*

Given that the exposure each member poses to the deposit insurance scheme is the amount of their insured deposits, it is proposed that their premiums be levied on the amount of those deposits (as measured once per year). This approach is widely used by deposit insurers internationally. An

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[63] As insured depositors would be protected from loss under an Open Bank Resolution, the deposit insurance scheme may also have a payout obligation if this resolution tool is used, although the timing of this obligation may not be as acute as that of a deposit insurance payout.

[64] The deposit insurance scheme's need to borrow funds quickly would depend on how quickly it aims to reimburse insured depositors after a deposit taker has failed.

alternative approach would be to levy premiums according to the total amount of deposits (insured and uninsured deposits); however, this approach would be a less precise measure of the exposure members pose to the scheme.

Proposed approach 8.10: *the insurer would pay a fee for access to the Crown backstop and any borrowing would become an obligation of the scheme and be repaid by members, with interest, over time.*

While it is proposed that the fund amount be adequate to pay out insured deposits in the event of a severe, but plausible, failure scenario, more severe events are possible, and would require the scheme to obtain additional funding to meet its payout obligations. With this in mind, it is proposed that the scheme have the legislated ability to borrow additional funding from the Crown, if needed, consistent with the in-principle decision that the Crown will backstop the deposit insurance scheme. This borrowing would become an obligation of the scheme and would be repaid by scheme members, with interest, over time. The scheme could also pay the Crown a fee for the benefit of having access to the Crown backstop. Without this ability to borrow from the Crown, it is possible that the scheme would not have adequate resources to fulfil its obligation to insured depositors.

However, it should be noted that there may be practical limitations to how much the Crown can provide to the scheme in a short time frame, given the small size of the government debt market and other stresses the economy could be facing at that time. Officials are working to design an operational approach to the backstop that would enable the Crown to provide sufficient funding to the scheme to ensure prompt payouts to insured depositors.

Questions for consultation

8.N Do you agree that the insurer should build a deposit insurance fund ahead of a failure? If not, what approach would you suggest?

8.O What are your views on the appropriate size of any deposit insurance fund?

8.P Should the insurer charge higher levies to higher risk deposit takers? What are your views on how risk should be assessed?

8.Q What are your views on how the Government funding backstop should be designed?

Summary

This chapter has outlined proposals for delivering on the Government's commitment to introduce deposit insurance. It is proposed that investors in transaction accounts, savings accounts, term deposits and redeemable shares provided by financial cooperatives will be eligible for the protection. Together with the perimeter of prudential regulation discussed in Chapter 3, the scope of protection will influence the range of products available to retail investors, and their safety and returns.

The deposit insurer is expected to play a narrow role in putting in place the infrastructure needed for depositors to have access to protected funds promptly after a failure. As discussed in Chapter 7, the resolution authority would make decisions on when and how to resolve a failing entity. It is proposed that the deposit insurance function be performed by the Reserve Bank, as this would deliver cost efficiencies and synergies.

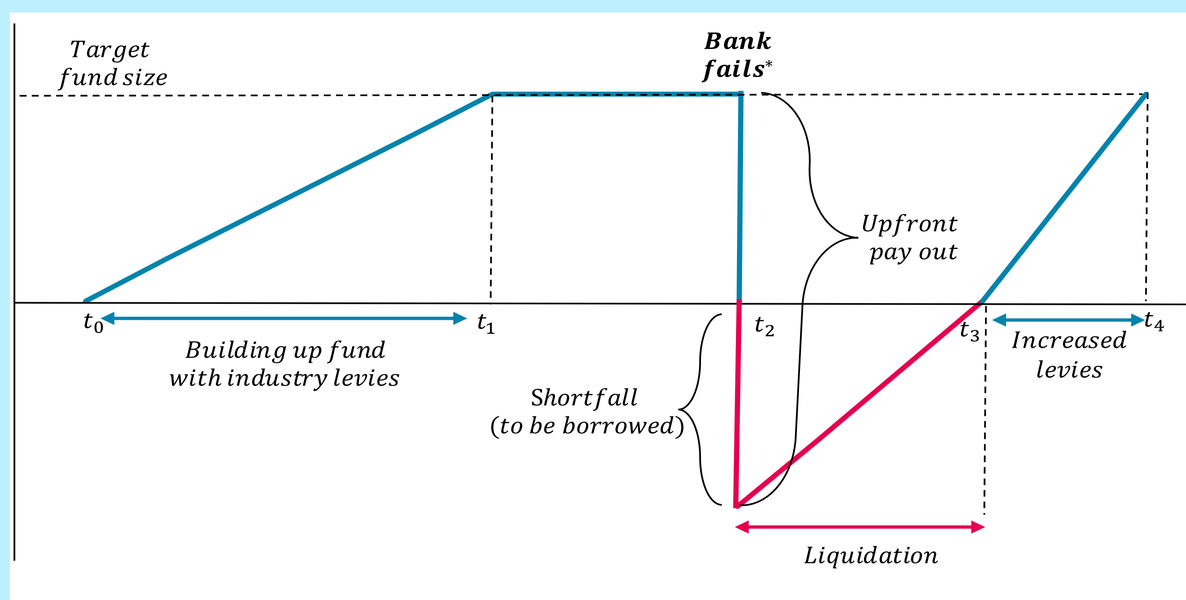
It is critical that there be adequate arrangements in place to fund the commitments of the deposit insurer. The chapter outlines proposed funding arrangements, including that a deposit insurance fund will be created ahead of a failure through levies charged to deposit takers. The Government is also seeking feedback on whether to introduce a preference for deposits, which would reduce the need to charge additional levies after a failure.

Box: Building a deposit insurance fund

In order for the deposit insurer to be able to fulfil its proposed objective "to protect depositors, and in doing so, contribute to financial stability" the deposit insurer will need to either have adequate financial resources available or a mechanism whereby funds can be obtained readily. The methodology and rationale for determining the fund size is a critical component for the legitimacy of the scheme. This Box considers the indicative target fund size and provides indications of how the target fund will affect levies charged for insurance.

Figure B1 demonstrates how the target fund size would affect the costs of establishing the scheme, and how the costs of a deposit taker failure would be distributed. There is an opportunity cost to building up a large target fund, as the funds would be invested in low-yield, highly liquid assets. Pre-funding would enhance the public confidence in the deposit insurance scheme and reduces the need for the scheme to temporarily access public funds. Higher target funding also reduces the potential need for the deposit insurance scheme to impose higher levies on surviving deposit insurance scheme members in the period after a failure event.

Figure B1: Example timeline of deposit insurance fund



Note: The example presented here shows a deposit taker being resolved through liquidation. There would be a range of other resolution options available to the Reserve Bank that would look different to the diagram presented above. For example, in an open resolution, the deposit insurer may contribute towards the costs of resolution and would not be expected to pay out all insured deposits of the failing member. In addition, the deposit insurance scheme is likely to have a longer time to pay out in an open resolution, if a payout is required at all.

The implementation of deposit insurance represents a shift from an uncertain implicit guarantee to a managed explicit guarantee. An implicit guarantee arises from the revealed preference of governments to not impose losses on creditors, particularly depositors, in a crisis and therefore assist banks during crisis periods. The amount covered by such an implicit guarantee is uncertain, but results in an effective subsidy on bank's debt funding. The subsidy is 'paid' for by taxpayers to the benefit of banks and potentially their customers. The new deposit insurance scheme will manage the government's liability and ensures that the beneficiaries of the insurance (member institutions and potentially depositors) pay for it.

Determining the target fund size

Unlike with 'standard' insurance, it is particularly difficult to determine the likelihood of deposit takers failing and the deposit insurance scheme's exposure in such an event with a reasonable degree of certainty– inputs that would help to determine a target fund size using a statistical approach – particularly in New Zealand where deposit taker failures are infrequent, sporadic and largely unpredictable. For this reason, many countries opt for a more simplistic approach, setting the target fund to a level sufficient to cover a particular failure scenario and/or the failure of particular banks. There is a wide range of fund sizes internationally, ranging from 0.25-15 percent of insured deposits.[65]

Two key factors for determining the fund size include:

- **the availability and adequacy of DIS borrowing**: In a liquidation, the deposit insurance scheme would promptly payout insured deposits. If there are adequate arrangements in place for the Government funding backstop, it may not be necessary to create a target fund that is large enough to cover the entire amount of the deposit insurance payout. Instead, the deposit insurance scheme would borrow from the Crown, with repayment (including interest) made from recoveries on assets from the failed member and, if necessary, from higher-than-normal levies on surviving members. However, as noted earlier, there are practical limitations to charging deposit insurance scheme members higher premiums after a stress event.
- **the resolution authority's preferred resolution method for different deposit takers**: In the case of a failure of a large deposit taker the deposit insurance scheme would likely protect depositors by supporting another resolution tool, such as the Reserve Bank's Open Bank Resolution (OBR) tool. Under such a resolution, the deposit insurance scheme may make a contribution towards the cost of resolution and would not be expected to pay out all the insured deposits of the member. The deposit insurance scheme is also likely to have more time to raise any funding for a shortfall when using resolution tools other than liquidation.

Table 1: Estimated deposit insurance pay out by bank size

	Prompt payout in a liquidation ($ billion, (% insured deposits))	Maximum payout for alternative resolution tools ($ billion, (% insured deposits))
Large bank failure	-	$1.1 (1.0%)
Medium bank failure	$2.8 (2.4%)	$0.4 (0.4%)
Small bank failure	$0.1 (0.1%)	$0.01 (0.01%)
Non-bank deposit taker failure	$0.2 (0.1%)	$0.04 (0.03%)

Note: Deposit takers are classed into four groups: a 'large bank' is represented by the average of the Big Four systemic banks; a 'medium bank' is represented by the average of non-systemic banks with insured deposits over $1 billion; a 'small bank' is represented by the average of all other banks; 'non-bank deposit takers' are represented by the average of all non-bank deposit takers. The loss given default for different entity sizes are 15% for a large bank, 25% for a medium bank, 25% for a small bank and 35% for a non-bank deposit taker.

[65] Results from a 2018 IADI survey, the average fund size for small open economies is around 0.8 percent and around 1.0 percent for advanced economies.

Table 1 illustrates the obligations that could arise for the deposit insurance scheme under a liquidation and other resolution tools. If there was uncertainty around the availability of backstop liquidity and a preference for liquidation as a resolution tool for non-systemic deposit takers, the deposit insurer may want to pre-fund the obligation arising from the *liquidation* of two medium-sized banks, or one medium-sized bank and several small banks or non-bank deposit takers – a fund size of around 5 percent of insured deposits. Conversely, with adequate liquidity and a preference for other resolution tools over a liquidation for larger banks the deposit insurer may want to pre-fund the obligation that could arise from the *open resolution* of one large bank or two medium banks – a fund size of around 1 percent of insured deposits.

Depositor preference

Insured depositor preference would influence the likely exposure of the fund to losses from failing members. A preference for insured depositors would concentrate losses on other creditors that rank below insured depositors meaning that in many cases, the deposit insurer would face smaller losses. Smaller losses would imply a smaller target fund size, provided backstop liquidity was available.[66] However, the benefit of needing a lower fund size with depositor preference needs to be weighed against the other implications of depositor preference (see section 8.1).

Cost of the fund

The following analysis explores the costs of establishing a deposit insurance fund of between 1-5 percent of insured deposits over a period of 5-20 years (Table 2). A common approach for other countries is to build up the fund over 5-10 years. For a 2 percent fund size built up over 10 years, the levy on a $10,000 deposit would be $22 per year during the time the fund is being built up. If this was not passed onto the depositor (by the deposit-taker), it would reduce industry profits by around 5% each year in that transition period. It is most likely the levy would partially impact depositors and partly industry.

Table 2: Indicative costs of deposit insurance by fund size and time to build

Fund size (percent of insured deposits)	Annual basis point levy on insured deposits				Annual average share of industry profits			
	Years to build fund							
	5	10	15	20	5	10	15	20
1	21	11	8	6	4.7%	2.6%	1.9%	1.6%
2	42	22	16	13	9.4%	5.2%	3.8%	3.2%
3	63	33	24	19	14.2%	7.8%	5.8%	4.8%
4	84	45	32	25	18.9%	10.4%	7.7%	6.4%
5	105	56	39	31	23.6%	13.0%	9.6%	7.9%

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 (3-year average). Industry profits are estimated assuming a 1.0% annual return on assets and 4.4% annual asset growth (10-year averages). The value of deposits covered is assumed to be stable at 33% of total deposits, however deposit splitting could see this coverage ratio rise. 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).

[66] The prompt payout required in a liquidation would likely be the same with or without depositor preference

These estimates show that deposit insurance is likely to come at a significant cost to deposit takers (and potentially depositors), particularly during the build-up stage or if the scheme is drawn on. To an extent, these costs can be managed through allowing longer timeframes to build up the fund, although this would result in a larger contingent liability of the Crown in the interim. As noted above, the introduction of an explicit insurance scheme will ultimately reduce the burden on taxpayers, by reducing the costs of the implicit guarantee that exists under the status quo.