

Regulatory Impact Statement: Deposit Takers Bill (Supplementary decisions)

Coversheet

Purpose of Document	
Decision sought:	Supplementary policy decisions for a new prudential framework for the regulation and supervision of deposit takers and the introduction of deposit insurance
Advising agencies:	Reserve Bank of New Zealand
Proposing Ministers:	Hon. Grant Robertson, Minister of Finance
Date finalised:	13 October 2021
Problem Definition	
<p>Cabinet agreed in April 2021 to introduce a new prudential framework for the regulation and supervision of deposit takers and to introduce deposit insurance.</p> <p>This new prudential framework responds to significant changes in the New Zealand and global financial systems since the Reserve Bank was established in its current form in 1989. It seeks to provide an enduring and trusted framework for prudential regulation that promotes financial stability and supports the economy.</p> <p>Whilst the majority of the new framework was agreed in April, some details of the resolution and crisis management regime for deposit takers remain undecided.</p> <p>In some cases the scope of powers has not been fully established. In others the details of safeguards in place over the resolution authority’s powers need further specification.</p> <p>The aim of the proposals discussed here is to finalise the resolution framework in a way that:</p> <ul style="list-style-type: none">• provides the Reserve Bank with the necessary powers for deposit taker resolution; and• creates appropriate structures of accountability and oversight to ensure those powers are used fairly, appropriately and in the public interest.	
Executive Summary	
<p>This RIS provides advice to inform the supplementary decisions that need to be made around some remaining details of the framework Cabinet has already agreed for the crisis management and resolution framework as part of the planned Deposit Takers Bill.</p> <p>Resolution powers are designed to increase authorities’ options for dealing with failing deposit takers. The failure of a financial institution can have powerful negative externalities. It can create harm for market participants (including depositors) by suspending essential services the institution provides. It can also create contagion across the financial system through the impact on asset prices and / or effects on confidence in the financial system. Without a robust resolution regime, authorities may be faced with a</p>	

stark choice between liquidation, which risks creating these effects, or the use of public funds to bail out a private institution.

A robust resolution regime allows a resolution authority to use a variety of powers to restructure failing institutions so as to protect the public interest. The resolution authority's powers have a significant impact on property rights. The resolution authority needs to be independent so that it can make decisions rapidly and without any perception of inappropriate political influence. However, since resolution is also connected to the public interest, there also need to be appropriate controls in place to ensure the transparency and accountability of its operations.

The proposals discussed in this regulatory impact statement are primarily concerned with establishing the scope of powers already agreed by Cabinet or specifying safeguards to ensure that appropriate controls are in place for the resolution authority's actions.

The proposals cover the following aspects of crisis management and resolution:

1. the resolution authority's statutory purposes and the Minister of Finance's power of Direction in relation to resolution
2. the mechanics of 'bail-in' powers to write-down creditors' claims or convert them into equity under certain circumstances
3. flexibility for the deposit insurance fund to provide larger payments to depositors who have a 'temporary high balance' due to certain prescribed events
4. safeguards for the use of deposit insurance funds to contribute to resolution costs
5. the implementation of a right for creditors to receive compensation if they are left worse off by the choice of resolution than they would have been in a liquidation (the no creditor worse off principle or NCWO)
6. limiting appeal rights relating to the use of resolution powers to judicial review
7. recovery of resolution funds through a levy
8. details of powers and controls around creating temporary or permanent stays on the exercise of certain contractual rights that might impede the ability to effectively resolve a failed deposit taker.

They also discuss (9) limits on directors' ability to obtain indemnity / insurance for any penalties imposed under the Deposit Takers Bill (including penalties unrelated to resolution and crisis management).

This regulatory impact statement and the Cabinet paper that it accompanies arrange the issues in a way that is logical given the subject matter. However, it may also be helpful to think of the proposals in terms of three broad sets of decision types:

1. the first set are largely concerned with filling out the details of pre-existing policy decisions, including appropriate safeguards:
 - safeguards on the use of deposit insurance funds (4)
 - implementation of NCWO (5)
 - clarifying the scope of appeal rights for resolution actions (6)
 - details of powers on stay and moratoria(8)
2. the second set concern issues that have emerged as the drafting and implementation process proceeded, which involve revisiting the detail of earlier decisions:
 - amending statutory resolution purposes and aligning the Minister's direction power (1)
 - reducing the ambit of planned bail-in powers (not implementing statutory bail-in) (2)

- replacing a prohibition on directors receiving indemnity or insurance in respect of penalties with restrictions on their ability to do so (9)
3. the third set involve provisions that would enable expanded powers in legislation, which would need to be specified in detail through subsequent regulations
- recovery of resolution costs through *ex post* levies (7)
 - flexibility for the deposit insurance scheme to make payments to depositors with 'temporary high balances' (3)

Statutory purposes and Minister of Finance Power of Direction

These proposals concern some minor additions to the statutory purposes the Reserve Bank should pursue in exercising its functions as resolution authority.

In the interests of clarity we have added the purposes of preserving value and resolving issues promptly. We also propose implementing a Cabinet decision on the need to preserve the creditor hierarchy (that would have existed in liquidation) by including preserving the creditor hierarchy as a statutory purpose.

Cabinet has previously decided that, given the impact that choice of resolution strategy can have on the need to use public funds, the Minister of Finance should have the power to make directions about how the Reserve Bank exercises its resolution powers. We propose that, when issuing directions, the Minister of Finance should be guided by broadly the same purposes as the resolution authority. That is to ensure that both parties are working with the same goals and considering the same trade-offs when shaping the approach to resolution.

Bail-in

Bail-in refers to the ability to write-down some creditor liabilities or convert them into equity as part of resolution, in order to recapitalise an entity in a way that reduces recourse to public funds.

Bail-in can be achieved through at least three routes:

1. through contractual clauses in loan contracts that allow write-down or conversion in specified circumstances (usually, deposit takers would be required to issue an appropriate quantity of such debt)
2. via a statutory power vested in the resolution authority
3. as part of a resolution strategy, such as the transfer of some assets and liabilities to a bridge bank

The proposal here is concerned with the second route, a statutory bail-in power. Cabinet had previously agreed that a statutory bail-in power should be introduced which could apply to all liabilities that were not expressly excluded by regulation.

We now propose that a statutory bail-in power should not be introduced at this time but the issue should be reconsidered once the Reserve Bank is further through the process of resolution planning on the basis of the new powers granted to it in the Deposit Takers Act (DTA) framework.

A statutory bail-in power would still need to operate in relation to instruments or accounts that had explicitly contemplated this possibility when they were established (either via contractual terms in the instruments or other disclosure requirements). New Zealand

contract terms do not currently contain the necessary measures. Determining which contracts or accounts should be eligible for bail-in is complex and better left until further work has been carried out on resolution planning.

In the meantime, the New Zealand capital framework contains high levels of equity (which absorb losses before bail-in is necessary). The Reserve Bank will still be empowered to reduce creditors' claims in the course of its other resolution activities (route 3) and would be in a position to implement route 2 (contractual bail-in) through standard setting (i.e., without additional primary legislation) at a later date.

Deposit insurance: payments for temporary high balances

Cabinet has agreed that deposit insurance¹ should be capped at \$100,000 per borrower, per institution. This might create hardship for borrowers with temporary high balances (THBs) due to certain life events (retirement or insurance pay-outs, sale of a house). We propose the DTA should empower regulations that would allow larger compensation for deposit takers with THBs in specified circumstances. The power would not come into force until regulations were made, which is only likely to be possible sometime after the broader deposit insurance scheme has been implemented. Public expectations will need to be managed around this issue.

Safeguards for the use of deposit insurance funds in resolution

Cabinet has already agreed that it should be possible to use resources from the deposit insurance fund to facilitate resolution where doing so produces superior results for insured depositors.

Resolution may produce superior results to liquidation for depositors. For example, it may facilitate transfer of deposits to a new institution, ensuring continuity of service. However resolution may require funding (for example, to cover the new institutions' risk in taking on deposits). Since a deposit insurance scheme's underlying purpose is depositor protection (rather than simply 'paying out in liquidation'), it makes sense to allow the scheme to deploy its funds to facilitate resolution in these circumstances, so long as the amount used in resolution is less than the amount that would have been paid to insured depositors in liquidation (the 'funding limit').

We propose that the deposit insurance scheme should not be able to contribute more than the funding limit even where it might expect to recover the excess later in resolution. We also propose a mandatory independent *ex post* review of the use of deposit insurance funds in resolution to ensure that the funding limit has not been exceeded.

This proposal provides appropriate flexibility to the resolution authority, without putting funds collected for the purposes of protecting uninsured depositors at undue risk.

No creditor worse off

The choice of resolution, rather than liquidation, may create better outcomes for creditors but it may also be pursued in order to protect the public interest in ways that adversely affect the rights of some creditors. While the resolution authority's statutory purposes oblige it to try to preserve the creditor hierarchy, financial stability interests or other

¹ At time of writing, discussions are underway as to whether to call the scheme 'deposit insurance' or 'deposit compensation' (since the latter makes it clearer that compensation is limited). Since Cabinet previously agreed 'deposit insurance', we are using that terminology in this RIS.

considerations may over-ride this hierarchy in some circumstances. In such cases it is appropriate to provide a compensation mechanism for affected creditors in recognition that property rights have been adversely affected. Cabinet has therefore agreed to a 'no creditor worse-off' (NCWO) principle under which compensation is paid to creditors where the choice of resolution leaves them worse off than they would have been under liquidation.

The proposals here set out the mechanics for the operation of this form of compensation.

We propose that:

1. all creditors and shareholders at the time an entity enters into resolution should be potentially eligible for compensation
2. an independent valuer should be appointed by the Minister of Finance to determine what compensation, if any, is required
3. determination should be made based on the difference between resources received in resolution (discounted back to the date on which resolution began) and the amount that would have been received in liquidation, disregarding any public assistance provided
4. the valuer should be given wide access to information and reports held by the Reserve Bank and deposit takers (and subject to restrictions on how such information is used)
5. determinations should be published in a report, explaining the valuations made and the valuation assumptions used
6. rights of appeal based on issues of law or the merits of the decision made should be available to creditors, the Reserve Bank and the Minister of Finance, subject to a three month time limit to enable certainty of resolution outcomes
7. the Crown should pay compensation in order to enhance credibility of the mechanism and the deposit insurance fund should be able to contribute, subject to appropriate safeguards

We considered allowing the Reserve Bank to appoint the valuer (in the interests of independence) but determined that this creates too great a risk of conflict of interest. We considered whether appeals should be heard by the High Court or an independent tribunal but recommend the High Court, since that is more consistent with New Zealand practice and the Court can commission expert advice if required.

Appeal rights

We propose continuing the status quo in which appeal rights over the exercise of powers in resolution are limited to judicial review. This is to ensure the resolution authority can act flexibly and with certainty. NCWO and its associated appeal rights provide additional safeguards to shareholders and creditors affected by the use of resolution powers.

Recovery of resolution funds

Where resolution is carried out to provide financial stability, it is *prima facie* appropriate to recover any losses of public funds used in support of the resolution from regulated entities, who benefit from financial stability and can threaten it by taking on risk. We propose including powers in the DTA to raise an *ex post* levy to compensate the Crown for the net costs of resolution, provided the resolution in question was carried out for financial stability reasons. The details of this levy will require further work and consultation. At this stage Cabinet is being asked to agree that the DTA may include a resolution levy mechanism, with further decisions on how this levy mechanism should operate to be taken by the Minister of Finance under delegation. Any proposals will be tested with industry in the

exposure draft process. The Minister of Finance will report back to Cabinet on the details and stakeholder feedback before the Bill is finalised for introduction to the house.

Stays on early termination rights

Some contractual rights can create impediments to resolution – for example, by crystallising liabilities in ways that compound asset shortages or by terminating contracts that underpin continuity of the provision of essential banking services.

Cabinet has already agreed the carry-over of some existing provisions designed to avoid these issues.

When an entity is in resolution, we propose to include a temporary suspension on the exercise of close out rights (e.g. acceleration, termination, and netting/offsetting rights) in relation to derivatives contracts. However, we also propose that all such suspensions should generally only operate until the close of the business day following the commencement of resolution (though this limit can be extended by the Reserve Bank under certain conditions, broadly designed to ensure that contracts are fulfilled over time).

In addition, we propose denying third parties the right to exercise certain contractual rights solely because the relevant entity has entered into resolution.

These provisions will prevent unnecessary disruption to resolution whilst minimising the impact on creditors.

Overall, these proposals complete a resolution regime that provides the Reserve Bank with sufficient flexibility to enable orderly resolution, while minimising recourse to public funds and ensuring that appropriate safeguards are in place to govern resolution powers.

Safeguards are important because resolution requires complex trade-offs between the rights of different stakeholders, including the New Zealand public. These proposals cannot eliminate the difficulty of those trade-offs but they provide a solid framework for decision-making and *ex post* accountability that closely reflects established international practice.

Directors' insurance and indemnity

The DTA will impose significant penalties on directors of deposit takers. Cabinet had previously agreed that deposit takers should not be able to indemnify or insure directors against these liabilities. Stakeholder feedback indicates this approach is too harsh and we now propose the possibility of indemnity or insurance in specified limited circumstances (acting in good faith, appropriate procedural safeguards for taking out insurance).

The preferred options proposed here are agreed by both Treasury and the Reserve Bank, with the exception of the two issues where new statutory powers are being proposed (*ex post* levies and THB coverage). On these two issues, the Treasury prefers the introduction of legislative powers while the Reserve Bank would rather legislation is postponed until further analysis has been carried out. The accompanying Cabinet paper reflects Treasury's preference.

Limitations and Constraints on Analysis

The primary constraint on the analysis for these proposals was that they need to fit into the framework already agreed by Cabinet in April 2021. The April decisions were informed by a comprehensive regulatory impact statement at the time. Many of the decisions taken

here are supplementary to those earlier decisions. They relate to technical questions about how to implement previously agreed policy goals.

As a result, there has not been any formal public consultation on the issues discussed here, beyond the extensive consultation that informed Cabinet's earlier decisions.

However, some of the proposals discussed here were developed with the assistance of an external technical reference group including lawyers, accountants and insolvency practitioners. Proposals were also reviewed by an independent expert advisory panel, appointed to assist with the overall Review of the Reserve Bank Act.

Proposals were compared with international practice across a range of jurisdictions and with international standards, particularly those contained in the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions.

Once the complete Bill is drafted, an exposure draft will be published for consultation before legislation is introduced to the House, so stakeholders will have a further opportunity to comment on decisions made.

The evidence base for the proposals is good but not conclusive. The evidence for proposed reforms is informed by our practical experience of prudential regulation in New Zealand. It also draws on a wide range of reviews carried out in other jurisdictions since the global financial crisis. Whilst there is not a prescriptive set of rules to govern deposit taker crisis management and resolution that will be suitable for all jurisdictions, there are established principles and examples of good practice to draw on.

The nature of the decisions involved in this proposal makes assessment of marginal costs and benefits inherently difficult. Crisis and resolution are 'tail events' – events with a low probability and frequency of occurrence but significant impact at the time they take place. Impact may also depend on the precise nature of any crisis or the nature of the affected entity's balance sheet. Assessments of marginal costs and benefits should be read with those difficulties in mind.

Recommendations on temporary high balances and the recovery of resolution funds through an *ex post* levy have been made under greater urgency and are less well-developed than the other proposals. This is noted where these issues are discussed in the impact statement and, in both cases, there will be an opportunity for further review before final decisions are made.

These two issues are also the only two issues where there is a difference of opinion between the Reserve Bank and the Treasury.

The Reserve Bank would prefer to leave legislation on *ex post* levies and temporary high balances until a later date. This would allow additional analysis and avoid potential delays to the implementation time-line. In the case of levies to recover resolution funding, it would also enable consideration of whether this mechanism should be extended to the other sectors the Reserve Bank regulates (insurers and financial market infrastructure providers).

Treasury would prefer powers to be included in legislation (with implementation to take place through later regulation) to enable swifter implementation, without needing to wait for further primary legislation.

Responsible Manager(s)

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13 October 2021

Quality Assurance (completed by QA panel)

Reviewing Agency:	Reserve Bank of New Zealand
Reviewer Assessment & Comment:	<p>The regulatory impact statement meets the Quality Assurance Criteria.</p> <p>The regulatory impact statement provides sufficient background to support the decisions which need to be taken at this stage to complete the design of the new deposit takers regime and deposit insurance regime. The RIS identifies the impacts of the various options but recognises that they cannot be quantified accurately given that they relate to resolving failing institutions and the nature and scale of any failure cannot be predicted. The RIS shows evidence of appropriate consultation, given the nature of the policy proposals being considered. The RIS clearly identifies the different types of decisions that need to be made.</p>

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Section 1: The overall problem context

(The Reserve Bank Review, existing Cabinet decisions on the content of the Deposit Takers Bill, including the resolution framework)

This Regulatory Impact Statement (RIS) provides an analysis of the outstanding policy issues relating to the Deposit Takers Bill, which is the final legislation needed to implement the government's Review of the Reserve Bank Act 1989.

This analysis supplements a comprehensive [RIS](#) that assessed options for a new prudential framework for the regulation and supervision of deposit takers and the introduction of deposit insurance.

The nature of the overall regulatory regime that will be contained in the Deposit Takers Bill was agreed in a series of Cabinet decisions in April 2021. However a number of details were left for further consideration, primarily relating to the regime for resolution and crisis management and these issues form the subject matter of the proposals reviewed in this regulatory impact statement.

This section provides a brief introduction to the overall review of the Reserve Bank Act and an overview of decisions that have already been made about the content of the Deposit Takers Bill. It then provides a more detailed summary of the decisions that were made in April concerning the shape of the planned resolution and crisis management regime in order to explain the relevance of the current proposals.

The review of the Reserve Bank Act

The Reserve Bank sets monetary policy in New Zealand and is the prudential regulator for banks, non-bank deposit takers (credit unions, building societies and retail funded finance companies), financial market infrastructure providers and insurers. The Reserve Bank was established in 1934, primarily to issue currency, and was then significantly reformed under the Reserve Bank Act 1989, which provided it with operational independence, subject to a monetary policy targets agreement made with the government. The Reserve Bank was also responsible initially for the prudential regulation of registered banks, with decision-making autonomy vested in the Governor. Although important amendments to the Reserve Bank Act have been made since then, the framework as a whole has not been reviewed for over 30 years.

During that time, international best practice in both monetary policy and prudential regulation has been transformed as global financial systems and economic theory have evolved. In terms of the Reserve Bank of New Zealand's role, some particularly important developments include:

- the growth and globalisation of the financial sector and consumers' changing expectations of it and engagements with it
- the increased dominance of large Australian-owned banks in New Zealand
- the Reserve Bank's increasing emphasis on local incorporation for banks and controls over outsourcing in the 2000s
- the Reserve Bank becoming the prudential regulator for insurers, financial market infrastructures and non-bank deposit takers (NBDTs), and the AML/CFT (anti-money laundering and countering financing of terrorism) supervisor for banks, NBDTs and life insurers

- changing patterns of prudential regulation internationally, accelerated by the lessons of the global financial crisis of 2008
- the subsequent international and local evolution of central bank functions including the development of macroprudential policy, liquidity policy, more prescriptive capital requirements and new forms of resolution regime.

The objective of the Review (as set out in the 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 (1989) has been amended several times since it was enacted in 1989, the core prudential provisions have been in place since the start. The Review aims to create a similarly enduring and trusted framework that promotes financial stability and supports the economy.

Phase 1 of the Review, completed in 2018, introduced a new overall economic objective for the Reserve Bank and created a Monetary Policy Committee to formulate monetary policy.

Phase 2 is a comprehensive review of the legislative framework and will result in two pieces of legislation.

The first, the Reserve Bank of New Zealand Act 2021, received royal assent on 16 August 2021. It modernises the institutional design and accountability requirements of the Reserve Bank, including by importing some of the transparency and accountability features of the Crown entity regime. The Reserve Bank Act 2021 introduces a new, and clearer, financial policy objective focussing on protecting and promoting the stability of New Zealand's financial system. The Act also requires the Minister of Finance to issue a Financial Policy Remit that the Board of the Reserve Bank must have regard to when fulfilling its prudential responsibilities.

The second piece of legislation will be the Deposit Takers Bill. This part of Phase 2 considers the prudential framework for regulating banks and other deposit takers on a first principles basis, limited only by its terms of reference. This RIS reviews the remaining policy decisions required before completing the drafting of the Bill.

April decisions concerning the Deposit Takers Bill

The overall nature of the new prudential framework to be contained in the Deposit Takers Bill was agreed in a series of Cabinet decisions taken in April 2021.

The Reserve Bank will operate a single prudential regime for the regulation and supervision of banks and NBDTs, using standards (a secondary legislative instrument) as the main mechanism for imposing prudential requirements. The Bill will establish specific statutory purposes and decision-making principles with respect to deposit takers, to further clarify the Reserve Bank's new overarching financial policy objective to protect and promote financial stability.

The new framework will provide for increased regulation and oversight of the activities of directors of regulated entities. New legislation will provide greater guidance to the Reserve Bank on 'fit and proper' requirements for directors. Directors will also be subject to an on-going duty to ensure that there are adequate systems, processes and policies in place so that entities comply with their prudential obligations.

The Reserve Bank's supervision and enforcement powers are enhanced. It will now have an on-site inspection power and a more graduated enforcement and penalty framework, with a

broader range of potential sanctions. Its powers over ‘associated persons’ of regulated entities are also recalibrated.

A deposit insurance scheme for New Zealand will be established, which will be compulsory for all licenced deposit-taking institutions and will be funded through levies on members (supported by a government back-stop).

Cabinet also made decisions on the broad shape of the resolution and crisis management framework but some details remain to be worked out, which are the subject of this impact statement.

Resolution and crisis management

Introduction: the purposes and functions of a regime for deposit taker resolution

An important part of the framework already agreed for the Deposit Takers Act is an expansion of the Reserve Bank’s resolution powers, accompanied by new safeguards for how powers are used.

A key lesson of the global financial crisis concerned the importance of special resolution regimes for deposit takers. The central role these entities play (particularly banks) in the financial system means that failures can be particularly damaging. Interconnections between particular deposit takers and the larger financial system mean failures can result in contagion that may set off a larger systemic crisis. That may be through the direct impact of deposit taker failure on customers and counterparties or through the broader impact of a failure on asset prices. Resolution regimes need to be designed to deal with deposit taker failures in a way that reduces the possibility of these impacts.

The difficulties of resolution can have powerful fiscal implications. Disruptive failures can lead to a highly costly systemic crisis. Alternatively, to avoid such a crisis, authorities may feel they have no alternative to a large fiscal outlay or public bailouts of private institutions.

A special resolution regime aims to provide the tools to enable orderly bank resolution, avoiding these stark choices. Such a regime enables the orderly restructuring and / or wind-down of all or part of a bank’s business in a way that adequately safeguards the public interest. The ‘public interest’ in this context can include the continuity of the bank’s critical functions (see below), containing distress at a failing bank and maintaining overall financial stability (see below), and avoiding or minimising the reliance on taxpayers for meeting the costs of resolving a failed bank.

‘Special resolution’ processes have been developed to keep critical parts of failing banks open without using public money – instead, they seek to restructure creditors’ liabilities to absorb losses and restore viability.

Bank resolution processes aim to maximise the continuity of critical functions and minimise contagion. The Reserve Bank Act 1989 created a particular form of statutory management to be used in crisis resolution. Under appropriate circumstances, the Reserve Bank can recommend to the Minister that the bank be placed under statutory management. A statutory manager takes over the management of the bank, assuming the rights of the bank’s board and shareholders and possibly replacing senior management, subject to advice and direction from the Reserve Bank.

More recently, the Reserve Bank has supplemented the Statutory Management Regime by developing the concept of ‘Open Bank Resolution’ (OBR). Under this procedure, a bank would be able to remain open, so depositors could still access some of their funds in a way that would not be possible under liquidation. This procedure would assist with

the maintenance of critical functions and rapidly provide greater certainty to creditors, reducing the risk of spill-over effects to the wider economy.

Whilst this regime fulfils many of the requirements of a special resolution regime for banks, it also has some weaknesses, which the decisions already made by Cabinet in April seek to remedy.

The new regime for resolution agreed by Cabinet in April 2021: overview

Cabinet has agreed to provide the Reserve Bank with additional powers to restructure deposit takers' assets and liabilities, whilst also increasing the accountability and safeguards surrounding the resolution process.

Additionally, Cabinet has agreed to the development of a deposit insurance regime, which will provide important support for resolution. Deposit insurance is primarily designed to protect depositors from the loss of financial resources that can result from a deposit taker's failure. However, the presence of deposit insurance also assists resolution by reducing the risk of contagion via bank runs if a deposit taker fails and providing some additional flexibility in the way liabilities can be restructured and resources mobilised. It makes it more likely that government will be able to allow a deposit taker to fail, rather than feeling compelled to use public funds to bail it out.

Core structure of the new regime

Cabinet has agreed to replace a system of statutory management under the Reserve Bank's direction and advice, with a system of resolution in which the Reserve Bank is the 'resolution authority'. The Reserve Bank will be given a full range of management and resolution powers directly. It will likely appoint one or more resolution managers and will be responsible for their performance.

This structure is more closely aligned with international best practice as set out in the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions (the 'FSB Key Attributes'). It also capitalises on the synergies between the Reserve Bank's knowledge and expertise as prudential regulator and the resolution function.

The Reserve Bank's powers as resolution authority

The Reserve Bank will generally be given all the powers currently available to a statutory manager. These include:

- suspending deposit repayments, debt payments, or any other obligation
- cancelling obligations to provide funding to any person
- negotiating a compromise with any creditor of the deposit taker or any creditor class
- setting up a new company to acquire the deposit taker's business (including a foreign branch)
- selling or transferring viable parts of the business (whether or not subject to any existing charge or other security), or
- with the Reserve Bank's approval, applying to put the deposit taker into liquidation (potentially imposing losses on any outstanding creditors and shareholders).

Cabinet has agreed that these powers should be available to the Reserve Bank as resolution authority and should also be available to use with an 'associated person' of a depositor that has been placed in resolution.

Additionally, Cabinet has agreed that the Reserve Bank should be given the power to 'bail-in' some of an entity's liabilities to assist with resolution. Under the existing OBR policy, the Reserve Bank can set aside a portion of a failing entity's liabilities for loss-allocation in a subsequent liquidation once surviving parts of the firm are transferred to a new entity. A statutory bail-in power would give the Reserve Bank the additional ability to directly write down or convert certain types of unsecured liabilities into equity and to write down share capital and cancel shares.

Cabinet has also agreed to a series of additional powers to prevent any impediments to resolution that might arise, where placing a depositor into resolution might create rights for:

- the enforcement of debts and security interests by creditors;
- disorderly close-out by derivatives counterparties; or
- the cessation or disruption to essential services provided to the deposit taker by third parties

Alongside the implementation of deposit insurance, these new powers should help to further ensure that the costs of a crisis fall to investors and creditors rather than taxpayers.

Overall the framework will provide the Reserve Bank with very significant powers, including to alter property rights. Since these powers are significant, it is also important to develop appropriate governance and procedural safeguards for their operation.

Governance and procedural safeguards

Cabinet has agreed to a clearer framework of governance around the way the resolution function operates, which also draws on the FSB Key Attributes.

There will be clear statutory triggers for a deposit taker to be placed in resolution, including a non-viability test and a necessity test. The Reserve Bank's objectives as resolution authority will be set out in statute.

Cabinet has also agreed to reforms in the Minister of Finance's involvement in the resolution process. The Minister of Finance has key responsibilities on behalf of the government when a deposit taker fails. These include:

- understanding and managing the economic and social impact risks associated with the failure and its management;
- the wider international (especially trans-Tasman) relationship if the failure was one of New Zealand's foreign-owned deposit takers;
- managing expectations that public funds will be put at risk to manage a deposit taker failure; and
- managing fiscal risk to the government.

The crisis management framework therefore needs to strike a balance between an appropriate level of operational independence for the Reserve Bank, with appropriate opportunities and levers for the Minister of Finance to manage the government's interest in crisis management.

As part of its planning to operationalise this framework and its ongoing work to pre-position deposit takers for orderly resolution, the Reserve Bank will prepare a 'statement

of approach to resolution'. It will consult the Minister of Finance when preparing this approach.

Once the statutory triggers for resolution have been met, resolution may proceed on an 'open' or 'closed' basis. Cabinet agreed that, for an 'open resolution', aiming for uninterrupted operations by rapidly recapitalising the entity based on its own resources, the Reserve Bank would operate without formal Ministerial approval. Otherwise Ministerial agreement would be required.

The Minister will also have the power to direct the Reserve Bank to act in particular ways during resolution in order to safeguard public funds.

Creditor safeguard: the 'No Creditor Worse Off' principle

Finally, in addition to these procedural safeguards, Cabinet also agreed to protect creditors' property rights by implementing the principle that no creditor should be worse off as a result of resolution than they would have been under a normal liquidation of the deposit taker.

Resolution authorities should generally seek to respect property rights when exercising a resolution strategy. If property rights are unclear, investors can find it hard to identify and price risks accurately. However, there is also recognition that sometimes creditors may need to take second place to wider or systemic stability interests. In such cases it is appropriate to provide a compensation mechanism for affected creditors and this is increasingly standard international practice, as reflected in the FSB Key Attributes.

Costs and benefits of the April proposals

The previous comprehensive RIS provides an assessment of the overall costs and benefits of this package of measures. The benefits come from increased protection for society from the damage to New Zealand's financial system and wider economy that could be caused by excessive risk taking by the deposit taking sector. Increased protection should also promote public confidence in the regulation of deposit takers, reducing the likelihood and severity of bank runs and disorderly deposit taker failures. The main costs will be: increased operating costs for the Reserve Bank; one-off costs for the financial sector in meeting new compliance requirements and broader ongoing costs of compliance, and the cost of the deposit insurance fund.

The resolution regime, which is particularly relevant to this RIS, is designed to increase the resolution options available and deliver resolution in an orderly manner without causing disruption to critical financial services or damage to financial stability. It will do so in a way that ensures continuity of systemically important financial services, while allocating losses to shareholders, secured and unsecured creditors in a manner that respects the hierarchy of claims. It will allow failures of financial institutions to be managed in ways that are less likely to require recourse to public funds.

Overview of remaining decisions

The main parameters of the new framework to be contained in the deposit takers bill were agreed by Cabinet in April 2021 but the Cabinet paper noted some details that needed further policy work. Some of these details were to be delegated to the Minister of Finance but others require further policy decisions from Cabinet.

Most of these details concern the precise specification of some resolution powers and the nature of the safeguards required for their operation:

- finalising the relationship between (a) the purposes that will govern the Reserve Bank's use of resolution powers and (b) the Minister's power to Direct the Reserve Bank's use of those powers under particular circumstances;
- determining the detailed mechanism for implementing 'bail-in' powers;
- provisions to allow the deposit insurance scheme to cover 'temporary high balances'
- designing appropriate safeguards to ensure that, if deposit insurance funds are used to finance resolution, the cost to the deposit insurance scheme does not exceed what would have been paid to insured depositors in liquidation;
- determining the appropriate mechanism for the implementation of 'No Creditor Worse Off' rights;
- agreeing the scope of appeal rights relating to the use of resolution powers;
- a system of *ex post* levies to recover funds used in resolution; and
- finalising the details of provisions for stays on the ability of certain creditors to exercise rights against a deposit taker in resolution

We also review a broader earlier decision about whether directors should be able to obtain indemnities or insurance for their liabilities under the DTA.

In the following section, we review proposals for each issue in turn, setting out problem definitions, option identification and evaluation.

Section 2: detailed problem definitions and assessment of options for reform

1. Purposes of the Resolution Function and Role of the Minister

DIAGNOSING THE POLICY PROBLEM

What is the problem?

Are the proposed statutory purposes adequate and are there any risks in their interaction with the Minister's power of Direction?

The crisis management framework needs to strike a balance between an appropriate level of operational independence for the Reserve Bank, and appropriate opportunities and levers for the Minister of Finance to manage the government's interest in crisis management.

In April, Cabinet agreed that an important part of this balance will be struck by:

- providing the Reserve Bank with clear statutory purposes for which it can use its resolution powers; and
- providing the Minister with a backstop power to direct the Reserve Bank as to how to exercise its resolution powers

The agreed statutory purposes at present are:

1. to enable the orderly resolution of deposit takers
2. to avoid significant damage to the financial system that could result from the failure of a licenced deposit taker including:
 - a. by maintaining the continuity of systemically important activities undertaken by licensed deposit takers in New Zealand;

- b. by mitigating, or otherwise managing, any loss of confidence in the financial system resulting from the failure of a licensed deposit taker;
3. to protect eligible investors to the extent they are covered by the deposit insurance scheme;
4. while also providing that in carrying out a resolution in accordance with the purposes, the Reserve Bank should seek to minimise the cost of dealing with a licensed deposit taker and minimise the use of 'public money'.

Since the April decisions were made, the Minister of Finance has made some decisions about the direction power under his delegated authority.

In the light of these decisions and the further work that has been done on the drafting and implementation of the regulatory framework, this section asks whether the proposed statutory purposes are adequate and whether there are any risks in their interaction with the Minister's power of Direction.

What objectives are sought in relation to the policy problem?

The aim of these proposals is to ensure that the Reserve Bank's objectives in carrying out its resolution function are well-defined, which will direct its activity and assist in holding it publicly accountable.

They also aim to ensure a balance between the value of a resolution authority's independence and the Minister of Finance's role in governing the use of public funds.

DECIDING UPON AN OPTION TO ADDRESS THE POLICY PROBLEM

What criteria will be used to compare options to the status quo?

We will use the previous decisions made by Cabinet as the status quo against which to compare proposed options. The criteria for assessment will be:

- clarity of resolution objectives
- completeness of resolution objectives
- effective balancing of the roles of the Reserve Bank and the Minister of Finance

What scope will options be considered within?

Options are considered against the background of previous decisions made about both the purposes of the resolution authority and the operation of the Minister's power of direction over the resolution authority.

What options are being considered?

Option one: (counterfactual) previously agreed arrangements

Retain the statutory purposes Cabinet has agreed as outlined above.

Cabinet has also decided that preservation of the creditor hierarchy (that would have occurred in liquidation) should be a requirement for resolution activity, except where financial stability considerations require a departure from the ranking.

In April, Cabinet agreed that the Minister of Finance should have the power to issue a direction as to how the Reserve Bank carries out its resolution functions. The Cabinet paper does not set out in any detail what factors the Minister of Finance should consider when issuing a direction, although it suggests that the power would only be necessary in rare circumstances where the Minister and Reserve Bank could not reach consensus.

Option two: (preferred option) alignment and increased guidance

Implement Cabinet’s decision on preservation of the creditor hierarchy by requiring the resolution authority to have regard to the creditor hierarchy when exercising its resolution powers.

Add two additional factors for the resolution authority to have regard to (alongside the existing goal of protecting ‘public money’): the preservation of value and the prompt resolution of the entities’ issues.

Require the Minister, when formulating a direction to protect public funds, to consider broadly the same set of overall resolution objectives as those proposed for the Reserve Bank.

Option two provides a fuller statement of the different factors that the Reserve Bank needs to have regard to when carrying out its primary resolution purposes (of orderly resolution, in the public interest, whilst protecting insured depositors). While pursuing these activities the Reserve Bank will have regard to four goals which will often, but not always, align:

- preserving the value of the entity to maximise recoveries;
- maintaining the ranking of claims of creditors;
- protecting ‘public money’, by dealing with a licenced deposit taker with a view to minimising, and otherwise managing, any reliance on public money in resolution; and
- resolving any issues of the entity as quickly as possible

The Minister of Finance’s direction power is primarily intended to reflect the Minister’s particular responsibility for preserving public funds. However, to avoid conflicting purposes between the Minister and the Reserve Bank, it is appropriate to clarify that the Minister should pursue that responsibility in the context of the broader purposes of resolution.

How do the options compare to the status quo/counterfactual?

	Option One – previously agreed approach	Option Two – alignment and additional powers
Clarity of resolution objectives	0	- Slight decrease in clarity as more objectives to balance
Completeness of resolution objectives	0	+ Better reflection of the trade-offs involved in effective resolution decision-making
Effective balancing of roles of Minister of Finance and resolution authority	0 Risks creating conflict, rather than enabling appropriate dialogue and oversight	++ Clarifies that Direction power is designed to reflect residual risk of different judgements as to the weight assigned to differing priorities
Overall assessment	0	+

What are the marginal benefits and costs of the preferred option

In this table, evidence certainty is generally reported as ‘good’ as there is little ‘missing evidence’ that could be obtained to improve certainty. However, considerable uncertainty remains about likely impact. We can be reasonably confident that the average impact on stakeholders, assessed over a long period of time, is likely to be small. However, at particular

times (a crisis event in which the circumstances of the deposit taker make it difficult for the Reserve Bank to determine an appropriate course of action) the impact on particular deposit takers or creditors may be high - but this impact is inherently unpredictable.

Affected groups <i>(identify)</i>	Comment	Impact.	Evidence Certainty
Additional costs of the preferred option compared to taking no action			
Deposit Takers	Difficult to assess impact of more aligned objectives as highly contingent. Circumstances in which Direction given will be rare. Impact on a deposit taker of marginal propensity to decide differently is highly contingent on circumstances.	Low (but possibly significant in highly contingent circumstances)	Good
Creditors	Impact of alignment change is highly contingent on circumstances.	Low (but possibly significant in highly contingent circumstances)	Good
The Reserve Bank		None	Good
Minister of Finance	Slight decrease in flexibility (and so marginally greater risk to public funds), offset by improved coordination	Low overall (but with risk of significant cost to public funds in highly contingent circumstances)	
General public and taxpayers	Some decreased emphasis on direct taxpayer costs, set off against better coordinated resolution	None	Good
Total non-monetised costs		Very low	Good
Additional benefits of the preferred option compared to taking no action			
Deposit Takers	Greater clarity as to the Reserve Bank and Minister's actions. Less risk that coordination problems will impair resolution. The impact of preserving value and swifter resolution should be positive but the marginal effect of introducing statutory purposes of this	Low (but possibly significant in highly contingent circumstances)	Good

	nature is difficult to assess.		
Creditors	Preservation of value objective may marginally increase the chance that the resolution authority will chose a higher risk but economically superior outcome (resolution) over a more certain but costly result (liquidation). Swifter resolution may provide benefits. Impact of greater alignment is difficult to predict but might result in significant costs or benefits at some times.	Low (but possibly significant in highly contingent circumstances)	
Reserve Bank	Greater clarity of purpose. Improved coordination with Minister of Finance. Marginally reduced risk that decisions will be over-ruled.	Low	Good
Minister of Finance	Improved coordination with the Reserve Bank	Low	Good
General public and tax payers	Increased likelihood of orderly resolution (offset by slightly reduced emphasis on direct protection of public funds)	Low	Good
Total non-monetised benefits		Low	Good

2. Bail-in

DIAGNOSING THE POLICY PROBLEM

What is the problem?

How should the Reserve Bank balance the need to limit calls on public funds against the need to maintain clearly defined creditor property rights in the context of New Zealand's capital regime?

Cabinet has previously agreed to introduce a statutory bail-in power but has also agreed that this power should only apply to instruments whose terms explicitly contemplate bail-in. However, the New Zealand capital regime does not currently have any instruments that a statutory bail-in power could attach, so statutory bail-in would not currently mobilise any funds for resolution. This section discusses whether it is still advantageous to include a statutory bail-in power that might be operationalised following future changes to the capital regime or whether doing so creates too much potential market uncertainty.

Introduction to bail-in

Following the global financial crisis, bail-in has become a common part of many jurisdictions' resolution tool kit and forms a central element of the FSB's Key Attributes.

Bail-in powers impose losses on creditors in order to reduce the need to resort to public funds. This might take place when an entity has formally entered into resolution ('closed bail-in') or when an entity is failing in order to promote a recovery without entering into formal resolution ('open bail-in').

Bail-in can be achieved in at least three ways (which need not be mutually exclusive):

- by including provisions in loan contracts that specify circumstances in which loan obligations may be written down, written off or converted into equity;
- by creating a statutory power to write-down obligations;
- or using broader resolution powers in a way that imposes losses on creditors. For example, under existing powers, certain assets and liabilities can be transferred to a separate holding company (a 'bridge bank'), leaving remaining creditors (in the 'rump bank') with a reduced pool of assets against which to claim in liquidation.

Bail-in powers weaken creditor rights and can therefore increase the cost of deposit takers' funding. It is important to have as much certainty as possible as to which liabilities will be subject to bail-in to ensure that the risk involved can be priced appropriately (and in order to avoid legal challenge to bail-in actions during or following resolution).

Clarity is usually achieved through a combination of clearly specified bail-in powers and some form of requirement to disclose bail-in powers to investors when they purchase deposit taker debt (either through specified contractual clauses or disclosure as part of conduct requirements).

As a result, bail-in powers usually apply in practice to particular pre-positioned liabilities and the level of available liabilities for bail-in forms an important element of resolution planning.

The 'no creditor worse off' principle, discussed in more detail later in this RIS, provides important additional safeguards by ensuring that creditors are not left worse off as a result of resolution than they would have been in liquidation.

Previous decisions

As part of its April decisions, Cabinet agreed that there should be a statutory bail-in power that would apply to all unsecured liabilities, except those on a list of exemptions.

The proposed exemptions were wide, so bail-in would primarily apply to unsecured fixed-term debt (potentially including subordinated debt and wholesale borrowing) that included specific clauses recognising the statutory bail-in power.

A decision on whether deposits should also be available for bail-in was reserved for further analysis but, again, would not come into force until the terms and conditions of deposit accounts specifically provided for bail-in.

The April Cabinet paper also noted that, at least for ‘open’ bail-in (i.e. before resolution powers were triggered) the Reserve Bank was likely to need to decide which sorts of debt should be pre-positioned as part of its resolution planning. It would then need to issue prudential requirements to ensure that entities held appropriate amounts of this type of debt and that contracts contained suitable bail-in clauses.

The creditor hierarchy and difficulties with statutory and contractual bail-in

In a resolution, bail-in would operate at the point when deposit taker losses had wiped out common equity. The most subordinated debt (the lowest remaining debt in the creditor hierarchy, which carries additional risk and therefore attracts an interest rate premium) would then be either written off or converted into equity in an attempt to re-establish a viable entity (one where remaining assets exceeded remaining liabilities).

In order to preserve property rights, bail-in should only apply to debt that was contracted with explicit knowledge that bail-in was a possibility.

Implementing both statutory and contractual bail-in regimes presents some difficulties under the current prudential framework. The Reserve Bank has recently completed a major review of bank capital (‘the capital review’). During that review, the Reserve Bank decided to significantly increase requirements for bank holdings of equity capital, increasing banks’ primary loss-absorbing capacity before the point at which bail-in becomes relevant. It also issued new prudential requirements for what must be contained in contracts when banks issue the most subordinated liabilities other than common equity (‘Alternative Tier 1’ (AT1) and ‘Tier 2’ (T2) capital). These requirements do not include contractual clauses that recognise statutory bail-in or provide for contractual bail-in. At present, then, there are no instruments that would be able to explicitly recognise a statutory bail-in power.

The capital review changes were subject to extensive consultation with industry and will impose significant costs. They are scheduled to be implemented over a six year period from 2022, partly to spread the costs and partly because banks have considerable volumes of AT1 and T2 capital issued under previous rules, which will need to be retired and replaced with capital compliant with the rules introduced as a result of the review.

Currently, the most subordinated debt in New Zealand has been issued without bail-in clauses. It is not possible to simply ‘add’ bail-in-able instruments on top of the currently agreed rules (for example by introducing some form of ‘Tier 3’ capital). That is because bail-in-able instruments would need to be lowest in the creditor hierarchy, since they would be the first to be written off once common equity was exhausted. In short, the rules agreed for AT1 and T2 capital during the capital review would need to be altered to allow for bail-in.

Overall problem

A bail-in regime needs to balance the advantage that bail-in powers create in limiting calls on public funds against the need to maintain clearly defined creditor property rights. Existing Cabinet decisions left some scope for deciding exactly how this balance was to be struck.

What objectives are sought in relation to the policy problem?

The primary aim is to maximise the funds available to draw on in resolution so as to avoid the need for recourse to public funds.

However, in doing so, it is important to retain clarity as to creditors’ property rights and to avoid undue increases in deposit takers’ funding costs.

DECIDING UPON AN OPTION TO ADDRESS THE POLICY PROBLEM

What criteria will be used to compare options to the status quo?

We will consider options based on:

- the degree to which they make funds available for resolution
- the degree to which they create certainty as to creditor's property rights

What scope will options be considered within?

The primary limitations on bail-in options are broad legal principles, confirmed by Cabinet in its previous decisions:

- the need to preserve the creditor hierarchy;
- and for *ex ante* clarity about the creditor rights produced by loan instruments or the terms and conditions of deposit accounts.

Those legal principles are an important part of the framework underpinning markets and overseas experience suggests that, where there is doubt as to whether bail-in powers respect those principles, legal challenge is likely.

Commitment to those principles would at a minimum significantly delay the use of a broad statutory bail-in power. Bail-in powers will generally be used with contracts that were entered into with knowledge that bail-in might take place in a crisis context and as outlined above it would take time to develop and introduce such contracts.

What options are being considered?

Option 1 (Status quo) – previous Cabinet proposals

The previous Cabinet proposals would allow a combination of possible approaches to bail-in, involving at least three routes:

1. contractual 'open' bail-in, which could take place before an entity entered into resolution by activating contractual clauses allowing write-down or conversion to equity (which is already possible under the existing framework)
2. statutory 'closed' bail-in, using a new statutory power as part of resolution to re-arrange a variety of an entity's liabilities (but with a requirement that contract terms or the terms and conditions of deposits explicitly contemplated bail-in before they were entered into).
3. bail-in in the course of other resolution strategies (such as purchase and assumption) (enabled by broader resolution powers introduced in the proposed Deposit Takers Bill)

Over the medium to long-term, this package of measures would create a broad menu of tools that could be used to accomplish bail-in as part of a resolution strategy.

However, as explained in the previous section, the bank capital framework that is being implemented currently does not support routes one and two. No instruments exist with clauses to enable contractual bail-in.

If statutory bail-in was introduced, there would not currently be liabilities that were suitable for bail-in. Introducing a statutory bail-in power would signal that it was likely some obligations would be subject to bail-in in the future, but without giving markets clarity about which obligations those would be. It could therefore create uncertainty and potentially increased funding costs for banks.

Option two (preferred option) – rely on contractual bail-in and resolution strategies, postponing statutory bail-in until a new resolution framework is better developed

Under this option, the Deposit Takers Act would not initially include a statutory bail-in power. Instead, it would add a direction power specifically allowing the Reserve Bank to trigger contractual bail-in clauses. This would mean that, if the Reserve Bank wished to introduce instruments with contractual bail-in clauses as part of its future regulation of deposit takers' capital, it would have a well-defined mechanism to achieve bail-in.

Reconsideration of a statutory bail in power would be delayed until the Reserve Bank had developed its approach to resolution using the tools established elsewhere in the proposed legislation, in the context of New Zealand's current capital settings.

If it was felt that statutory bail-in was useful at that point, a power could be introduced in the context of well-developed resolution approach, allowing the power to be clearly tailored to identified pre-positioned liabilities. Under that scenario, when a statutory power was introduced, its planned scope would be clear to markets.

In the meantime, New Zealand's requirements for bank holdings of common equity Tier 1 capital are significantly higher than those of most jurisdictions that are more reliant on bail-in for their resolution strategies, potentially reducing the need for bail-in.

The wider powers given to the Reserve Bank as resolution authority would also enable it to impose some losses on creditors via its chosen resolution strategy (subject to the no creditor worse off safeguards discussed below).

Additionally, if resolution strategies subsequently indicated the need for additional bail-in-able liabilities, the direction power would offer another way to achieve this by requiring regulated entities to issue capital with the necessary clauses to facilitate contractual bail-in.

How do the options compare to the status quo/counterfactual?

	Option One – previously agreed approach to statutory bail-in	Option Two – direction power for contractual debt only
Availability of resources for resolution	0 Potentially allows three routes to achieve bail-in (contractual, statutory and via resolution). However development of suitable liabilities for contractual and statutory bail-in would likely not happen for some time.	- Allows bail-in through resolution tools. Leaves open the possibility of future contractual bail-in if the Reserve Bank introduces requirements. Statutory bail-in would require subsequent legislation
Certainty of creditor rights	- Creates a potentially intrusive statutory power without clarity about how it would be used	++ Creditor rights retain current clarity
Overall assessment	0 Creates potential for more future options but at the cost of establishing a strong but ill specified power.	+ Greater creditor clarity, though more work would be required to introduce any stronger bail-in regime in the future

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

We recommend option two because previous decisions would create too much uncertainty as to creditor rights, without delivering significant additional access to resolution resources. It is also more practical to develop the statutory power alongside future work on the creation of suitable liabilities as these two processes can inform each other, and there will be more global experience using statutory bail-in powers in a few years.

What are the marginal benefits and costs of the preferred option (relative to previous Cabinet decisions)?

Affected groups <i>(identify)</i>	Comment.	Impact	Evidence Certainty
Additional costs of the preferred option compared to taking no action			
Deposit Takers	None	None	High
Creditors	None	None	High
The Reserve Bank	Slightly reduced powers	Low	High
Others (government and public)	Not introducing a statutory bail-in power may decrease resource availability at the margin, increasing costs to government / taxpayers but that judgement is dependent on a range of contingencies (to do with the broader regulatory and capital regime)	Low	Medium
Non-monetised costs		Very low	High
Additional benefits of the preferred option compared to taking no action			
Deposit takers	Reduced uncertainty may marginally reduce funding costs	Low	High
Creditors	Greater certainty as to property rights	Low	High
The Reserve Bank	Makes little difference to Reserve Bank's effective options at present.	None	High
Others (government and public)	Very modest indirect benefits from greater market efficiencies	None	High
Non-monetised benefits		Low	

3. Deposit insurance: payments for temporary high balances

DIAGNOSING THE POLICY PROBLEM

What is the problem?

Should the deposit insurance scheme cover temporary high balances in excess of the normal cap for deposit insurance claims?

The deposit insurance scheme imposes a cap on the maximum amount that is covered. Cabinet has agreed this cap should be set at \$100,000, per depositor, per institution. A cap reduces the cost of the scheme and limits moral hazard by maintaining an incentive for depositors to manage the risk of their deposits.

However, depositors may be in a situation where they have a ‘temporary high balance’ (THB) due to a variety of life events (for example, large insurance settlements or the proceeds of property sales). Cabinet decisions on the deposit insurance scheme do not make provision for THBs to be covered.

Around 40% of OECD deposit insurance schemes provide additional coverage above the normal pay-out cap for depositors with a THB (coverage is usually still limited but often 3 to 5 times base coverage).

What objectives are sought in relation to the policy problem?

The objectives are to achieve scheme coverage that is well-understood, fair and perceived to be fair, in order to maximise the contribution of the deposit insurance scheme to financial stability.

DECIDING UPON AN OPTION TO ADDRESS THE POLICY PROBLEM

What criteria will be used to compare options to the status quo?

We will compare options based on:

- level of protection offered
- perceived fairness – which option is most likely to appear ‘fair’
- expected cost to the scheme
- clarity of scheme coverage

What scope will options be considered within?

The base level of coverage for the scheme has already been agreed by Cabinet.

The details of any THBs coverage would need to be set out in subsequent regulations. We are only considering whether or not to introduce a power to provide THBs in legislation. Any final decision on implementation would be taken at a later date on the basis of further impact analysis

What options are being considered?

Option one: status quo – no coverage for THBs

Under this option, deposit insurance would be limited to the \$100,000 per person per institution as previously agreed by Cabinet.

This arrangement should be straightforward for depositors to understand.

However, depositors who hold THBs at the time when a deposit taker fails may experience hardship and that may undermine the perceived fairness of the scheme, creating potential political pressure for further public support to depositors. Some depositors, seeking to maintain protection, may incur costs by spreading temporary high balances across different accounts.

Option two: THBs coverage option, implemented through regulations

Under this option legislation would include explicit flexibility to allow the deposit insurance scheme to cover THBs.

Coverage of THBs would provide additional protection for affected depositors but would also increase the costs of the deposit insurance scheme as a whole.

However, any THBs coverage would only be introduced through subsequent implementing regulations, which would also detail the scope and duration of THBs to be covered.

Providing flexibility would preserve the option of providing coverage for depositors with THBs.

Regulation would be unlikely to be ready when the deposit insurance scheme first comes into effect and there is a risk that including a THB coverage option might create inaccurate public expectations.

How do the options compare to the status quo/counterfactual?

	Option One – status quo – no THB coverage	Option Two – THB option implemented through regulation
Level of protection offered	0	++
Perceived fairness	0	++
Expected Cost	0	-
Clarity	0	-
Overall assessment	0	+

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

On balance the Reserve Bank prefers option one. While the Reserve Bank has no objection to covering THBs in principle, no analytical work has been done to consider the precise scope of coverage and the impact on scheme costs.

Determining scope will raise difficult boundary questions (Which life events should be covered and which should not? How long can a 'temporary balance' be held?) but, without a clear idea of scope, the cost of the scheme cannot be assessed.

Introducing a statutory power, even one that will remain inoperative without implementing regulation, risks creating public expectations of coverage before analysis has been completed. Resource constraints mean it will not be possible to have regulation in place

when the deposit insurance scheme is first implemented. THB coverage could be reconsidered in the context of the planned 5 year review of the legislation.

The Treasury prefers option 2, since it increases the likelihood that THB coverage can be introduced in a timely fashion if it is supported by subsequent analysis, without creating an irrevocable commitment to implement cover.

What are the marginal benefits and costs of THB coverage?

Given greater information and further analysis, it would be possible to provide better estimates of what the costs of the scheme are likely to be. Fuller analysis would need to be carried out before any scheme was implemented.

Affected groups	Comment	Impact	Evidence Certainty
Additional costs of the preferred option compared to taking no action			
Deposit Takers	Potential increase in cost of deposit insurance scheme (though costs may be passed on to depositors)	Low	Low
Depositors	Potential indirect contribution to cost of deposit insurance scheme (if the additional cost is not absorbed by profits of deposit takers)	Low	Low
Total non-monetised costs		Low	Medium
Additional benefits of the preferred option compared to taking no action			
Deposit takers	Deposits more attractive as more secure. Some diffuse financial stability benefits.	Low	Medium
Depositors	May reduce costs from splitting short-term deposits across accounts. Contingent but significant benefits for some depositors. Some diffuse financial stability benefits	Low on average (though significant for some depositors in contingent circumstances)	Medium
Total non-monetised benefits		Low	Medium

4. Deposit insurance: use of scheme funds in resolution

DIAGNOSING THE POLICY PROBLEM

What is the problem?

What safeguards should be put in place when using deposit insurance scheme resources to fund resolution?

Cabinet has already decided [DEV-21-MIN-0078] that:

- 1.1 The funds of the Scheme may be released by the Reserve Bank for the purpose of protecting insured depositors in resolution (outside of a liquidation and payout), subject to safeguards that will be set out in legislation;
- 1.2 Safeguards will provide that the overall contribution of the Scheme funds is expected to be no more than it would otherwise have expected to incur in a liquidation and payout of insured depositors, net of expected recoveries;

This section is concerned with defining the detail of what such safeguards should look like.

Why should the Scheme be drawn on to contribute to the costs of resolution?

Deposit insurance is often thought about in the context of liquidation, where the deposit insurance scheme pays out depositors who would otherwise face losses, up to the coverage limit.

In some cases, though, resolution can produce better outcomes than liquidation, although it may give rise to costs that require funding. A liquidation can be disruptive to depositors and could have broader financial stability impacts. The liquidation of a deposit taker affects the continuity of services to its customers, and requires depositors to set up alternative accounts at a different deposit taker. Allowing the deposit insurance scheme to contribute to the costs of resolution could facilitate the delivery of improved outcomes when compared to a liquidation.

For example, under a purchase and assumption transaction, an outside bank might take on the failing deposit taker's deposit liabilities (and offer continuity of service to depositors). This arrangement could protect depositors, minimise disruption to customers, support consumer and market confidence, and better preserve value.

The purchasing bank would expect to receive sufficient assets from the failing deposit taker to back the deposit liabilities it was taking on. Given the risk of taking on the failing deposit taker's liabilities, it might also expect to receive a premium, which would need to be funded.

Using the deposit insurance scheme's funds to cover this premium could represent good value for money if it produced better results for insured depositors at a lower cost than liquidation.

The costs of resolution that the deposit insurance scheme fund may contribute to include NCWO compensation payments (so long as the overall cost remains lower than the expected payout in liquidation). A resolution may protect depositors (and achieve other resolution objectives), but may give rise to NCWO compensation payments if creditors receive less in a resolution than they otherwise would have received in a liquidation. Contributions from the scheme can be justified on the basis that the resolution achieves the objectives of the deposit insurance scheme, and at no greater cost to what the scheme would have incurred in a liquidation and pay out scenario.

Why do there need to be controls in place?

The consequences of choosing resolution over liquidation (and of different resolution strategies) will vary between stakeholders. Resolution may be the preferred option to preserve value or for public interest reasons, from providing continuity in the deposit taker's key functions to avoiding contagion to the wider financial system.

The extent to which the public interest motivations underpinning the choice of resolution overlap with insured depositors' interests might vary.

The deposit insurance scheme's purpose is to protect insured depositors' interests, and provide consequential financial stability benefits. The scheme is funded by levies from licenced deposit-takers that are members of the scheme (and some of these costs are likely to be transferred to depositors).

Safeguards are necessary to ensure that any use of the deposit insurance scheme's funds in contributing to resolution is compatible with the scheme's purpose.

Context and existing controls

It is important to note that the resolution authority and the deposit insurance scheme will be located inside the Reserve Bank. The Reserve Bank, as resolution authority, will have a statutory objective of protecting insured depositors.

Additionally, there are other funds available for resolution in New Zealand. This legislation will amend the Public Finance Act to provide the Minister with a standing authority to spend during financial crises. The Reserve Bank is also empowered to provide emergency lending to firms in resolution under the new Reserve Bank Act.

What objectives are sought in relation to the policy problem?

Safeguards should allow as much flexibility in resolution as possible, without compromising the purposes of the deposit insurance scheme (to protect insured depositors). Also (as agreed by Cabinet): overall contribution should be "no more than it would otherwise have expected to incur in a liquidation and payout of insured depositors, net of expected recoveries" (the 'funding limit').

DECIDING UPON AN OPTION TO ADDRESS THE POLICY PROBLEM

What criteria will be used to compare options to the status quo?

We will compare options based on:

- the extent to which they create flexibility of resolution options
- the degree to which they safeguard the purposes of the deposit insurance fund (protecting insured depositors) including by limiting the overall contribution to the 'funding limit'

Whilst there may be some scope for trade-off between flexibility and safeguards, safeguards must not be reduced below an acceptable level.

What scope will options be considered within?

The primary constraints on policy options were Cabinet's previous decision that funds should only be used where doing so provided value to depositors ("protecting insured depositors",

noting that some overseas regimes are more permissive in this respect). With this constraint in place, most remaining decisions concern the practicalities of securing this goal.

In developing options, we reviewed the International Association of Deposit Insurers (IADI) core principles, principle 9(8) and a Bank for International Settlements survey of international comparators. We also considered the experiences of the United States and European Union.

We ruled out some of the IADI principles on the grounds that they were designed for deposit insurance schemes that were more independent of the resolution authority or schemes that were more permissive about the use of deposit insurance funds than Cabinet have decided is appropriate for New Zealand.

What options are being considered?

Option one – (counterfactual) - no use of deposit insurance scheme (DIS) funds for resolution

Option two – tight safeguards

Two safeguards will be put in place:

- (a) limiting use of funds at all times to the estimated net amount DIS would have to pay out in liquidation (the ‘funding limit’);
- (b) independent *ex post* review, assessing whether use of funds was compliant with the funding limit

Cabinet has already agreed that any use of DIS funds in resolution should be limited to the expected net cost to the scheme of a liquidation. Cabinet has agreed that the Reserve Bank, as resolution authority, will make the decision to release funds.

The Reserve Bank will need to make this decision drawing on estimates of the net cost that the DIS would have incurred in a liquidation. The Reserve Bank (or the resolution manager) will rely on information and records it has on deposit takers obtained as part of its supervisory activities and resolution planning. The Reserve Bank (or the resolution manager) will be able to commission valuations and other assistance when making determinations necessary for the safeguards. This approach is consistent with what the Reserve Bank does under the existing legislative framework when considering its approach to resolution and will allow a prompt and flexible approach to a deposit taker facing difficulties.

To provide a transparent process and incentivise the Reserve Bank to ensure compliance with safeguards, we propose that there is a statutory requirement to commission and then publish an independent *ex post* review assessing whether the use of the DIS funds is compliant with the funding limit.

Option three – looser safeguards

It would be possible to introduce broadly the same controls but also allow the DIS to make a larger up-front contribution to resolution funding than the funding limit, so long as procedures were in place to recover funds later so that the ultimate net contribution did not exceed the funding limit.

Allowing the DIS to do this could provide additional flexibility in some types of resolution.

However, doing so would put DIS funds at risk, given the uncertainties involved in resolution. DIS funds are levied with the express purpose of protecting insured depositors. If the fund turned out to be unable to recover its commitments, deposit insurance funds would have

been used for other purposes. (As noted earlier, there are other potential sources of funding for resolution).

How do the options compare to the status quo/counterfactual?

	Option One – counterfactual, no use of DIS funds	Option Two – tighter safeguards	Option Three – Looser safeguards
Flexibility in resolution	0 Does not allow DIS funds to be used, when doing so might produce preferable outcomes	+	++ Allows a larger contribution from DIS where recovery of excess over the funding limit is expected
Safeguarding purpose	0 Ensures funds cannot be used for different purposes (but may prevent some positive purposes)	+	-- Creates risk of unintentional overspend of DIS resources
Overall assessment	0 Safeguards funds but may prevent positive outcomes for depositors	+	0 Marginal increase in flexibility over option 2 does not justify increased risk to DI funds

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

The Reserve Bank agrees with Option 2.

Although Option 3 might provide some additional resolution flexibility, it involves too high a risk of compromising the purpose for which DIS funds were collected, particularly given the existence of alternative sources of resolution funding.

What are the marginal benefits and costs of the preferred option?

Affected groups	Comment	Impact	Evidence Certainty
Additional costs of the preferred option compared to taking no action			
Deposit insurance scheme	Increases the likelihood scheme funds will be used but only where doing so produces a superior outcome	None	High
Depositors	Receive the same protection	None	High

Reserve Bank		None	High
Public finances		None	High
Total non-monetised costs		None	High
Additional benefits of the preferred option compared to taking no action			
Deposit insurance scheme	Facilitates better outcomes than liquidation	Low	High
Depositors	Receive the same protection and may receive better outcomes (e.g. Continuity of service)	Low	High
Reserve Bank	Increased flexibility	Low	High
Public finances	Reduces costs of resolution	Medium	High
Total non-monetised benefits		Medium	High

5. No creditor worse off

DIAGNOSING THE POLICY PROBLEM

What is the problem?

How will the 'no creditor worse off' (NCWO) principle be made operational?

In December 2019, Cabinet agreed to introduce an after-the-event compensation mechanism to compensate any creditors that a resolution leaves worse off than they would have been in a normal liquidation (the NCWO safeguard).

The resolution of a deposit taker can avoid the economic and social spill-overs of a failure, and support the public interest in maintaining the continuity of critical financial services and preventing contagion. While Cabinet agreed that resolutions should be conducted in a manner that respects the creditor hierarchy that would normally apply in a liquidation, they noted sometimes departure from the hierarchy is necessary to maintain the stability of the financial system.

The choice of resolution, rather than liquidation, may create better outcomes for creditors but it may also be pursued in order to protect the public interest but in ways that adversely affect the rights of some creditors. While the resolution authority's statutory purposes oblige it to try to preserve the creditor hierarchy, financial stability interests or other considerations may over-ride this hierarchy in some circumstances. In such cases it is appropriate to provide a compensation mechanism for affected creditors in recognition of rights that have been adversely affected. The NCWO safeguard provides a compensation mechanism for creditors in these circumstances.

Following the Cabinet's decision to introduce the NCWO principle, the Reserve Bank needs to elaborate how the mechanism will operate. This detail includes who makes the compensation determination, appointment and removal provisions, how compensation is to

be calculated, and appeal rights. Without further detail, the NCWO safeguard may not provide credible protection for the property rights of creditors. There are range of policy problems for the NCWO safeguard that need to be addressed including:

1. Determining who is entitled to compensation.
2. Assigning responsibility for assessing NCWO compensation.
3. Deciding how NCWO compensation is calculated.
4. Providing access to relevant information for the valuer.
5. The disclosure of valuation calculation.
6. Providing appeal rights for the NCWO determination.
7. Funding of NCWO compensation payments.

The Reserve Bank has developed a proposal for each of these seven policy problems.

What objectives are sought in relation to the policy problem?

In carrying out a resolution in accordance with its financial stability purposes, Cabinet has already agreed the Reserve Bank should seek to minimise the cost of dealing with a licenced deposit taker. This includes having regard to preserving the value of the entity in resolution, maintaining the creditor hierarchy, and protecting public money. Introducing the requirement to make NCWO payments where necessary helps to re-enforce these requirements, since NCWO payments may well require recourse to public funds. For all these reasons, the resolution authority will have incentives to develop resolution strategies that preserve franchise value (which is likely to be lost in a liquidation).

The NCWO framework needs to provide creditors and shareholders with a credible and fair process for determining any payment due, respecting their property rights in an insolvency process. It needs to do so in a way that balances the resolution authority's need for operational independence with the need for transparency and public accountability over how creditors' rights have been determined.

DECIDING UPON AN OPTION TO ADDRESS THE POLICY PROBLEM

What criteria will be used to compare options?

The options will be assessed on the basis of:

- **Consistency with the loss minimisation and creditor hierarchy objectives of the resolution authority**
- **Credibility and fairness:** The desirability of presenting creditors and shareholders with a credible and fair process for determining their treatment in a way that respects their property rights in an insolvency process.
- **Accountability / Transparency:** Appropriately balancing operational independence and delegated decision-making to the resolution authority with accountability for their actions and transparency of their decision-making processes.

What scope will options be considered within?

The technical review group recommended the Review look at NCWO provisions for other jurisdictions and adapt requirements for New Zealand. Consistent with this advice, NCWO safeguards in Canada, Europe, Hong Kong, Singapore, and the United Kingdom were examined in developing the proposals.

Generally, there is a high-level of consistency across jurisdictions in how NCWO provisions operate and the options developed here reflect this consensus.

The proposals have also been reviewed by insolvency experts and members of the Independent Expert Advisory Panel, and reflect their feedback.

What options are being considered?

The following options have been identified and were consulted on as part of the consultation process. Policy problems 2 and 6 have more than one option being considered. For these two issues, tables evaluating the different options are produced at the end of the exposition of options and preferred options are proposed at that point.

1. Determining who is entitled to compensation:

Proposal: Any creditor or shareholder who is worse off in a resolution when compared to normal insolvency proceedings shall be entitled to compensation.

Clarity on when compensation is payable is essential for the NCWO safeguard. It is important to determine: which legal or natural persons are entitled to NCWO compensation; which types of resolution trigger NCWO rights to compensation; and the point in time at which assessments are made.

To be consistent with existing Cabinet decision and international practice, *all* shareholders and creditors of a deposit taker immediately before the commencement of resolution should be eligible for compensation (if payable). Shareholders, like creditors, have rights and entitlements in connection with their shareholding. It is important that the treatment of shareholders is considered in a resolution in a similar manner to creditors. The scope of persons potentially entitled to compensation is intentionally broad as it would be difficult to define all creditors and shareholders affected by a resolution in advance.

In terms of types of resolution, the Reserve Bank's power to place an entity in resolution will apply to all licensed deposit takers along with their locally incorporated associated persons and subsidiaries.

Since associated persons and subsidiaries will be subject to the same set of resolution powers, it is also possible that resolution decisions will be made that violate the creditor hierarchy in order to promote the public interest. The same entitlement to compensation therefore arises, so creditors and shareholders of associated persons and entities will also be eligible for NCWO compensation.

However, there is one important situation in which NCWO compensation cannot be offered because of operational complexities. That is where the licensed deposit taker in New Zealand is operating as a branch of an overseas deposit-taker.

There are two ways in which overseas deposit-takers can operate in New Zealand. They can set up a New Zealand incorporated subsidiary, owned by the overseas entity. In this case the situation creates no complications and NCWO compensation will apply. Alternatively, an overseas deposit-taker may choose to operate as a branch. In that case, the New Zealand business has no formal legal personality in New Zealand; legally, it remains part of the overseas entity. As a result, the Reserve Bank's resolution powers will operate very differently and in a much more limited way. An NCWO valuation would require an assessment of insolvency and regulatory treatment in both jurisdictions. There would be challenges for a valuer in accessing necessary information, the valuation could take a longer period of time and would be very costly (due to the need to engage professionals in both jurisdictions). Any assessment is likely to be heavily qualified because of the cross-border aspects. For this reason, NCWO compensation will not be offered where an overseas deposit taker operating in New Zealand as a branch is placed in resolution.

The question of timing should be dealt with using the resolution commencement date. Anyone who was a creditor or shareholder on the commencement date is eligible for compensation. The commencement date also serves as the point in time at which the solvency counterfactual is calculated.

This proposal provides a credible and fair process for the treatment of shareholders and creditors.

There were no alternative options considered for this issue.

2. Assigning responsibility for assessing NCWO compensation:

Option One - An independent valuer is appointed by the Minister of Finance to determine whether compensation is payable to prescribed persons.

Option Two - The Reserve Bank can appoint and remove the independent valuer to determine whether compensation is payable to prescribed persons.

Option One and Option Two both propose that an independent valuer determines whether compensation is payable. Independence helps mitigate conflicts of interest and enhances the credibility of the NCWO process. This is common practice in other jurisdictions with NCWO provisions, where the valuer is independent from both the deposit taker and the resolution authority. In addition to independence, the valuer will need to have appropriate skills and expertise. Expertise in financial market structures, accounting and strategic performance are likely to be criterion for selection.

Option one, under which the Minister would appoint the independent valuer, better aligns with the objective of having a credible and fair process. Internationally it is common for the Minister of Finance (or the Treasury) to be involved in the appointment of an independent valuer. This is because the NCWO mechanism may result in the deployment of public funds if compensation is found to be payable, and the Minister of Finance has an interest in provisions which present risks to public funds. Having the Minister involved in the appointment of the independent valuer is consistent with the approach taken more generally across the DTA in respect of provisions which relate to the deployment of public funds. It may also be seen to further mitigate against conflicts that the Reserve Bank may have and enhance legitimacy.

Option two, under which the Reserve Bank would appoint an independent valuer, would reflect a core objective of the Phase 2 Review - to empower the Reserve Bank as resolution authority by giving it the power and tools to perform its functions. However, the Reserve Bank as resolution authority would have made the decision to put the deposit taker in resolution and will be making decisions on resolution strategy that will affect the rights of creditors and shareholders. This would create a potential conflict of interest when appointing a valuer.

For either option, we propose that there should only be a power to remove the valuer on the grounds of serious misconduct, incapacity, lack of competence, or the presence of conflicts. This sets a relatively high bar for the removal of the valuer, which will add credibility to the valuation mechanism (and is consistent with the approach taken in other jurisdictions).

The relative advantages of the two options are examined and a preferred option identified below (page 40).

3. Deciding how NCWO compensation is calculated:

Proposal: The valuation calculation shall assess the difference between insolvency treatment and resolution treatment, and shall be made in accordance with certain assumptions and principles.

The independent valuer will assess that compensation is payable when (a) is higher than (b):

- a) what creditors and shareholders of the licenced deposit taker would have received had the winding up of the licenced deposit taker commenced immediately before the resolution;
- b) what creditors and shareholders have received (or are expected to receive) as a result of the resolution, discounted back to the resolution start date.

The wind-up valuation will be based on information that was known to the Reserve Bank at the resolution commencement date. Decisions to resolve a deposit taker can be made in circumstances involving considerable uncertainty. Provided the resolution authority has acted on known information at that time, the benefits of hindsight should not be included in the calculation.

Any public financial assistance will be disregarded in the calculation of insolvency treatment. The inclusion of any public financial assistance would distort the value of the deposit taker's balance sheet in a liquidation.

We propose that regulations can be used to provide additional guidance to valuers on the detailed assumptions and principles that could be applied to the insolvency valuation. In general, and in keeping with other jurisdictions, we would expect valuers to be asked to conduct a fair and realistic valuation, based on prudent and realistic assumptions. Beyond that, there are a range of technical assumptions that could be made in respect of an entity's assets and liabilities. Regulation on these matters would be advantageous in providing greater transparency and certainty, and help ensure a consistent approach to valuations over time.

There were no alternative options considered for this issue.

4. Providing access to relevant information for the valuer:

Proposal: The independent valuer shall have access to a broad range of information necessary to conduct the valuation

The valuer requires ample information to determine what each class of creditors has received as a result of the resolution, and what they would have likely received in a hypothetical liquidation scenario. Access to a broad range of information will allow the independent valuer to credibly perform its functions subject to maintaining the confidentiality of information received from the deposit taker.

Both deposit takers and the Reserve Bank should therefore be required to provide the valuer with any documents or records required for performing the valuation. Since this information may be valuable and market sensitive, the valuer will be required to keep this information confidential and only to use it for a proper purpose.

All the jurisdictions considered provide the valuer with broad access to information, and as such, the Reserve Bank did not consider a narrower scope for access to information.

5. The disclosure of valuation calculation:

Proposal: The independent valuer shall prepare a valuation report and give prescribed persons notice of its compensation determination.

The report will be published and include the compensation determination, the methodologies and assumptions applied to the valuation assessment, together with any additional information prescribed by the regulations. After publication of the report, creditors and shareholders will be provided with procedural information from the Reserve Bank which will deal with practical aspects such as notice, publication, payment provisions (if applicable) and how to lodge objections. Some sections of the published report may be redacted where they contain sensitive information.

This ensures a transparent process for how the independent valuer makes their compensation determination, how interested persons will be notified, and what the next steps are.

The proposal aligns with the credibility and accountability / transparency objectives of the NCWO mechanism. There were no alternative options considered for this issue.

6. Providing appeal rights for the NCWO determination:

Proposal: Broad appeal rights shall be available for NCWO determinations.

Creditors and shareholders of the deposit taker, the Reserve Bank, or the Crown will all be entitled to appeal valuer's determinations on points of fact as well as on matters of law. This enhances the credibility of the NCWO mechanism and protects parties by providing them a right to be heard, and to challenge decisions that affect their interests. The technical reference group supported broad appeal rights and advised that it would provide market confidence in the process. In New Zealand there are a number of examples of broad appeal rights for decisions of specialist decision makers including the Land Valuation Tribunal, the Weather Tight Homes Tribunal, and decisions of the Official Assignee. The proposal aligns with the accountability / transparency objective by supporting greater accountability for the actions for the resolution authority.

To provide certainty for all parties, appeals must be made within 3 months of the publication of the valuation report. After the expiration of three months, there will be no further rights to challenge the independent valuer's determination.

While appeal rights can ensure decisions are in accordance with the law, and incentivise good decision making, they need to strike the right balance between protecting the interests of affected parties against enabling the Reserve Bank to pursue its statutory mandate efficiently and effectively. Broad rights of appeal could increase the risk of protracted court proceedings given the subjectivity and uncertainty associated with valuations. These risks could be mitigated by the design of the NCWO calculation by ensuring that the information, valuation principles, and assumptions that the independent valuer must take into account are sufficiently clear. Time limits on appeals (3 months from the NCWO determination), and preventing further rights of appeal from the court, should facilitate a more efficient process.

Reflecting international practice, the Reserve Bank considered two options for how appeals should be assessed.

Option One - The courts will hear appeals to the determination of the independent valuer

Option Two - A specialist tribunal should be set up to hear objections to determinations by the independent valuer.

Internationally there are some examples of specialist tribunals to hear appeals of a valuer's NCWO determination, including Hong Kong and the United Kingdom. While a tribunal may provide benefits in terms of the specialist expertise of its members, this needs to be weighed up against the cost and administrative complexity of providing for a tribunal in legislation. In New Zealand it is common practice for the courts to deal with appeals on technical matters and for judges to commission assistance from experts to guide their judgment.

The relative merits of the two options are considered and a preferred option is identified below (p.41).

7. Funding NCWO compensation payments:

Proposal: The Crown shall satisfy any compensation that is not met in full by the deposit insurance scheme fund.

Consistent with international practice, Cabinet has agreed that the Reserve Bank may use the deposit insurance fund to protect insured depositors in a resolution, including contributions to NCWO compensation payments, subject to the safeguards discussed earlier in this RIS.

The policy intent is that any compensation obligation under the NCWO mechanism is promptly paid. Any delays or uncertainties associated with the payment of compensation undermines the credibility of the NCWO mechanism.

It is proposed that NCWO payments will first be funded by contributions from the deposit insurance fund, and when they are not met in full (noting that contributions by the fund are limited by applicable safeguards as discussed above), the Crown will satisfy the outstanding balance. This combined approach will mitigate the reliance on public funds and align with the loss minimisation and objectives of the resolution authority and enhance the credibility of the NCWO mechanism.

Reliance on other funding models would not address the policy intent that any NCWO compensation obligation is promptly paid. An appropriations model under the Public Finance Act (PFA) would not address the policy intent for prompt payment. Sufficient funds may not

be available under an existing appropriation, and Parliament may not be able to agree to make a new appropriation available in a timely manner.

How do the options compare to the status quo/counterfactual?

Problem 2 - Assigning responsibility for assessing NCWO compensation

	Counterfactual of no responsibility assigned	Option One – An independent valuer is appointed by the Minister of Finance	Option Two – The Reserve Bank can appoint / remove the independent valuer
Consistency with the loss minimisation and creditor hierarchy objectives	0	++ The Minister of Finance has an interest in provisions which present risks to public funds, including the NCWO mechanism.	0 Similar to the counterfactual.
Credibility	0	++ Greater credibility if the appointment of the independent valuer is made by a person at arms-length from the resolution authority.	+ Appointing an independent valuer enhances credibility, however, there may be perceived conflicts of interest for the Reserve Bank.
Accountability / Transparency	0	+ Promotes accountability to the Minister of Finance as a publicly elected official.	+ Empowers the resolution authority by giving it the power and tools to perform its functions.
Overall assessment	0	++	+

Overall, the Reserve Bank prefers option one in order to avoid conflicts of interest and secure the Minister of Finance's oversight into a process that is likely to involve use of public funds.

Problem 6 - Providing appeal rights for NCWO determinants

	Counterfactual of no appeal rights	Option One – The courts will assess appeals and judges can seek assistance from experts	Option Two – A special tribunal will assess objections to determinations by the independent valuer
Consistency with the loss minimisation and creditor hierarchy objectives	0	+ The right to challenge a determination protects the creditor hierarchy, at a lower cost to public funds	+ The right to challenge a determination protects the creditor hierarchy, but setting up a tribunal may be costly.

		compared to Option Two.	
Credibility	0	++ Enhanced credibility provided that judges can commission assistance from experts.	++ Enhanced credibility from the specialist expertise of its members.
Accountability / Transparency	0	++ Broad appeal rights for NCWO determinations provides greater accountability for the resolution authority.	++ Broad appeal rights for NCWO determinations provides greater accountability for the resolution authority.
Overall assessment	0	++	++

Overall, the Reserve Bank prefers option one on the basis that outcomes are likely to be similar and option one will be more cost effective.

What are the marginal benefits and costs of the preferred option?

This table analyses costs and benefits of the intended package of seven NCWO proposals.

Affected groups	Comment.	Impact	Evidence Certainty
Additional costs of the preferred option compared to taking no action			
Creditors		None	High
The Reserve Bank		None	High
Public funds	The NCWO mechanism potentially requires payments to creditors. These payments may be met in part by the deposit insurance scheme. Potential payments are difficult to calculate and contingent on resolution strategy (which must be determined with a view to preserving value and minimising call on public funds)	Low	Medium
Total non-monetised costs		Low	Medium
Additional benefits of the preferred option compared to taking no action			

Creditors	Compensation if disadvantaged by resolution	Low	Medium
The Reserve Bank	Underpins flexibility in resolution strategy	Low	Medium
Public funds	Allows flexibility in resolution strategies in a way that should be significantly positive overall	Medium	Medium
Total non-monetised benefits		Medium	Medium

6. Appeal rights in the resolution framework

DIAGNOSING THE POLICY PROBLEM

What is the problem?

The Reserve Bank Act 1989 limits appeal rights for resolution actions to judicial review. Judicial review allows challenge where decisions made were illegal, procedurally unfair or irrational but doesn't provide for a review of the merits of the particular decision that was made.

It is important to consider whether this remains the appropriate decision under the new framework.

Since resolution actions can have significant financial consequences, one might normally expect broad rights of appeal to apply. On the other hand, in a context of fragile market sentiment and the potential for financial contagion, it is also important that the resolution authority can act swiftly, flexibly and in a way that produces certain and unambiguous outcomes.

What objectives are sought in relation to the policy problem?

Appeal rights need to provide for appropriate judicial oversight over significant decisions but in a way that will not undermine the resolution authority's ability to promote rapid, orderly and certain solutions.

DECIDING UPON AN OPTION TO ADDRESS THE POLICY PROBLEM

What criteria will be used to compare options to the *status quo*?

We will compare options based on:

- the adequacy of judicial oversight, given the significance of the decisions being made
- the need for flexibility and certainty in decision-making

What scope will the options be considered within?

The scope is limited by the broader practices of the New Zealand legal system.

We have also examined practice in other jurisdictions, particularly as codified in the FSB Key Attributes, which state (at KA 5.5) that:

resolution regimes should not provide for judicial actions that could constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their legal powers and in good faith. Instead, it should provide for redress by awarding compensation, if justified

We note that creditors will also have the right to NCWO compensation and will have broad rights of appeal against the valuers' determination in that context.

We also considered introducing restrictions to the court's right to judicially review decisions, for example restricting injunctive relief or the ability to unwind a resolution action (including 'privative clauses'). However, the grounds for judicial review are already narrow. The right to judicial oversight is an important constitutional right, protected by the New Zealand Bill of Rights Act 1990. The courts will interpret privative clauses narrowly. Our preferred approach to reducing the risk of judicial review is to ensure that the Reserve Bank is properly empowered to conduct (and conclude) resolution through a coherent legislative schema designed around remedies being in the form of *ex post* compensation and appeal rights against those compensation decisions.

We have therefore only considered one option, of retaining the status quo.

What options are being considered?

Option 1 – (status quo) appeal limited to judicial review

This option allows relevant parties to obtain compensation if resolution powers have been used inappropriately but does not allow any legal process to obstruct the process of resolution. Since this is the preferred option and preserves the status quo, we do not provide a cost benefit analysis in this case.

7. Recovering public funds expended in resolution

DIAGNOSING THE POLICY PROBLEM

What is the problem?

Should it be possible to recover funds expended for resolution using ex post levies on deposit takers?

Resolution, rather than liquidation, may be chosen for public interest or financial stability reasons (particularly to ensure continuity of essential services or avoid contagion and the wide-ranging economic consequences that might follow from a financial crisis).

Some resolution strategies may require resources, to recapitalise the deposit taker or facilitate purchase and assumption transactions. Those resources may exceed the loss absorbency of shareholders and any creditors subject to bail-in, together with the contribution that can be made by the deposit insurance scheme (as discussed in a previous section). The core policy problem concerns who should meet these costs and via which mechanisms?

As a matter of general principle, institutions that pose a risk to financial stability and gain from financial stability should bear the costs of the risks they pose. However, there are questions about how easy it might be to regulate in a way that produces this outcome, without producing unintended consequences.

Resolution may be carried out for a number of reasons but, to the extent that it is designed to preserve financial stability, it seems reasonable to pass on the costs from the Crown to regulated entities.

As with the case of deposit insurance, this could be done by creating an *ex ante* resolution fund, financed through industry levies or by giving the Crown the right to create *ex post* levies to reimburse it for some resolution costs. *Ex ante* funding would mean that at least some of the costs had been paid by the entity that required resolution and would avoid the need to levy funds on a weakened sector after a systemic crisis. However, the use of resolution funds is more discretionary than the use of funds for deposit insurance, given the potential range of resolution strategies. It may therefore be more difficult to determine the level of levies that can be justified and to quantify the opportunity costs involved creating a resolution fund. The presence of a large fund may create moral hazard risks.

The options discussed therefore only relate to the possibility of *ex post* levies.

What objectives are sought in relation to the policy problem?

To consider mechanisms for funding resolution that, as far as possible, ensure that regulated entities bear the costs of the risks they pose to financial stability but not the costs of achieving broader social goals.

DECIDING UPON AN OPTION TO ADDRESS THE POLICY PROBLEM

What criteria will be used to compare options to the status quo?

We will compare options based on:

- enabling appropriate recovery of costs
- preventing inappropriate recovery of costs
- moral hazard risk
- consistency across the Reserve Bank's regulatory regime

What scope will options be considered within?

Due to time constraints, the options here are not as well developed as most of those considered in this regulatory impact statement. There has also only been very limited stakeholder consultation on this issue. The possibility of introducing a resolution funding levy was raised briefly during Phase 2 consultation and was not supported by submitters.

For reasons explained in the problem definition section, we have ruled out an *ex ante* funding mechanism.

The remaining options request an in principle decision, rather than firm agreement on a proposed approach.

What options are being considered?

Option one – status quo

Any costs faced by the Crown in resolution would not be recovered via a pre-positioned *ex post* levy mechanism (it would remain possible to create one immediately following a crisis via legislation, as the UK authorities did some years after the global financial crisis).

Option two – provide the Minister of Finance with delegated powers to develop proposals for consultation on an *ex post* funding levy

Cabinet would delegate authority to the Minister of Finance to develop fuller proposals for the detail of an *ex post* levy to be included in the DTA.

Including a levy would have the advantage that it would be possible to impose a levy to recover resolution costs without the need to explicitly legislate to do so at that time. At the

margin, it might also provide deposit takers with greater incentives for prudence, given that they would know that costs of resolution would be met by the industry.

The exposure draft would be used as a basis for consultation with industry in relation to the approach that was decided. Cabinet would be informed of the outcomes and make a decision as to what should be included in the Deposit Takers Bill before it is introduced to the House.

Developing appropriate rules could be complex. Decisions would need to be made about how to specify the circumstances in which a levy could be imposed. This would involve mechanisms for calculating the cost to government of a resolution and establishing whether the costs had been incurred for financial stability reasons. It would also be important to have safeguards in place to ensure that a pre-positioned levy did not undermine disciplines on the use of public funds for the bail-out of private sector entities. While the levy itself would be raised through regulation, the legislation would also need to provide guidance to the Minister of Finance in determining who should be liable for the levy and how quickly funds should be recovered.

Option three – introduce powers later, possibly through an alternative mechanism

The issue of *ex post* funding for resolution might also apply to the other sectors the Reserve Bank regulates (insurance and financial market infrastructure providers). It might therefore make sense to provide a mechanism for *ex post* levies to recover resolution costs that applied to all three sectors and for that mechanism to be contained in alternative legislation. This would be a fiscal measure and so could, potentially, be pursued by Treasury at a later date.

How do the options compare to the status quo/counterfactual?

	Option One – status quo	Option Two – delegate power to develop levy	Option Three – introduce legislation later
Enables appropriate cost recovery	0 No cost recovery	++	++
Prevents inappropriate cost recovery	0	- Depends on drafting, may be difficult to achieve	- Depends on drafting, may be difficult to achieve
Consistency with other sectoral legislation	0	0	+ Allows consideration across RBNZ regulated entities
Moral hazard risk	0	- Risk that funding mechanism reduces discipline on use of public funds	- Risk that funding mechanism reduces discipline on use of public funds
Overall assessment	0	+	+

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

Option two increases the certainty that legislation to recover resolution costs will be put in place but creates some risks for the DTA implementation time-line and would prevent considering coverage across the entities regulated by the Reserve Bank.

Both option two and three create some moral hazard risk, though this could be mitigated by providing tight controls on when a levy can be imposed.

On balance, option three is preferred by the Reserve Bank, while the Treasury prefers option two.

What are the marginal benefits and costs of introducing an *ex post* levy?

Affected groups	Comment	Impact	Evidence Certainty.
Additional costs of the preferred option compared to taking no action			
Deposit takers	Cost of levies (contingent on how the scheme will work and the frequency of crisis)	Low in most circumstances but potentially medium following a crisis	Low
Public finances		None	High
Total non-monetised costs		Low	Low
Additional benefits of the preferred option compared to taking no action			
Deposit takers		None	
Public finances	Value of levies (contingent on how the scheme will work and the frequency of crisis)	Low in most circumstances but potential high following a crisis	
Total non-monetised benefits		Low	Low

8. Stays on early termination rights

DIAGNOSING THE POLICY PROBLEM

What is the problem?

Entities that go into resolution are likely to have a variety of on-going contracts in place, from derivatives contracts to third party service agreements. It is important to prevent rights under these agreements from impeding an orderly resolution and to create clarity about the status of such rights when an entity is put into resolution.

Some contractual rights can create impediments to a successful resolution, in particular:

- Enforcement of debts and security interests by creditors: can result in losses crystallising and compounding the deposit taker's existing shortfall of assets vis-à-vis liabilities;

- Disorderly close out by derivative counterparties: Close out rights refer to a bundle of rights commonly included in derivatives contracts. These include rights to accelerate the speed at which obligations fall due (acceleration rights), terminate obligations otherwise owing (termination rights), and set-off/net obligations (set off and netting rights). Exercising these rights can result in losses crystallising, and the enforcement of rights over certain collateral, compounding the deposit taker's existing shortfall of assets vis-à-vis liabilities. The exercise of these rights can mean that certain risks faced by the entity (e.g. foreign exchange and interest rate risks) are no longer hedged, increasing the likelihood that the entity will suffer otherwise avoidable losses in the future;
- Cessation of or disruption to essential services provided to the deposit taker by third parties: On entry into insolvency proceeding or resolution, certain service providers may have contractual rights to terminate the provision of services to a deposit taker.

It is therefore important to impose restrictions on the exercise of these rights while resolution is in progress.

At the same time, because stays or moratoria limit the legal rights otherwise available to third parties, they are generally scope and/or time limited (to ensure they are no broader than necessary), and their use may be subject to additional legal constraints.

Existing decisions deal with some of these difficulties, particularly in terms of the enforcement of debts and security interests. For example, Cabinet has already decided that the DTA should carry over a suitably adjusted version of the Reserve Bank's ability to impose a moratorium on a variety of claims on an entity in resolution, contained in s.122 of the Reserve Bank Act [DEV-21-Min-007 para 33].

The remaining problems concern:

- whether existing arrangements for moratoria and stays are adequate to avoid possible impediments to resolution; and
- whether stays are of appropriate duration to balance the need to avoid impediments to resolution on the one hand and the need for market certainty over property rights on the other

What objectives are sought in relation to the policy problem?

Our objective is to reduce impediments to resolution as far as possible, without unduly limiting market participants' contractual rights.

DECIDING UPON AN OPTION TO ADDRESS THE POLICY PROBLEM

What criteria will be used to compare options to the status quo?

We will compare options based on:

- the extent to which they adequately prevent impediments to orderly resolution
- the extent to which the duration of stays is appropriate (sufficient but not excessive)
- comparability with the Reserve Bank's other sectoral legislation

What scope will options be considered within?

There were no constraints on options considered, other than the need to achieve the intended purpose in the context of decisions that have already been made.

Options were developed in the light of practice in other jurisdictions (particularly in relation to derivatives close-out) and comparison with other relevant New Zealand legislation, including the FMI Act and Companies Act.

What options are being considered?

Option one: status quo

The arrangements that have been agreed by Cabinet so far broadly carry over existing powers contained in the Reserve Bank Act.

In particular, s.122 of the Reserve Bank Act enables a resolution authority (currently the statutory manager) to impose a moratorium on a wide range of creditor claims. Under s.127, the resolution authority can also suspend the payment of obligations to creditors and cancel any future funding obligations. Finally s.139 provides some protection from the cancellation of contracts for essential services.

Scope

Between them, these provisions provide good general protection against claims by creditors and security holders.

For derivatives contracts, the current moratorium provisions cover some types of close out rights but not others. They don't cover acceleration rights, termination rights or set off and netting rights.

Suppliers of essential services are prevented from cancelling contracts on the grounds of non-payment that took place prior to resolution (under s.139, incorporating s.275 of the Companies Act). However, a wider range of contracts than those for 'essential services' may be necessary to secure business continuity. Additionally, some contracts may give service providers the right to cancel a contract simply on the basis that their client is in resolution or that the Reserve Bank has exercised its other resolution powers.

Duration

Restrictions under the moratorium provisions could be in place for a long period of time (up to twelve months or more). To the extent that these provisions cover derivatives contracts, such a long stay is out of line with international practice and has the potential to deter market participants from offering derivatives products to New Zealand deposit takers.

There is an exception to the moratorium provisions for a sub-set of close out rights - the enforcement of security rights over collateral posted under derivatives contracts. In this case, there is generally a stay on enforcement rights until the close of the business day following the day when the entity is placed into resolution, which is more in keeping with normal international practice. However, this stay can be extended by the Reserve Bank if (in summary) it is confident that the entity will eventually be able to make good on its obligations under outstanding contracts.

Overall, existing arrangements provide some protection against the kinds of contractual rights that might impede resolution but that protection is incomplete. In some cases, a moratorium also suspends rights for too long.

Option two: additional powers

Option two would create two new powers.

1. *Stay on all derivatives close out rights*

A short stay on all derivatives close out rights would replace the partial coverage in the current moratorium provisions.

The default duration of the stay, though, would be limited. It would be the close of the business day after the day the entity was placed in resolution. The Reserve Bank would be able to shorten this duration at its discretion. It would also be able to lengthen it if appropriate conditions were met (broadly that the entity was able to pay debts as they fall due and had an adequate capital position, making it likely obligations would be met over time).

2. *Preventing exercise of other contractual rights solely on the basis that the deposit taker is placed into resolution*

New rules to prevent other third parties from cancelling their contract with entities (or exercising certain other contractual rights) solely on the grounds that those entities have been placed in resolution or made subject to resolution powers (sometimes known as '*ipso facto*' clauses).

These rules would sit alongside the existing s.139 rules (preventing cancellation for non-payment prior to liquidation, for a narrower set of providers).

No rules would, for example, prevent service providers from cancelling contracts for non-payment *after* resolution. Although the new bar on the application of *ipso facto* clauses is drafted widely, in practice such clauses will generally appear in a small number of relatively high-value contracts that are relatively central to business continuity.

The following table summarise the impacts of this option on different categories of contracts:

Reason for cancellation	Contracts for essential services	Other contracts
Non-payment prior to resolution	Cannot cancel	Can cancel
Ipsso facto – mere fact of entering resolution	Cannot cancel	Cannot cancel (unlikely many contracts will have this clause)
Non-payment during resolution	Can cancel	Can cancel

Overall, these provisions would provide a more adequate range of measures to prevent unnecessary impediments to an orderly resolution.

Whilst the coverage of derivatives close-out rights would be extended beyond the *status quo* position, the duration of any stay would be clearly limited in ways that are more reflective of international practice and global market expectations.

Very similar powers to those contained in this option are included in the recent Financial Markets Infrastructure Bill 2021. Introducing this option will therefore improve the consistency of the sectoral legislation across areas regulated by the Reserve Bank. Similarities also provide additional confidence that stakeholders are unlikely to object to this option.

How do the options compare to the status quo/counterfactual?

	Option One – current arrangements	Option Two – additional powers
Removes appropriate impediments to resolution	0	+
Appropriate duration	0	+
Consistency with other sectoral legislation	0	+
Overall assessment	0	+

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

The Reserve Bank and Treasury agree with option 2.

What are the marginal benefits and costs of the preferred option?

Affected groups	Comment	Impact	Evidence Certainty
Additional costs of the preferred option compared to taking no action			
Affected creditors	Some creditors will be unable to enforce short-term claims, which may result in reduced ultimate recovery.	Low	Medium
Creditors overall	The overall asset pool available will not be reduced	None	High
The Reserve Bank (as resolution authority)		None	High
Total non-monetised costs		Low	Medium
Additional benefits of the preferred option compared to taking no action			
Affected creditors		None	High
Creditors overall	The overall outcome should be a more orderly resolution with less destruction of value	Medium	Medium
The Reserve Bank (as resolution authority)	Increased ability to enable orderly resolution.	Low	High
Total non-monetised benefits		Low	Medium

9. Penalties and Director's liability insurance

DIAGNOSING THE POLICY PROBLEM

What is the problem?

To what extent should directors be able to obtain indemnity or insurance in respect of any penalties they incur under the DTA?

The planned regulatory regime will impose duties on directors with significant potential civil penalties for non-compliance (we expect these to be fines with an upper limit in the region of \$1 million).

Directors might seek insurance to protect themselves against this liability and that insurance might be provided by their employers, potentially reducing the incentive effect of penalties.

On the other hand if potential personal liability is too high, that may make it difficult to recruit directors of appropriate quality.

In April, Cabinet agreed that it should not be possible for directors to be insured or indemnified against their liabilities by their employers but subsequent advice from a range of stakeholders suggests this may place too great a personal burden on directors.

What objectives are sought in relation to the policy problem?

To ensure that directors have appropriate incentives for compliance with regulatory requirements.

DECIDING UPON AN OPTION TO ADDRESS THE POLICY PROBLEM

What criteria will be used to compare options to the status quo?

We will assess options based on:

- the degree to which directors will maintain incentives for compliance
- reducing the risk of recruitment difficulties

What scope will options be considered within?

The penalty regime has already been established. We have reviewed the provisions in similar New Zealand legislation and in overseas jurisdictions such as Australia.

What options are being considered?

Option 1 (Status quo) no indemnity or insurance

This option would maximise directors' incentives to comply with regulation but might make it difficult or costly to recruit directors.

Option 2 limited indemnity / insurance

Under this option, indemnity or insurance would be allowed but only under limited circumstances set out in the DTA (such as in cases where actions were carried out in good faith and with prescribed procedures for agreeing to provide insurance that ensure Board level approval, along the lines of those in the Companies Act).

How do the options compare to the status quo/counterfactual?

	Option One – (status quo) no indemnity	Option Two – limited indemnity/insurance
Strength of Director’s compliance incentives	0	- Reduces compliance incentives, but not all actions can be indemnified/insured
Reduced recruitment risk	0 Status quo implies quite high risk of difficulties	+ Reduces recruitment risk
Overall assessment	0	+ Overall, Option Two is a more balanced approach

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

Option Two

What are the marginal benefits and costs of the preferred option?

Affected groups	Comment.	Impact	Evidence Certainty
Additional costs of the preferred option compared to taking no action			
Directors	Possible reduction in salary to offset costs of employer insurance.	Low	Medium
Regulated entities	Possible increased cost of insuring directors (though should be offset by lower salaries)	Low to none	Medium
Overall economic welfare	Slightly weaker incentives to comply with regulatory regime and therefore marginal financial stability reduction	Very low	Medium
Total non-monetised costs		Very low	Medium
Additional benefits of the preferred option compared to taking no action			

Directors	Limited indemnity for breach of duties	Low in general as breaches should be low but potentially high for a particular Director that has breached a duty	Medium
Regulated entities	Increased ease of hiring directors	Low	Medium
Overall economic welfare		None	Medium
Total non-monetised benefits		Low	Medium

Section 3: How will the new arrangements be implemented?

The changes proposed here are part of those that will be given effect to by a bill scheduled for introduction in early 2022. This bill will create a new Deposit Takers Act. Subject to Parliamentary process, we would expect the bill to be enacted some time in 2023.

This process will be led by the Reserve Bank and the legislation, once enacted, will be administered by the Reserve Bank. The Treasury will also monitor the performance of the Reserve Bank on behalf of the Minister of Finance.

Implementation of the DTA as a whole will be a multi-year process, potentially taking until 2026-7. There will be substantial work to develop new prudential requirements for deposit takers. Licensing of deposit takers under the new standards will also be an extensive process.

The implementation of the Deposit Insurance Scheme is planned for 2023. Some operational elements of the scheme will require further development and public consultation including, for example, the size of any deposit taker levies and regulations requiring depositors to update their data systems so as to group together all accounts belonging to the same depositor (a 'single customer view').

The comprehensive regulatory impact statement produced for earlier decisions in April notes a range of risks involved in implementation, particularly: resourcing for the Reserve Bank; the potential moral hazard that may arise from implementing the Deposit Insurance Scheme before some elements of the new prudential framework; and the risk of unintended consequences in the Trans-Tasman context, particularly in relation to resolution and crisis management regimes. The Reserve Bank will be given a new statutory resolution function of coordination with other authorities and significant coordination with Australian counterparts is anticipated in resolution planning and the operation of any actual resolution.

The specific risks involved in the changes discussed in this regulatory impact statement are largely subsidiary to those larger risks Cabinet has already considered.

How will the new arrangements be monitored, evaluated, and reviewed?

As monitor of the Reserve Bank, established through the Reserve Bank of New Zealand Act 2021, the Treasury will need to establish robust ongoing monitoring arrangements, including

establishing regular requirements for information from the Reserve Bank and working with the Reserve Bank to identify and assess relevant performance metrics.

As part of its role in administering the new Deposit Takers Act, the Reserve Bank will review the new prudential regime for deposit takers and the deposit insurance scheme five years after it has come into force. This review will provide an opportunity to evaluate the effectiveness of the new prudential regulatory regime and deposit insurance scheme, and to ensure no unexpected issues have arisen. It will also allow the Reserve Bank to examine the interactions with the new Reserve Bank Act.