# New Zealand: Financial Sector Assessment Program Technical Note-Contingency Planning and Crisis Management Framework

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IMF Country Report No. 17/116

# NEW ZEALAND

## FINANCIAL SECTOR ASSESSMENT PROGRAM

May 2017

## TECHNICAL NOTE—CONTINGENCY PLANNING AND CRISIS MANAGEMENT FRAMEWORK

This Technical Note on Contingency Planning and Crisis Management Framework on New Zealand was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in May 2017.

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E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

**International Monetary Fund**
**Washington, D.C.**

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May 2017

# TECHNICAL NOTE

## CONTINGENCY PLANNING AND CRISIS MANAGEMENT FRAMEWORK

Prepared By
**Monetary and Capital Markets Department**

This Technical Note was prepared by Michael Andrews (External Expert) in the context of the Financial Sector Assessment Program in New Zealand. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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# Glossary

| | |
|---|---|
| AMI | Allied Mutual Insurance |
| APRA | Australian Prudential Regulation Authority |
| ASIC | Australian Securities and Investments Commission |
| AUD | Australian Dollars |
| CIMA | Corporations Investigation and Management Act |
| CoFR | Council of Financial Regulators |
| ESAS | Exchange Settlement Account System |
| FMA | Financial Markets Authority |
| FMI | Financial Market Infrastructure |
| GMRA | Global Master Repurchase Agreement |
| IAIS | International Association of Insurance Supervisors |
| IPSA | Insurance (Prudential Supervision) Act 2010 |
| MOC | Memorandum of Cooperation on Trans-Tasman Bank Distress Management |
| MOU | Memorandum of Understanding |
| MMOU | Multi-lateral Memorandum of Understanding |
| NBDT | Nonbank Deposit Taker |
| NBDT Act | Nonbank Deposit Takers Act 2013 |
| NZD | New Zealand Dollar |
| OBR | Open Bank Resolution |
| OMO | Open Market Operation |
| ORRF | Overnight Reverse Repurchase Facility |
| PRESS | Proportionate Risk Evaluation Surveillance System |
| RBA | Reserve Bank of Australia |
| RBNZ | Reserve Bank of New Zealand |
| RMBS | Residential Mortgage Backed Securities |
| TAF | Term Auction Facility |
| TTBC | Trans-Tasman Banking Council |



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# EXECUTIVE SUMMARY

**Several unique considerations apply to contingency planning and crisis management arrangements in New Zealand.** These include dependence on self-discipline, market discipline and low intensity prudential supervision. There is also strong interdependence with Australia given that the four systemically important New Zealand banks are all large enough to be of material concern to their Australian parents and home supervisor. Successive New Zealand governments have elected not to introduce deposit insurance, one of the usual elements of the financial safety net.

**The Reserve Bank of New Zealand (RBNZ) is the prudential supervisor, lender of last resort, and has oversight responsibility for designated payment systems.** The Financial Markets Authority (FMA) is the market conduct regulator, and together with the RBNZ oversees securities settlement systems. The Treasury is the lead advisor to the government on economic, financial, and regulatory management. These three agencies, together with the Ministry of Business, Innovation and Employment (portfolio responsibility for the FMA) comprise the Council of Financial Regulators (CoFR).

**The CoFR is an advisory and coordinating body.** There are no standing arrangements for crisis management, but as the experience in dealing with the failure of a large insurer after the Canterbury earthquakes illustrates, incident-specific committees can be quickly formed. Work to date on financial sector crisis preparedness has focused on the large banks.

**Greater clarity is required on the decision-making process for dealing with a crisis and the exercise of resolution powers.** There are currently differences among key stakeholders in their interpretation of the legal framework and respective roles and responsibilities in resolution. The RBNZ should be the sole resolution authority, with clear mandates and accountabilities. In addition, the RBNZ should require an approval by the Minister of Finance only for resolutions with fiscal or systemic implications. The Treasury's lead role should focus on whether and how to provide a guarantee or public funds in support of a resolution recommended by the RBNZ, and provision of advice to the Minister in this respect.

**Work has already begun to identify the necessary resources such as rosters of potential statutory managers, and personnel from government, agencies and the private sector, who could be mobilized to deal with a crisis.** This work needs to be further developed. In parallel, the RBNZ should continue with documenting the procedures required for appointing a statutory manager, open bank resolution (OBR) and other resolution options. The Treasury should complete "shelf" agreements that may be required for provision of a Crown guarantee or other support in a crisis.

**Trans-Tasman cooperation arrangements are well-established.** The Memorandum of Cooperation on Management of trans-Tasman Bank Distress (MOC) should be expanded to include insurance and financial market infrastructures (FMIs). While there are work streams underway to address both areas, it would be preferable to broaden the existing crisis management agreement.



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**In the absence of support for deposit insurance, consideration should be given to establishing through legislative amendment a limited depositor preference to provide legal certainty for the *de minimis* deposit exemption from haircutting in OBR.** A suitable *de minimis* amount could provide some of the benefits of deposit insurance, including mitigating against runs, and permitting purchase and assumption-type resolutions. It would also add to the credibility of OBR as an alternative to bailouts by mitigating potential pressure to protect depositors, as happened through the extension of the Crown Retail Deposit Guarantee Scheme to finance companies.

**The RBNZ has well designed standing liquidity facilities.** During the global financial crisis, the RBNZ revised conditions for standing facilities and introduced three new facilities. These remain in the RBNZ tool-kit and could be reintroduced on short notice if required.

**The RBNZ has a wide range of remedial supervisory powers with respect to banks, insurance companies and nonbank deposit takers.** However, for banks, the consent of the Minister of Finance is required for the issuance of directions. The RBNZ Act 1989 should be aligned with the Insurance (Prudential Supervision) Act 2010 (IPSA) and the Nonbank Deposit Takers Act 2013 by removing this role of the Minister in taking remedial supervisory action. The same principle should be reflected in the implementation of the oversight regime for FMIs.

**Revision to the RBNZ Act to establish objectives for resolution should introduce requirements to consider the interests of depositors and the broader public interest.** The RBNZ Act and IPSA should be revised to require post-reporting by the RBNZ on performance against resolution objectives to enhance accountability. The RBNZ Act should be revised to have the same power as in IPSA to apply for the appointment of a liquidator. A special resolution regime paralleling that in IPSA should be introduced for nonbank deposit takers.

**The credibility of OBR would be enhanced by a legislative foundation for its key elements rather than relying on policy which is subject to change.** Establishment of a depositor preference to an appropriate limit, and specific powers to bail-in (haircut) depositor and other creditor claims, would eliminate potential ambiguity around the requirement for a statutory manager to "have regard to" the priority of creditor claims.

**A legal mechanism is required to temporarily exempt information that might impair effective resolution from the continuous disclosure requirements for listed companies.** In addition, the RBNZ should pursue the possibility of including in the MOC specific provisions for the Australian authorities to ensure continued provision of services to the New Zealand subsidiary by the parent bank or other group member.



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**Table 1. New Zealand: Main Recommendations**

| Recommendation | Timing | Authorities |
|---|---|---|
| Strengthen domestic crisis management arrangements:<br>• Reach ex ante agreement on roles, responsibilities and decision-making processes.<br>• Preposition logistics and communications plans.<br>• Complete initial work on plans to mobilize resources in a crisis.<br>• Complete procedural guidance for appointment of a statutory manager, implementation of OBR and other resolution tool-kit options.<br>• Test domestic preparations in simulation exercises. | MT | CoFR |
| Revise the trans-Tasman MOC to specifically include insurance and FMIs. | MT | CoFR |
| Reconsider the merits of deposit insurance, or in the continued absence of policy support, introduce a limited depositor preference to provide legal certainty for the *de minimis* exemption contemplated in OBR. | MT | Treasury/RBNZ |
| Revise the RBNZ Act in line with IPSA and the NBDT Act to remove the role of the Minister in issuing directions. | MT | RBNZ/Treasury |
| Revise the RBNZ Act to provide greater clarity and certainty in resolution:<br>• Insert objectives in resolution including protection of depositors and the public interest.<br>• Require accountability reporting against the resolution objectives in both the RBNZ Act and IPSA, and NBDT Act when revised as recommended above.<br>• Clarify that the RBNZ is the sole resolution authority.<br>• Insert an express requirement for Ministerial consent for resolutions with fiscal or systemic implications only.<br>• Clarify Treasury's role as a provider of advice to the Minister on the RBNZ recommendations regarding resolution.<br>• Provide express bail-in powers to the statutory manager. | MT | RBNZ/Treasury |
| Ex ante agreement on reporting requirements and decision-making procedures for OBR and other resolution options with fiscal or systemic implications. | MT | CoFR |
| Provide a legal foundation to exempt from continuous disclosure requirements information on resolution if such disclosure would be harmful to effective resolution. | ST | CoFR |



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# INTRODUCTION

**1. Contingency planning and crisis management arrangements need to be considered in the context of the unique circumstances of New Zealand.** There is a long-standing commitment to minimizing the role of government and the various regulatory agencies, with a reliance on three pillars of self-discipline, market discipline, and regulatory discipline. While in recent years the approach to prudential supervision has evolved away from an almost complete reliance on disclosure and market discipline, it continues to be less resource intensive and intrusive than is common in most countries. Successive New Zealand governments have chosen not to introduce deposit insurance, one of the usual elements of the financial safety net.

**2. The New Zealand financial system is bank-dominated, and the banking sector is highly concentrated.** Four large banks, all subsidiaries of large Australian banks (3 also have dual registration as branches), comprise about 83 percent of banking sector assets. Each of these subsidiaries is material to the parent bank, creating unique interdependencies as the 4 subsidiaries are considered systemically important in New Zealand, and are also sufficiently large to pose a material risk from the perspective of the home supervisor. Recognizing the interdependencies, home-host relationships are well developed and extend as far as both countries having introduced in their respective legislation requirements to take into account the potential impact on financial stability in the other country when taking supervisory and resolution actions.

**3. The current resolution regime has shortcomings with respect to the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions*.** Several gaps could be addressed by revising current legislation and approaches, and even the gaps arising from the absence of deposit insurance could be narrowed.

**4. New Zealand has been a pioneer in addressing too-big-to-fail.** Bank creditor recapitalization, the concept that has evolved into the current OBR policy, was first discussed in the early 2000s, well in advance of the global financial crisis when it became an international priority. Motivated by the need to have a credible alternative to bailing out a failing systemically important institution, the RBNZ proposed what has since become more commonly known as bail-in. Conceptually elegant, a failing institution would be seized, and creditor claims reduced ("haircut") by a sufficient amount to absorb the losses of the bank, ensuring that bank creditors, including depositors, incur any losses exceeding the bank's capital.

**5. There are many practical issues to be addressed with respect to OBR.** Since 2013 New Zealand banks have been required to have the information technology system capability pre-positioned to permit the freezing of the portion of liabilities that may be prescribed as necessary to absorb the losses of the bank. Contingency planning has focused on the capability to close a bank, appoint a statutory manager, and open for business the following day with the required portion of liabilities frozen. Questions around the legal framework, in particular the powers required to implement an actual resolution after entry into statutory management, still need to be addressed. For example, a statutory manager clearly has the power to freeze creditor claims, but there is no explicit power to impose losses on creditors in resolution.



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**6. Oversight and resolution of nonbank institutions has changed considerably since the failure of more than 60 finance companies and insurers between 2006 and 2011.** While the global financial crisis and Canterbury earthquakes were the proximate cause for some failures, these events served more to bring to light underlying weaknesses in governance and risk management that had not been addressed in the absence of prudential supervision, rather than being exogenous triggers for failure. Completing a review that had been initiated prior to the failures, government established new RBNZ mandates for the prudential supervision of insurance companies and the regulation of nonbank deposit-takers (NBDTs), building on the RBNZ's existing role as prudential supervisor of banks.

**7. This note is divided into three main sections.** The second section reviews the institutional arrangements, including the elements of the financial safety net. The third section reviews the current resolution regime. Recognizing the policy preferences of the New Zealand authorities, the recommendations are intended to close some of the gaps between the current situation and best practices, without necessarily introducing deposit insurance. Similarly, for the legal framework for resolution, the recommendations focus on enhancements to the well-established and understood New Zealand statutory management regime.

# INSTITUTIONAL ARRANGEMENTS, COORDINATION, AND PREPAREDNESS

**8. The RBNZ is the sole prudential supervisor (which includes responsibility for macroprudential policy), the lender of last resort, and is currently responsible for the oversight of payment systems.** The FMA is the market conduct authority and together with the RBNZ jointly oversees securities settlement systems that are not pure payment systems. The Treasury is the lead advisor to government on economic, financial and regulatory management.

**9. The CoFR comprises the RBNZ, FMA, Ministry of Business, Innovation, and Employment (portfolio responsibility for the FMA), and the Treasury.** It meets quarterly, with the chair rotating between the RBNZ and the FMA. The terms of reference are publicly available on the RBNZ website, establishing the CoFR's objectives as: (i) sharing information on the strategic priorities of member agencies; (ii) identifying important issues and trends in the financial system that may impinge upon achievement of the agencies' regulatory objectives and where appropriate agree processes to address those issues; (iii) ensuring a coordinated response to issues that may require cross-agency involvement and putting in place appropriate mechanisms to achieve this; and (iv) ensuring that appropriate coordination arrangements are in place for responding to events or developments. There is also a subcommittee of CoFR—the Banking Forum—which meets to discuss ongoing and upcoming regulatory issues pertaining to registered banks.

**10. The CoFR maintains and regularly discusses a risk register providing a summary of risks in the New Zealand financial sector.** The CoFR has not been the main forum for development of the approach to crisis preparedness, with most work taking place within the RBNZ and Treasury, and bilaterally between those two entities.



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**11. There are no standing arrangements for crisis coordination and management among the New Zealand domestic authorities.** When required, an incident-specific crisis committee would be formed to share information and coordinate inter-agency actions. It is expected that the RBNZ would trigger the formation of a committee if its ongoing supervision indicated that the intrusive supervisory powers of Part V of the RBNZ Act would need to be used. The Minister would trigger the formation of a committee when there was a possibility that powers under the Public Finance Act 1989, for example, the provision of a guarantee to maintain confidence or support resolution of a failing institution, might be required.

**12. The crisis committee would not be a decision-making body, but would act as an advisor to the decision-making bodies pursuant to the relevant legislation.** Depending on the nature of the crisis, the decision-makers could include the RBNZ, Minister of Finance, and FMA.

**13. The failure of a general insurance company subsequent to the Canterbury earthquakes provides a recent example of inter-agency cooperation to deal with a crisis.** Allied Mutual Insurance (AMI), the fourth largest general insurer in New Zealand, had a high level of business concentration in Christchurch, holding around one third of all home and contents insurance in the region. In March 2011, AMI approached the government to advise that it was in financial distress due to its claims exposure. Upon learning of the company's financial problems, the Treasury and RBNZ promptly set up an information sharing and advisory forum.

**14. At that time, IPSA had been enacted but the RBNZ, as prudential regulator and supervisor, had no formal powers as AMI Insurance was not yet a licensed (or provisionally licensed) insurer.** The arrangements between the Treasury and RBNZ worked well and enabled the agencies to provide mutual support in response to the AMI crisis (Box 1).

**15. Work to date on financial sector crisis preparedness has tended to focus on the banking sector.** This is in part because of the relative newness of the prudential regimes for insurers and NBDTs, and the not yet complete legal framework for FMIs. Following from the 2013 requirement for 10 banks (those with more than NZD 1 billion of retail deposits) to pre-position for OBR, the RBNZ is reviewing the outsourcing policy with a view to ensuring that the five largest banks would be able to continue essential operations without ongoing provision of services by the parent or other group members. For the 4 trans-Tasman banks, this includes a requirement to develop robust separation plans.

**16. There has been no specific resolution planning for smaller banks, insurers or NBDTs.** While there is a history of dealing with smaller institution failures, there is no experience under the new regimes. The general presumption is that failing smaller institutions would be liquidated, although finance companies that issue secured debt could be subject to receivership and smaller institutions could be dealt with in voluntary administration. However, experience in the global financial crisis and subsequent to the Canterbury earthquakes is that the government of the day may pursue different options in particular circumstances.



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## Box 1. Resolution of AMI

**AMI was a large mutual insurer based in Christchurch.** While optimistic that it would be able to meet its Canterbury earthquake claims from a combination of reinsurance, reserves and future profits, on March 9, 2011 AMI approached the government for financial support to maintain public confidence. Upon review, officials were of the view that there was a material risk of net claims exceeding net assets by a large amount.

**The government announced a support package for AMI on April 7, 2011 comprising an agreement to purchase, as needed over 5 years, up to NZD 500 million convertible preference shares.** Several factors contributed to the decision to provide government support, including concern for the disruption to the economy if rebuilding in Christchurch was delayed by the failure of an insurer covering about one-third of earthquake claims. There was further concern that, with other insurers also under stress, AMI customers outside Christchurch might find it difficult to obtain replacement policies, at least in the short term.

**The outlook for AMI deteriorated as claims estimates increased**. This led to a restructuring announced in December 2011 and completed in April 2012, which saw the continuing business sold to an Australian-owned insurer, IAG, with the Canterbury claims and related reinsurance remaining in AMI, renamed Southern Response, now a wholly Crown-owned entity.

**The full extent of AMI's Canterbury liabilities has yet to be determined.** Agreed government support for Southern Response has been increased to NZD 1.25 billion from the original NZD 500 million support package announced for AMI.

**17. Domestic crisis management arrangements should be strengthened drawing on the lessons from the trans-Tasman crisis simulation and the Canterbury earthquakes.** While it is impossible to have specific plans in place for all eventual crises, it is important to ensure that the domestic arrangements include meeting agendas to ensure that key issues are not overlooked in the initial planning and pre-positioning the necessary logistical arrangements (including communications facilities). The work-streams under the Trans-Tasman Banking Council (TTBC) focus on these issues with respect to cross-border coordination. However, it appears that these arrangements are not supported by the same detailed planning, or testing through simulations, at the domestic level.

**18. Strengthening domestic crisis management arrangements should also advance the work to address the recommendations of the Auditor General with respect to the Crown Retail Deposit Scheme.** These included articulating a framework for dealing with distressed institutions, setting out possible courses of action, deterrent processes, contingency plans for failure, the roles and responsibilities of the agencies, and communications arrangements.[1]

**19. The CoFR, supported by staff of the member agencies, should be specifically tasked with the responsibility for system-wide crisis preparedness.** This mandate could be established in legislation, or through revision of the CoFR terms of reference. Standing arrangements should clearly spell out the individual roles and responsibilities for each member in a crisis situation, including ex ante agreement on the decision-making process with respect to systemic situations.

[1] *The Treasury: Implementing and managing the Crown Retail Deposit Guarantee Scheme*, Performance Audit Report, Office of the Auditor General, September 2011, and *The Treasury: Learning from managing the Crown Retail Deposit Guarantee Scheme: Progress in Responding to the Auditor-General's Recommendations*, March 2014.



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**20. Greater clarity is required on the decision-making process with respect to dealing with a systemic crisis and the exercise of resolution powers.** While these topics are addressed at a high level or obliquely in the current Treasury-RBNZ Memorandum of Understanding (MOU), and at a very high level in the CoFR terms of reference, there are no detailed decision-making procedures established, and currently there are differences in interpretation of key issues. In part, this can be addressed through providing greater certainty for the resolution arrangements as discussed below, and in part through revisiting the bilateral MOU between the RBNZ and Treasury to provide more detail to clarify the decision-making arrangements and more specifically define roles and responsibilities in relation to resolution of systemic and non-systemic institutions.

**21. It should be clarified that the RBNZ is the resolution authority, both in normal times and in financial distress.** The Treasury's operational responsibilities should focus on whether and how to commit government resources. The RBNZ, as outlined later in this note, should have clear resolution objectives and accountabilities. The RBNZ would require Ministerial consent before proceeding with a resolution which potentially required a guarantee or public funds, or a non-least cost resolution the RBNZ might recommend due to systemic considerations. The RBNZ would take the lead on identifying and analyzing the resolution options, with the Treasury providing the Minister with the benefit of review and advice in support of the Minister's decision-making process.

**22. The current plans for mobilizing the necessary resources, for example, rosters of potential statutory managers and personnel from government, agencies and the private sector that could be mobilized to deal with a crisis, should be further developed.** This work should be led by the RBNZ, with other CoFR participants contributing. Similarly, the initial work by the RBNZ on developing procedural guidance for implementation of OBR, and other resolution tools, should be continued. Quite sensibly given the expected infrequent use of resolution powers, neither the RBNZ nor Treasury has a dedicated unit. However, more needs to be done to ensure that resources could be quickly mobilized in a crisis, and that there is suitable procedural guidance on the use of resolution powers.

**23. Contingency plans should be periodically tested in domestic simulation exercises in addition to the trans-Tasman simulations.** As with the trans-Tasman exercise, a domestic simulation involving a determination of systemic importance, the decision-making process including the role of the Minister, and the practical implementation challenges of OBR, will be useful in identifying issues requiring further attention. The lessons from banks' annual testing of their OBR capability should also be expressly incorporated into contingency planning. These include potential need on short notice for large amounts of bank-notes to meet customer withdrawals. Other identified issues such as a lack of clarity around payments "in flight"—that is, a customer instruction has been delivered but the payment is not yet complete, also need to be resolved.[2]

[2] A legislative amendment is currently being considered to clarify the point at which a transaction involving a customer affects the liability of the bank to that customer. This would provide greater certainty than the current reliance on decision-making by the statutory manager in accordance with the OBR policy and agreements with banks and Payments NZ.



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**24. There is limited cross-border coordination aside from trans-Tasman arrangements.** While there are non-Australian banks and insurers in New Zealand, none are systemically important, and most are quite small in the local market. There is a supervisory MOU covering banking and insurance in place with the U.K. Prudential Regulation Authority.

**25. Cross-border oversight of FMIs is supported by an MOU between the RBNZ and the Reserve Bank of Australia (RBA) in respect of ASX Clear Futures, and an MOU between the RBNZ and Bank of England in respect of LCH.Clearnet.** The RBNZ is also a member of the oversight college of CLS Bank and therefore a signatory to the CLS Oversight protocol. The staff of the RBNZ regularly attend meetings of the CLS Oversight committee, meet with RBA colleagues at least annually, and are expected to commence attendance at the LCH.Clearnet College in 2016–17, following the admittance of New Zealand banks as direct members of LCH.

**26. The RBNZ is a party to the International Association of Insurance Supervisors (IAIS) Multilateral MOU on Cooperation and Information Exchange (IAIS MMOU).** The IAIS MMOU includes most of the major jurisdictions of relevance to New Zealand.

## A. Trans-Tasman Arrangements

**27. Cooperation arrangements between the New Zealand and Australian authorities are well-established.** The TTBC was established in 2005. Its main role is to monitor trans-Tasman home-host issues, including crisis management. One of the key developments arising from the TTBC's work was the amendment in 2006 of the RBNZ Act and parallel Australian legislation to require the respective authorities to take into account the potential impact on financial stability in the other jurisdiction when discharging their responsibilities.

**28. Crisis management is primarily addressed through MOC, and two bilateral MOUs.** The RBNZ MOU with the Australian Prudential Regulation Authority (APRA) was revised in 2012 to include insurance, and the MOU between the RBNZ and RBA addresses FMIs. Given the expansion of the membership of the TTBC to include the respective market conduct regulators, and the shared interest in insurance and FMI oversight, it would be timely to recast the arrangements more broadly, for example by renaming the TTBC to reflect its broader financial stability objectives, and by revising the MOC to better reflect the additional work now being undertaken to deal with potential insurance and FMI distress.

**29. The MOC should be revisited with a view to expanding the scope to include resolution of insurance companies and FMIs.** While there are relevant work-streams established under the auspices of the MOC and the respective MOUs, it would be better to have an expanded crisis management agreement. The interdependencies between insurance branches and subsidiaries in New Zealand and their Australian parents parallel the issues that led to the original trans-Tasman focus on bank distress. Subsidiaries of banks in New Zealand are in many cases dependent on their Australian parents for access to key FMIs. For example, not all of the New Zealand subsidiaries have their own SWIFT gateway, and some New Zealand banks access LCH.Clearnet through their parent or another bank.



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**30. A simulation exercise in 2011 identified a number of areas where enhancement of the trans-Tasman arrangements was required.** One key element of the ensuing workplan was the development of a TTBC Protocol for Coordination of Crisis Communications. Information sharing arrangements, proforma agendas for crisis committees and logistical arrangements have also been addressed.

**31. Other issues identified in the trans-Tasman simulation have proved more challenging.** There is no ex ante consensus regarding single- or multiple-point-of-entry resolution strategies. There has been progress on a framework for assessing systemic importance, and discussions regarding possible coordinated responses, which would support decision-making in an actual crisis. The authorities involved ultimately have national mandates and accountabilities, which may constrain their ability to agree in advance on measures to deal with a potential crisis whose precise details are necessarily unknown. All parties agree that thorough review of the issues has been beneficial in developing a full understanding of the other perspectives, even when consensus is elusive. A second trans-Tasman crisis simulation exercise is planned for 2017.

## B. Depositor Protection

**32. New Zealand governments have consistently decided not to introduce one of the usual elements of the financial safety net—deposit insurance.** The Crown Retail Deposit Guarantee Scheme (Box 2) introduced during the global financial crisis was removed in 2011 and not replaced by a permanent limited deposit protection scheme.

**33. The merits of deposit insurance should be reconsidered.** If there continues to be no policy support for deposit insurance, consideration should be given to establishing a limited depositor preference at an appropriate level to provide some of the benefits of deposit insurance, including mitigating against runs and facilitating minimally disruptive resolutions.

**34. The main argument against deposit insurance has been moral hazard—the risk that directors may not exercise self-discipline and insured depositors would not exercise market discipline—two of the three pillars of the New Zealand approach to financial sector regulation.** Other concerns include the challenges in accumulating a sufficiently large fund to deal with failure of a large institution in a concentrated banking system, and a view that protecting depositors is outside of a pure financial stability mandate.

**35. These issues and concerns over deposit insurance are not unique to New Zealand.** In most other jurisdictions, however, over time the perceived advantages and mitigating techniques of a well-designed depositor protection scheme have come to be seen as more than counterbalancing the disadvantages. Consequently, New Zealand is one of only two OECD jurisdictions without explicit depositor protection.[3]

[3] Israel is the only other OECD country without a formal deposit protection system. The Israeli authorities have recently established a working group on adopting deposit insurance together with an enhanced bank resolution framework, following the June 2016 recommendations of a review committee focused on increasing competition in the banking system.



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### Box 2. The Crown Retail Deposit Guarantee Scheme

**During the global financial crisis, the New Zealand Treasury designed and introduced over the space of two days the Crown Retail Deposit Guarantee Scheme.** Australian authorities had advised on October 10, 2008 that introduction of a guarantee to supplement the existing depositor preference regime was imminent. The Australian government had earlier announced plans to introduce the Financial Claims Scheme with a limit of AUD 20,000, but this was overtaken by the events of the Global Financial Crisis. In response to the failure of Lehman Brothers, Australia announced the guarantee as a preemptive measure to maintain confidence. Faced with concerns over a flight of deposits to Australia, New Zealand departed from its long-held opposition to depositor protection, announcing on October 12 a guarantee which continued in place until end-2011.

**The scheme covered 96 institutions, including 12 banks, 60 nonbank deposit-takers, and 24 collective investment schemes.** While no bank, building society or credit union failed, nine finance companies failed, resulting in an estimated net cost to the Crown, after recoveries from the liquidations and receiverships, and fees from the scheme, of approximately NZD 600 million to compensate 42,000 depositors. By comparison, the smallest bank pre-positioned for OBR, The Co-operative Bank, today has about 150,000 customers and 1.8 billion in deposits.

**None of the failed firms, and indeed, none of the institutions covered aside from the large banks would have been considered systemic in normal times.** The government was motivated to extend the guarantee beyond banks by the potential failure of institutions contributing to the diversity of the financial sector and serving markets viewed as not well served by the banks.

**There was no run on deposits in New Zealand banks, indicating that the Guarantee Scheme played a part in maintaining confidence.** One unintended consequence was the rapid growth of the finance company sector immediately after the introduction of the guarantee, with depositors rationally choosing higher interest rates when all deposits were guaranteed. Avoiding this is the reason why deposit insurance best practice requires an appropriate limit to the coverage.

**A subsequent review of the Guarantee Scheme resulted in a number of findings relevant to contingency planning**: (i) a need for earlier and documented formal planning; (ii) usefulness of being guided by experience elsewhere; (iii) the need for effective monitoring and oversight of institutions included in the guarantee scheme; and (iv) a need for advance planning to deal with failure of an institution.

Source: *The Treasury: Implementing and managing the Crown Retail Deposit Guarantee Scheme*, Performance Audit Report, Office of the Auditor General, September 2011.

36. **Recent evidence from New Zealand, which is consistent with experience elsewhere, calls into question the moral hazard argument against deposit insurance.** In addition, experience in the global financial crisis suggests that reconsideration of depositor protection could be helpful from several policy perspectives. It is also worth considering that some form of explicit depositor protection, with an appropriate limit, would add to the credibility of OBR.

37. **The 2011 Parliamentary Commerce Committee inquiry into finance company failures found depositors often had no understanding of the risks they were assuming.**[4] This led to recommendations to the government to enhance New Zealanders' financial education. The committee findings and recommendations around financial literacy raise the question of whether it is reasonable to expect ordinary depositors to exert market discipline on deposit taking institutions.

[4] https://www.parliament.nz/en/pb/sc/reports/document/49DBSCH_SCR5335_1/inquiry-into-finance-company-failures-i1a accessed September 1, 2016.



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The committee also identified governance shortcomings, which were addressed in the NBDT Act, and a new prudential regime intended to provide prudential discipline to enforce governance standards.

38. **It is important to consider that the dependence of New Zealand banks on wholesale funding does provide market discipline which would in no way be undermined by deposit insurance.** Sophisticated institutional investors consider ratings, analyze disclosure statements and offering documents and will refuse to roll over maturing securities if they develop material concerns about the soundness of the bank. Indeed, this leads to one of the principal crisis scenarios that all New Zealand banks consider in their contingency funding plans—an inability to access offshore markets. Further, this leads to the development of "self-securitization" programs whereby banks can manufacture residential mortgage backed securities (RBMS) as eligible collateral to access RBNZ liquidity facilities so that in crisis the RBNZ could provide short-term liquidity allowing banks to deal in an orderly manner with a run-off of foreign funding.

39. **One of the roles of deposit insurance is to contribute to financial stability by mitigating against runs.** The Crown Retail Deposit Guarantee Scheme introduced in 2008 was motivated by fears of a run of deposits to Australia which supplemented its depositor preference scheme with an explicit guarantee during the global financial crisis. Had an appropriate depositor protection scheme been in place in New Zealand, it may not have been necessary to proceed with the hastily designed and implemented Guarantee Scheme.

40. **One of the stated rationales for the Crown Retail Deposit Guarantee Scheme was to support diversity—smaller institutions—in the financial sector.** This is a legitimate policy objective, but is at odds with a focus purely on financial stability and the New Zealand reliance on the pillars of self, market, and regulatory discipline. An explicit rationale for deposit insurance is often to promote competition in the financial sector by leveling the playing field between smaller institutions, which may struggle to attract deposits when competing with institutions viewed as too-big-to-fail. It is unclear why the ability of smaller institutions to compete would only be a policy concern in a crisis.

41. **A further consideration when introducing the Crown Retail Deposit Guarantee Scheme was the potential fallout from the failure of the entire NBDT sector.** Given that NBDTs collectively accounted for less than five percent of total financial sector assets at the time, it is difficult to see the systemic implications from collapse of the sector. However, there was certainly the potential for widespread loss by depositors and other creditors.

42. **The competitive concerns of smaller banks are reflected in the inclusion of non-systemically important banks in the pre-positioning for OBR.** While the motivation for OBR was to deal with systemically important banks, it offers the only minimally disruptive resolution option, other than bail-out, in the New Zealand tool kit. Any institution not pre-positioned for OBR would likely be liquidated, meaning that all trading would immediately cease. Thus, in consultations over OBR it became clear that, despite the costs involved, many smaller banks saw value in being pre-positioned for OBR.



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**43. For depositors, it is a lesser hardship to be subject to partial freezing and possible loss of a portion of deposits through OBR than to face the certainty of having all deposits frozen for an extended period and recovering some portion over a lengthy liquidation.** This was in fact what happened to depositors of some finance companies who were subject to extended periods of moratoria, liquidation and receivership before claims were finally settled. Thus, for small banks to be able to attract and retain deposits in a period of financial stress, they would have to offer the same certainty as the larger banks that deposits, even if partially frozen, would not be tied up for extended periods in liquidation.

**44. If OBR is to provide a credible alternative to bailing out a failing institution, there has to be the political will to use the tool.** Without some form of depositor protection, OBR would result in the immediate freezing and likely eventual loss of a portion of all deposits. Faced with the certainty of incurring the wrath of the up to 25 percent of voters whose deposits would be partially frozen if one of the 4 large banks were subject to OBR, there may be some reluctance on the part of a Minister of Finance to consent to appointment of a statutory manager with the intent of triggering OBR.

**45. One of the strengths of a well-designed deposit protection scheme is that it can facilitate resolution by ensuring that the majority of depositors incur no loss, while at the same time leaving the bulk of the value of deposits at risk.** This reduces the potential pressure for a bailout to protect depositors. The design of OBR contemplates a *de minimis* exemption from the deposit freeze, which the RBNZ in its public discussions has suggested would be at a level of NZD 500. Even with the typically small deposit accounts maintained by New Zealanders, this would not provide an equivalent to deposit insurance as at least half of depositors would be subject to some loss. However, a higher *de minimis* amount could provide many of the benefits of deposit insurance.

**46. Recent analysis suggests that a *de minimis* exemption of NZD 10,000 per depositor would result in 80 percent (by number of accounts) of all bank deposits being exempted from the freeze and ultimate loss in OBR.** This is a very low amount compared to the usual rule of thumb of two-to-three times per capita gross domestic product for deposit insurance limits, reflecting that New Zealanders generally do not accumulate significant savings in bank accounts. The losses would still be borne by the creditors of the bank, thus meeting one of the key objectives of OBR by avoiding a bailout. The exclusion from freezing and protection of all small deposits may make haircutting depositors less controversial and thus make OBR more credible by mitigating potential reluctance by the Minister to consent to its use.

**47. Pre-establishing the *de minimis* amount in legislation rather than leaving it to be addressed on a case-by-case basis could provide the same certainty to depositors as a deposit insurance scheme.** This could mitigate against runs. It could also contribute to consumer education, as it is a simple message to communicate that deposits will be protected only up to the *de minimis* limit. The greatest certainty would be provided through a clear legislative framework including depositor preference for the *de minimis* amount.



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**48. In contrast with Australia, in a future crisis New Zealand may again be faced with the need to implement a guarantee scheme on short notice.** Post crisis, Australia introduced a permanent AUD 250,000 deposit guarantee, reversing a long-held opposition to depositor protection (other than a priority claim in liquidation). This differs from deposit insurance best practices in that it is not funded through levies on the industry and no fund is being accumulated to pay for potential failures. The likelihood of ultimate loss to the government is low given that the Australian government would step into the shoes of guaranteed depositors and thus have a priority claim on the assets of the failed bank. The Australian guarantee provides certainty to depositors and thus mitigates against runs on Australian banks.

## C. Lender of Last Resort

**49. The RBNZ standing facilities give eligible counterparties the ability to borrow cash and/or bonds in the event they are unable to source these assets from the marketplace.** The Overnight Reverse Repurchase Facility (ORRF) is open to any counterparty that has executed a global master repurchase agreement (GMRA) with the RBNZ. There is also an automated ORRF open to Exchange Settlement Account System (ESAS) holders who have executed a GMRA, generally used outside of normal business hours to automatically repo securities when settlement account balances fall below a specified threshold. The RBNZ also offers two bond lending facilities for counterparties in need of a specific Government bond.

**50. The RBNZ Act (Section 31) establishes very broad powers to provide extraordinary liquidity support "if the Bank considers it necessary for the purpose of maintaining the soundness of the financial system."** In normal times, banks would be limited to the standing facilities described above. In dealing with financial distress, the RBNZ may use its discretionary powers to revise the conditions of its standing facilities or provide new facilities.

**51. During the global financial crisis, the RBNZ focused on the high reliance of the banking system on offshore funding, implementing a number of measures to bolster liquidity.** The intent was to ensure that the banks, which were otherwise sound, would be able to replace their offshore funding if required. Key steps included: (i) extension of the range of securities eligible for acceptance in the RBNZ's domestic liquidity operations to include, among other things, Residential Mortgage Backed Securities (RMBS), and AA-rated New Zealand government sector debt—including that of government agencies, state owned enterprises and local authorities; (ii) the discount margin applied in the RBNZ's ORRF was standardized at 50 basis points above the overnight cash rate for all eligible securities (i.e., bank paper had initially been set at 100 basis points); (iii) a graduated risk margin regime ('haircut') to replace the prevailing limit structure for all securities eligible for domestic liquidity operations; (iv) extension of the ORRF to allow loans to a maximum maturity of 30 days; (v) creation of a new Term Auction Facility (TAF) offering maturities of 3, 6 and 12 months; and (vi) introduction of a weekly Open Market Operation (OMO) where the RBNZ was willing to accept corporate paper and asset backed securities for terms out to 3 months.



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**52. The TAF, term ORRF and term OMO were suspended in November 2009.** These facilities remain in the RBNZ toolkit and could be reintroduced at short notice if required. The RBNZ has retained the broad list of eligible securities following a review in 2012 and subsequently reviewed the haircut regime in 2013. All of the large and a number of the smaller banks have created RMBS to access RBNZ facilities and are potentially capable of creating more at short notice if required.

**53. The RBNZ is the sole decision-maker on provision of liquidity in normal circumstances.** Should the RBNZ be called upon to provide liquidity support for a bank subject to OBR, the expectation is that this would be pursuant to a Crown guarantee while the bank operates in statutory management. The planned freezing of an amount of creditor claims conservatively estimated to be sufficient to absorb the losses of the bank means that in principle, the RBNZ would be lending to a solvent institution. However, the possibility of a run on the bank while in statutory management raises the possibility that the collateral usually required for access to RBNZ facilities would not be available, hence the expectation that any liquidity support would be underpinned by the Crown guarantee.

## D. Early Supervisory Intervention

**54. No bank, insurer or NBDT has faced serious distress since the introduction of the current legal regimes.** The RBNZ uses a similar approach for identifying emerging problems in banks (the Proportional Risk Evaluation Surveillance System—PRESS) and insurers (iPRESS). Each supervisory rating system incorporates four supervisory stances, with the last two being Regulatory Response and Crisis Management. No institution has reached either of these stages under the current prudential oversight regimes.

**55. While the RBNZ Act, IPSA and the NBDT Act provide for a wide range of remedial supervisory action, exercising all powers short of appointing a statutory manager is within the discretion of the RBNZ only with respect to insurance companies and NBDTs.** The scope of remedial powers is very broad, however the consent of the Minister of Finance is required to exercise the most intrusive supervisory powers with respect to banks, including issuance of directions pursuant to sections 113, 113A, and 113B of the RBNZ Act.

**56. The RBNZ Act should be revised to align with both IPSA and the NBDT Act by eliminating the role of the minister in exercising remedial supervisory powers.** In developing and implementing the framework for FMI oversight, the same principle should apply. Although there is no evidence in practice of political interference in supervisory activities, the role of the Minister in supervision is not in line with best practice for supervisory independence.[5] This likely results from the RBNZ Act being much older legislation, while the drafting of both IPSA and the NBDT Act was informed by more current international standards.

[5] See Basel Core Principle 2.



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**57. The grounds for appointment of a statutory manager are broad enough to permit the RBNZ to take action prior to actual insolvency.** An element of judgement is involved, as the RBNZ is required, pursuant to section 117, to have reasonable grounds to believe that: (i) a registered bank or associated person is insolvent or is likely to become insolvent; or (ii) the registered bank or associated person is about to suspend payment or is unable to meet its obligations as and when they fall due; or (iii) the affairs of the registered bank or associated person are being conducted in a manner prejudicial to the soundness of the financial system; or (iv) the circumstances of the registered bank or associated person are such as to be prejudicial to the soundness of the financial system; or (v) the business of the registered bank has not been, or is not being, conducted in a prudent manner.

**58. The regime for building societies, credit unions and finance companies has been significantly revised with the introduction of a prudential regime for NBDTs.** Review of the previous approach, which relied entirely on the oversight by trustees pursuant to agreements in trust deeds, disclosure and market discipline, had begun in 2006 in advance of the global financial crisis. A number of finance companies failed in advance of the crisis, largely due to poor governance, insider transactions and inadequate risk management. Approximately 60 finance companies failed between 2006 and 2009. Some were wholesale funded, but many relied on retail deposits. Nine failed finance companies were covered by the Crown Deposit Guarantee Scheme introduced in 2008.

**59. Under the prudential regime for NBDTs, the RBNZ became the regulatory authority, with primary supervisory responsibilities remaining with the trustees.** There was a transition period through to April 2015 when the licensing process for all NBDTs was completed. The regime has established minimum prudential standards with respect to capital, liquidity, governance, and risk management. Currently two firms are the main providers of trustee services to the NBDT sector. Oversight by trustees was found to have been ineffective in the failure of many finance companies,[6] but has been strengthened through the requirement that trustees be licensed and subject to FMA oversight under the Financial Markets Supervisors Act 2011. NBDTs are required to report regularly to the RBNZ, which prepares a monthly Deposit-Taking Oversight Report.

# RESOLUTION REGIME

**60. In addition to shortcomings in the legislative framework, the current resolution regime suffers from a lack of consensus on key issues.** These include decision-making processes, roles, and responsibilities. While the need for improvement is acknowledged, there is no agreement among the key stakeholders on what should constitute the appropriate legal framework and governance arrangements for an effective resolution regime.

**61. The legal framework for resolution of banks and insurers is established in the RBNZ Act and IPSA respectively.** Each act contains broadly similar approaches, including the

[6] https://www.parliament.nz/en/pb/sc/reports/document/49DBSCH_SCR5335_1/inquiry-into-finance-company-failures-i1a accessed September 1, 2016.



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appointment of a statutory manager with wide powers to operate or liquidate a failing institution (Box 3). A bridge bank option is available through the power of the statutory manager to transfer any or all of the assets and liabilities to a newly incorporated institution. The legal framework for resolution of FMIs is still under development, with the RBNZ having recently completed consultation on a proposed new statutory framework for FMI oversight.

### Box 3. Statutory Management

**A statutory manager in New Zealand has broad powers for resolution**. Because of the potential infringement on the rights of shareholders and creditors, appointment of a statutory manager, whether pursuant to the RBNZ Act, IPSA, or the Corporations Investigation and Management Act (CIMA), requires Ministerial consent to the recommendation by the relevant authority—the RBNZ or FMA.

**Appointment of a statutory manager immediately imposes a moratorium on legal proceedings.** All powers of the board and management are vested in the statutory manager, who may also exercise many of the powers of a liquidator. The business of a branch of a foreign bank or insurer may be vested in a corporation formed by the statutory manager, and a statutory manager may prohibit the removal of assets from New Zealand, providing ring-fencing powers. A statutory manager may suspend payment of any money owing, pay any creditors, and compromise claims. The statutory manager is empowered to sell all or any part of the bank, or transfer all or part of the assets and liabilities of the bank to a new institution incorporated by the statutory manager, potentially providing both purchase and assumption and bridge banking powers.

62. **Statutory management provisions in the relevant legislation could be used for open resolutions, but the general expectation of the RBNZ is that non-systemic institutions are more likely to be liquidated.** This philosophy is explicitly stated in IPSA Section 170 (2) which requires the RBNZ to recommend the appointment of a statutory manager only if the public interest, financial system or economy of New Zealand or any policy holder cannot be adequately protected under the other provisions of IPSA or the Companies Act.

63. **The exercise of resolution powers is a multi-part process.** With respect to banks, the RBNZ would first identify the existence of one or more of the conditions specified in the RBNZ Act Section 113 (1), warranting the appointment of a statutory manager under section 117.[7] This would be followed by an RBNZ recommendation to the Minister of Finance, who, if in agreement with the recommendation, would then seek from the Governor General an Order-in-Council appointing one or more statutory managers.

64. **The RBNZ has two roles in resolution.** First, upon identifying an institution as failing or likely to fail, the RBNZ recommends to the minister initiation of resolution through the appointment of a statutory manager. Second, the RBNZ has a role in overseeing the statutory manager. Once a statutory manager is appointed, the RBNZ may, but is not required to, give binding directions to the statutory manager. The RBNZ's approval is required before the statutory manager can take certain actions including the sale of the whole or a substantial part of the business undertaking of the bank or insurer in statutory management.

[7] There is a parallel process for insurers provided in Part IV of IPSA.



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**65. The RBNZ Act does not establish any objectives for the RBNZ specifically with respect to resolution.** In exercising its resolution powers—including the ability to give binding directions to the statutory manager—the RBNZ would have regard to its mandate pursuant to Section 68 of the RBNZ Act to promote the maintenance of a sound and efficient financial system and avoid significant damage to the financial system that could result from the failure of a registered bank. The RBNZ interprets this in line with its broad mandate for financial stability, and thus focuses on the protection of the system and not necessarily individual institutions or depositors. This leads to a general presumption that in the absence of a market-based resolution such as a sale of the institution or recapitalization by private investors, any failing non-systemically important institution would be liquidated pursuant to Part 16 of the Companies Act 1993, or in limited circumstances resolved through receivership or voluntary administration.

**66. The legislation provides various roles for the Minister in resolution of a bank.** These include: (i) approving commencement of resolution other than petition of a creditor to the courts for the appointment of a liquidator (Companies Act Section 253); (ii) the Minister may appoint a committee tasked with providing non-binding advice to the statutory manager on the exercise of the powers conferred by the Act, or to do such other things as may be specified by the Minister, from time to time, by notice in the Gazette (RBNZ Act Section 119); (iii) the consent of the Minister is required for sale of all or a substantial part of the business of a bank in statutory management (RBNZ Act Section 132); and (iv) the Minister may terminate the statutory manager's appointment on the recommendation of the RBNZ (RBNZ Act Section 141).

**67. The Treasury's role in resolution is established through the MOU between the Treasury and RBNZ, which among other things specifies that "the Treasury will lead on operational matters arising from financial distress where these have fiscal implications."** This broad statement is open to multiple interpretations. There would clearly be fiscal implications when the OBR option described below is used, or potentially with respect to resolution of any of the four large banks. It could also apply in other situations, as was the case with AMI, an insurer which came under financial distress following the Canterbury earthquakes. However, the nature and extent of the Treasury's "lead" role is not defined.

**68. To the extent required by the RBNZ, a statutory manager must consult with the RBNZ in relation to the exercise of powers.** Coupled with the requirement to comply with the directions of the RBNZ (Section 120), this provides the ability for the RBNZ to direct the resolution process, albeit through the statutory manager and thus at one remove from the institution itself.

**69. The RBNZ Act also provides guidance and requirements governing the activities of a statutory manager, evidently contemplating that the RBNZ may not exercise its resolution powers in all cases.** Section 121 requires a statutory manager to "have regard to" a number of specific considerations in exercising powers including: (i) the need to maintain public confidence in the operation and soundness of the financial system; (ii) the need to avoid significant damage to the financial system; (iii) to the extent not inconsistent with the considerations in (i) and (ii) above, the need to resolve as quickly as possible the difficulties of that registered bank; (iv) to the extent not inconsistent with the considerations in (i), (ii), and (iii) above, preserving the position of creditors and



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maintain the ranking of claims of creditors; and (v) the advice of the RBNZ. In addition, statutory managers are required to: (i) consult with the RBNZ to the extent required by the RBNZ as to the exercise of powers; (ii) provide the reports that the RBNZ may require as to the state of the affairs, business, and statutory management of the bank in the form and frequency the RBNZ may require; and (iii) provide the information that an advisory committee appointed under section 119 may reasonably require as to the affairs, business and statutory management of the bank.

**70. Section 121A requires a statutory manager to seek the explicit approval of the RBNZ if an action he or she proposes to take is likely to have a detrimental effect on financial system stability in Australia.** As with Section 121, 121A appears to contemplate that the statutory manager could in some circumstances undertake, or at least propose, significant alternatives that were not in response to directions provided by the RBNZ.

**71. Section 142 provides that the statutory manager may apply to the High Court for direction.** While this could be in connection with actions directed by the RBNZ, there is no requirement that this be so, raising the possibility that the statutory manager in his or her own right might seek a resolution requiring direction by the court, for example, requiring acceptance of a compromise by a hold-out class of creditors.

**72. Taken collectively, Sections 117 through 121A, and Section 142 of the RBNZ Act are somewhat ambiguous regarding the exercise of resolution powers.** It is clear that the resolution authority is the RBNZ if it exercises its powers under Section 120 to direct the statutory manager. However, the guidance for the use of the powers of a statutory manager including having regard to the advice of the RBNZ when the RBNZ also has the power to direct a statutory manager appear to contemplate circumstances where the RBNZ would not exercise its option to issue directions. In such circumstances, the statutory manager would in effect be the resolution authority.

**73. There is a need for clarity on the identity of the resolution authority and the process for exercise of resolution powers.** This includes the respective roles and responsibilities of the RBNZ and the Treasury in resolution, particularly in dealing with a systemically important bank using the OBR.

## A. Open Bank Resolution

**74. OBR is a tool developed to provide a credible alternative to a bailout should it become necessary to resolve a systemically important institution.** Market-based resolutions such as sale or recapitalization by private investors are preferred, and the existence of OBR does not preclude other possible resolutions.

**75. Despite the name, OBR does not actually resolve a failing bank.** OBR is a tool to take control of the institution and continue operations while seeking a resolution. The most cost effective would be a sale to new investors, likely another bank, which would preserve the value of the banking franchise. If suitable new investors could not be found, the alternative would be an orderly wind-down. This is certainly achievable using the powers of statutory management and is less



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disruptive than liquidation as the bank would continue to trade to facilitate run-off of the business. However, this could impose larger losses on creditors as any remaining franchise value of the bank would be lost.

**76. The OBR concept is simple** (Figure 1). A failed bank would be placed under statutory management and reopened the next business day. A portion of all creditors' claims, estimated to be sufficient to cover the bank's losses in excess of its capital, would be frozen. Depositors and other creditors whose claims are pre-positioned for OBR would have immediate access to the unfrozen portion of their claims, and the bank would then continue normal business under statutory management while a resolution was pursued. The disruption arising from liquidation—a bank must cease trading once a liquidator is appointed—is avoided, and the losses should ultimately be absorbed by the bank's shareholders and creditors.

**77. There are many complexities to be addressed if OBR is to be seen as a truly credible alternative to a bail-out.** These arise from policy choices with respect to the RBNZ's supervisory approach and the absence of one of the usual safety-net component, deposit insurance, absence of some direct legal powers, as well as the challenges of dealing with any large failing institution.

**78. An immediate challenge when the bank reopens under statutory management is to maintain confidence so that the unfrozen liabilities are not quickly withdrawn, leading to a liquidity crisis.** To address these concerns, OBR contemplates a Crown guarantee of all unfrozen liabilities on the assumption that depositors would leave their unfrozen deposits in the bank for continuation of normal business. The Crown guarantee extends to all liabilities incurred after entry into statutory management, addressing concerns that depositors and other counterparties might be reluctant to deal with the bank while operating under statutory management. The RBNZ would stand ready to provide any liquidity support required by the bank operating under statutory management, with the Crown guarantee ensuring that the RBNZ could provide liquidity even if the bank was unable to meet normal collateral requirements.

**79. It is impossible to predict actual depositor and creditor behavior if OBR is implemented.** The possibilities for individual depositors range from acceptance of the freeze and continuation of business as usual to a widespread run as depositors withdraw all of the unfrozen amounts. One possible unintended consequence in a period of financial distress is that the first bank to enter OBR would, as a result of the ensuing Crown guarantee, draw deposits from other banks and in the extreme, trigger liquidity crises in banks that initially proved more resilient. While the statutory manager could be directed to lower interest rates to lessen the attractiveness, in a crisis the safety provided by the Crown guarantee may outweigh depositors' interest rate concerns. Administrative measures such as limiting the acceptance of new deposits by a bank in statutory management could have a counterproductive effect on public confidence and inhibit achieving the OBR objective of continued operation as a going concern.



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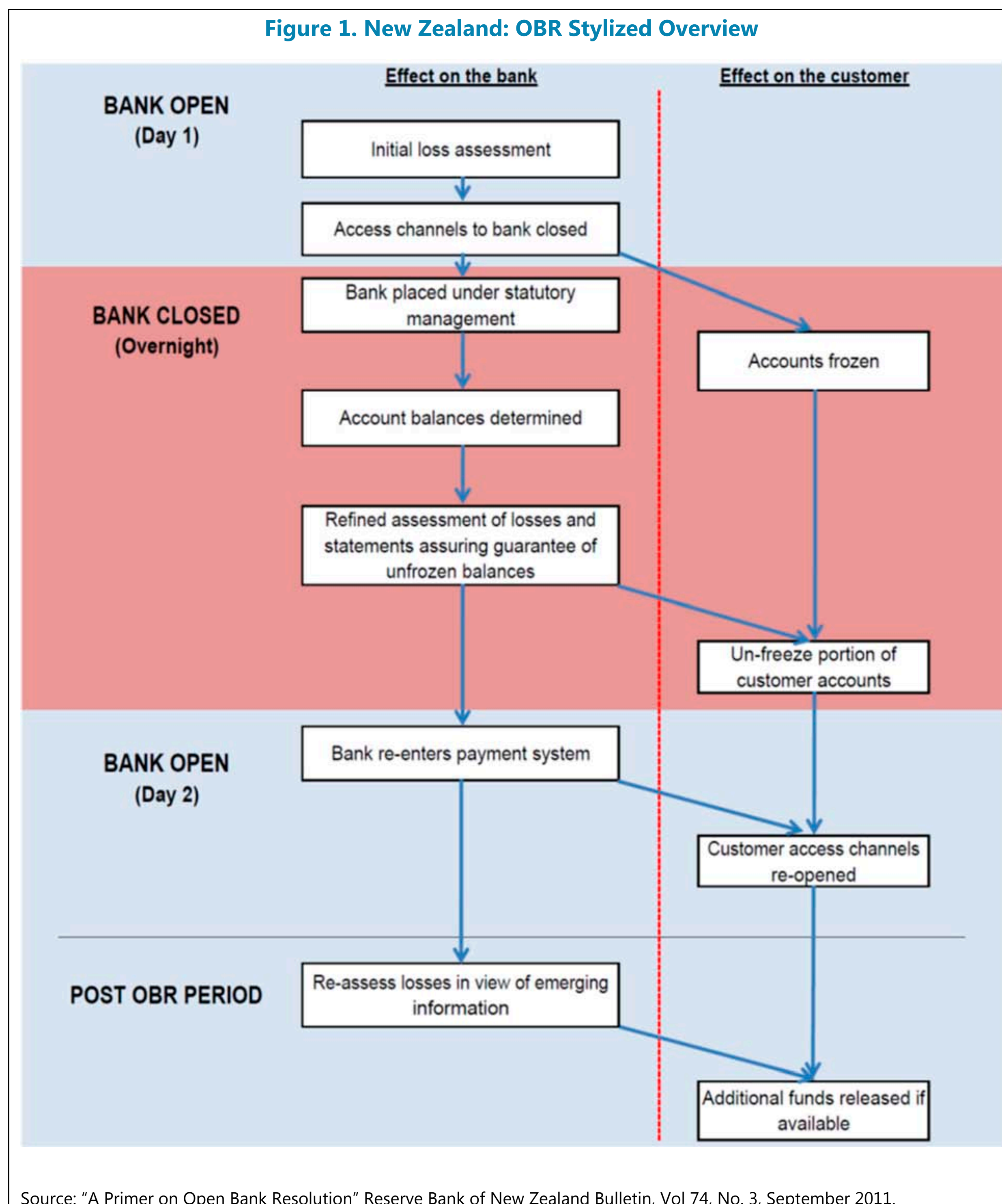
**Figure 1. New Zealand: OBR Stylized Overview**




Source: "A Primer on Open Bank Resolution" Reserve Bank of New Zealand Bulletin, Vol 74, No. 3, September 2011.

**80. OBR contemplates that creditors' losses would not exceed the initially frozen amount.** Actual losses in excess of the frozen amount would be borne by government through the Crown guarantee. This provides an incentive to provide a comfortable cushion in the initial estimate of losses to protect the Crown exposure, which would have to be balanced against the hardship and economic losses to depositors and other creditors of having a potentially large portion of their



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claims frozen for the duration of the OBR process. One mitigating measure would be to take an initially conservative approach, and then periodically unfreeze further amounts as the scale of losses is more accurately determined.

**81. An accurate initial estimation of likely losses will be challenging.** Experience from around the world indicates that it is common to underestimate the losses at the outset. There is also evidence that initial loss estimates, particularly in a period of widespread market disruption, can be too conservative if asset price corrections overshoot during the crisis and subsequently recover. The intrinsically difficult assessment process could be even more challenging given the RBNZ's minimally resourced approach to supervision. As the RBNZ does not as part of normal supervision undertake or commission detailed asset quality reviews, it will not have this information available if required to estimate likely loss amounts overnight.

**82. As mentioned above, the imposition of losses on individual depositors may make the Minister of Finance reluctant to appoint a statutory manager with a view to implementing OBR.** The absence of deposit insurance means that all depositors are subject to the hardship of having a portion of their deposits, beyond a *de minimis* amount, frozen and ultimately haircut during the OBR process. In addition to the Ministerial consent required for the appointment of a statutory manager, a necessary but not sufficient step to implement OBR, the required Crown guarantee could have fiscal implications. Thus, the Minister would de facto have to consent to the implementation of OBR

**83. The current legislation clearly provides the power for a statutory manager to freeze a portion of claims and operate the bank.** The rights of shareholders and "frozen" liability holders are not extinguished, and there is no express power for a statutory manager to haircut claims or convert debt into equity. The power to transfer some or all of the business to a new entity would be used to achieve the objective of haircutting claims. These powers are untested and may be subject to legal challenge, although legal advice to the RBNZ suggests that challenge is likely to be limited to judicial review, rather than on the substantive merits of the decision.

**84. For New Zealand-based FMIs the powers of the statutory manager and the payment system rules would facilitate continued participation by a bank under OBR, notwithstanding any failure of the bank to settle on the day of entry into statutory management.** For non-New Zealand-based FMIs such as LCH.Clearnet the expectation is that the power of the statutory manager to unfreeze claims on a selective basis would be used to permit settlement of outstanding obligations to ensure continued access to the foreign FMI. The Crown guarantee of liabilities incurred after entry into statutory management would likely be required by both New Zealand-based and foreign counterparties for the bank to continue to participate in payment systems.



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**85. There is no provision in New Zealand law that would provide a breathing space with respect to financial contracts when resolution powers are exercised.**[8] Entry into statutory management and the freezing of creditors' claims would likely trigger insolvency remedies including contract acceleration or the exercise of early termination rights by the counterparties to a bank's financial contracts. Reliance on foreign currency funding which is swapped into New Zealand dollars, and the prevalence of fixed-rate mortgage lending funded by variable or short-term deposits means that interest rate and currency swaps agreements are important elements of the banks' operations which would have to be replaced for the bank to be prudently managed.

## B. Other Resolution Options

**86. Statutory management is a well-established and understood legal mechanism in New Zealand.** Outside of statutory management, the other legal options for resolution of a financial institution or FMI are: (i) liquidation under Part 16 of the Companies Act 1993; (ii) voluntary Administration under Part 15A of the Companies Act 1993; and (iii) in certain circumstances, receivership under the Receiverships Act 1993.

**87. Liquidation involves a creditor (or certain other parties) applying to the court for a liquidator to be appointed.** IPSA provides that the RBNZ may apply to the courts for the appointment of a liquidator of an insurance company, but there is no parallel provision in either the RBNZ Act or the NBDT Act. On entry into liquidation the institution will cease carrying on business, making this option unsuited for systemically important institutions, and likely undesirable even in the case of smaller institutions from the perspective of preserving value through the potential sale of all or part of the business of the failed institution.

**88. Voluntary administration is likely only a practical resolution option for very small institutions.** While it is conceivable that the directors of a troubled small NBDT might opt for voluntary administration as an alternative to a direction from the RBNZ to cease accepting deposits, the process is not well suited to dealing with a large number of creditors and complex claims. A small insurer might use voluntary administration.

**89. Receivership involves a secured creditor exercising rights under a security agreement to appoint a receiver for the assets charged pursuant to the security interest**. NBDTs that issue secured debt might be resolved through receivership, although in most cases financial institutions are unlikely to have granted security interests over all or the bulk of their assets, making receivership generally impractical.

## C. Bail-in Within Resolution

**90. There is currently no explicit legal provision for bail-in within resolution.** This would require write-down in a manner that respects the priority of claims in liquidation. OBR contemplates achieving the broad objective through the power of a statutory manager to pass some or all of the

[8] See Key Attribute 4, Set-off, netting, collateralization, segregation of client assets.



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assets and liabilities of the failed bank to a new institution. By leaving some portion of the liabilities in the shell of the failed bank, creditors' claims would effectively be written down. However, OBR also contemplates providing a *de minimis* exemption for deposits, which does not strictly respect the hierarchy of creditor claims and relies on the legal provision that the statutory manager must "have regard to"—not necessarily strictly observe—the priority of creditors' claims, and the other provisions of Section 121 including avoiding significant damage to the financial system.

**91. Greater certainty would be provided by legislative amendment.** The statutory manager should have the express power to write-down creditor claims in accordance with the established hierarchy. Deposit insurance would provide the basis for depositor protection, but in its absence legislation should provide a limited depositor preference, thus establishing the legal basis for the *de minimis* exemption.

**92. Some New Zealand banks have issued non-common equity capital instruments with write-down and convertibility features at the point of non-viability.** This provides an additional loss-absorbing buffer, however, as with use of OBR, there may be reluctance to trigger write-down or conversion due to the potential of imposing losses on individual creditors. For at least one of the New Zealand banks which has issued such instruments, the bulk is held by individuals. While the risks were disclosed and the investment should have been deemed suitable for the individuals, experience with the finance company failures suggests that the full extent of risks may not have been appreciated. Thus, while loss-absorbing additional Tier 1 and Tier 2 capital instruments provide a buffer of bail-inable securities above common equity Tier 1 capital, there may be some reluctance to trigger write-down or conversion unless the bulk of the instruments is held by institutional investors.

## D. Funding in Resolution

**93. There is no privately financed deposit insurance or resolution fund in New Zealand.** This could be addressed through the introduction of a well-designed deposit insurance scheme. In the current framework, OBR is intended to meet the objectives of Key Attribute 3 of not being limited to public ownership or bailout to resolve a failing institution. However, OBR is predicated on provision of a Crown guarantee and may still require temporary government ownership. Further, since OBR contemplates that any losses beyond the initially frozen amount would be borne by the Government, OBR does not meet the objective of providing a recovery mechanism for any public funds used in the resolution process. This risk is mitigated but not eliminated by the intention to take a conservative approach to the initial freeze.

## E. Insurance Resolution

**94. Unlike dealing with a failing bank where there is no explicit requirement to protect depositors, the RBNZ must have regard to protecting the interests of policy-holders in the resolution of an insurance company.** The RBNZ Act focuses resolution powers solely on the maintenance of a sound and efficient financial system and avoiding significant damage to the



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financial system through the failure of a registered bank (Section 68). In contrast, IPSA Section 4 requires the RBNZ, in addition to systemic stability concerns, to take into account a number of principles, including the importance of dealing with an insurer in financial distress in a manner that aims to adequately protect the interests of policy-holders and the public interest.

**95. IPSA also provides to the RBNZ options that could be used as alternatives to recommending to the minister appointment of a Statutory Manager to initiate resolution.** These include the power to apply for appointment of a liquidator, or to apply to the High Court to reduce the value of contracts of insurance. This latter power is a parallel to bail-in, permitting the recapitalization or sale of an insolvent insurance company by reducing the value of its liabilities. These options could also be used in the unlikely event that the Minister of Finance did not consent to the appointment of a statutory manager, providing a fail-safe that is absent from the RBNZ Act, where there is little practical alternative to continued operation if a statutory manager is not appointed.

**96. The increase in concentration in the general insurance industry since the Canterbury earthquakes may pose challenges in resolution.** Should one of the two largest firms which have a combined 65 percent market share face financial difficulty, concerns that influenced decision-making in the case of AMI—consumers' potential difficulties in obtaining replacement cover—would likely recur. The absence of a policy-holder protection scheme which would ensure that consumers were not left without cover in the event of an insurance company failure may lead to pressure for bailouts.

## F. NBDT Resolution

**97. There is no tailored statutory management regime for NBDTs under the NBDT Act.** NBDTs continue to be subject to the statutory management regime applying to all entities under CIMA. Under CIMA an entity may be placed into statutory management by the Governor-General acting on the advice of the Minister of Commerce given in accordance with a recommendation of the FMA.

**98. A specialized resolution regime for NBDTs would be preferable.** The RBNZ is established as the prudential regulator under the NBDT Act, but is unable to initiate resolution or recommend resolution. The power to issue directions could be used to require an NBDT to cease taking new deposits, but ultimately seizing control of and resolving a failing NBDT would require the RBNZ, upon itself identifying a serious issue or being advised of such by the trustee, to then advise the FMA which could initiate the process of appointing a statutory manager. While not systemic, NBDTs take deposits from the public and thus the public interest and protection of depositors warrant a special resolution regime.



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## G. FMI Resolution

**99. New Zealand is in the process of developing a crisis management framework for FMIs.** The RBNZ consulted on a proposed crisis management framework in 2016. Under the new regime the RBNZ would be the resolution authority for systemically important payment systems and the RBNZ and FMA jointly for other systemically important FMIs. The proposed framework includes resolution powers for the RBNZ and FMA, taking into account recent and ongoing international developments.[9] The planned regime would use the same well understood—and tested with smaller institutions—statutory management regime found in other financial sector legislation. Powers of a statutory manager would include placing a moratorium on payments to general creditors and the power to sell or otherwise transfer to a third party the whole or part of the business of the FMI in statutory management.

## H. Resolution Regime—Recommendations

**100. In the near term, greater clarity is required on roles and responsibilities in dealing with resolution of a systemically important institution.** In the medium term, legislative amendments are required to provide additional resolution powers and greater credibility for the OBR option. The resolution objectives recommended below would help to clarify that the powers of a statutory manager should be used to resolve both systemic and non-systemic institutions. Transferring all or part of the business of the bank minimizes disruption and maximizes recoveries relative to the liquidation of a non-systemically important institution.

**101. The RBNZ would be the sole decision maker in any non-systemic situation without fiscal implications when it was pursuing a resolution option to maximize recoveries from a failed institution.[10]** This is consistent with the requirement for operational independence of the resolution authority pursuant to the FSB *Key Attributes*. The RBNZ would exercise its power by issuing binding directions to the statutory manager, which would cover the scope and terms of the engagement, to the statutory manager. The RBNZ would keep the CoFR and the minister informed consistent with the communications protocols established by the CoFR for crisis management.

### Objectives and Accountability of the Resolution Authority

**102. Legislation should provide that the RBNZ as resolution authority is required to pursue resolution options not requiring public funds and maximizing the recoveries from the failed institution.** This is consistent with the objective to avoid unnecessary destruction of value established in the FSB *Key Attributes*. It is further intended to avoid the use of public funds while protecting the interests of depositors and other creditors, also in line with the *Key Attributes*. There should be a systemic risk exception, permitting the RBNZ, with the consent of the Minister, to

[9] For further detail, see the Financial Market Infrastructure technical note.

[10] It would be preferable for the RBNZ to be able to trigger resolutions that do not have fiscal implications without ministerial consent. This is not possible given the current requirement for ministerial consent to appoint a statutory manager.



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pursue options that may not maximize recoveries, or may require public funds, when essential to protect financial system stability.

**103. There are no specific objectives established in legislation or regulations for the use of the statutory manager regime for registered banks.** In contrast, IPSA includes a provision specifying that statutory management is only to be used if the interests of policy-holders and the public interest cannot be protected under alternative options. Adding a parallel provision to the RBNZ Act in addition to the current broader financial stability objectives would help to clarify the intent to use statutory management in systemic situations, while also leaving open the option to use statutory management to achieve minimally disruptive and lower cost resolutions as an alternative to liquidation of non-systemic institutions.

**104. Having established objectives for the exercise of resolution power, it is also necessary to have accountability.** This should involve ex post reporting by the RBNZ on its performance in the resolution relative to its financial stability mandate and specific resolution objectives of maximizing recoveries and protecting depositors and the public interest. Other accountability mechanisms that could be considered include an explicit legislative requirement for ex post review of all resolutions by the Auditor General or a parliamentary committee.

**Entry into Resolution**

**105. Triggering the resolution process is currently clear with respect to the appointment of a statutory manager by an Order-in-Council made on the advice of the Minister in accordance with a recommendation by the RBNZ.** However, the current ambiguity about whether the RBNZ would in all cases be the resolution authority should be removed by specifying in law that that the RBNZ will direct the statutory manager, having regard to the resolution objectives recommended above—protection of depositors and the public interest, and maximizing the recoveries from the failed institution, in addition to its existing financial stability mandate.

**106. A parallel to the provision in IPSA that the RBNZ may apply for the appointment of a liquidator of an insurance company should be added to the RBNZ Act.** This provides an alternative to continued operation in the unlikely event that a Minister did not consent to the appointment of a statutory manager for a registered bank. Similarly, the NBDT Act should be revised to parallel IPSA, providing the RBNZ with the power to apply for appointment of a liquidator, and to recommend to the Minister of Finance the appointment of a statutory manager.

**Systemic Risk Exception**

**107. Additional provisions are needed to address circumstances when public funds may be required or a non-least cost resolution is desirable from a systemic risk perspective.** The legislation should require the RBNZ to specify the systemic risk considerations that warrant the provision of a guarantee to support OBR or possibly some other resolution, or in extraordinary circumstances such as the AMI insurance case, commitment of public funds to recapitalize a failing institution. The RBNZ should be required to provide an assessment of other possible resolution



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options, and a recommendation to the Minister specifying why use of public funds or a non-least cost resolution is required for financial stability purposes.

**108. The Treasury would provide advice to the Minister on the RBNZ's recommendations that public funds, a guarantee, or a non-least cost resolution is, in the opinion of the RBNZ, required for financial stability purposes.** Only if the Minister concurs with the RBNZ recommendation to pursue a non-least cost option and/or to provide a Crown guarantee or public funds, would these alternatives be implemented.

**109. Commitment of public funds or a guarantee requires additional reporting, decision-making and accountability provisions for the duration of the Crown exposure.** These provisions need to balance the requirement for operational independence of the RBNZ as resolution authority, with the fiscal responsibilities of the Minister. The Treasury should be charged by CoFR with developing "shelf" guarantees, shareholder agreements and debt covenants that include in their terms and conditions reporting requirements by the statutory manager and RBNZ to meet the Minister's needs.

**110. These shelf documents should also include decision-making provisions, specifying types or categories of decision in resolution that would require Ministerial consent.** These should exclude the day-to-day operations of the bank which should be the responsibility of the statutory manager pursuant to directions from the RBNZ, but should include any major organizational changes, pursuit of new investors, sale of material parts of the business, and exercise of bail-in powers. Similarly, the RBNZ should be tasked by the CoFR with revising its shelf statutory manager terms of engagement to include specific provisions for reporting and decision-making in situations where there is Crown exposure, differentiating from the requirements when there is no Crown exposure. All of the provisions in the "shelf" documents should be consistent with and reflected in the CoFR's contingency plans for crisis management.

### Protection of Depositors

**111. Providing a legislative footing for key elements of OBR could remove some of the current uncertainty.** Because OBR is a policy, actual implementation, for example the *de minimis* amount, would be decided only at the time of implementation. Currently, the provisions of Section 121 of the RBNZ Act, which require the statutory manager to "have regard to" the priority of creditors' claims to the extent not inconsistent with financial stability, have been interpreted to mean that the statutory manager may depart from the established priority, and thus exclude *de minimis* amounts on financial stability grounds.

**112. Greater certainty would be provided by establishing in law a limited depositor preference.** The hierarchy of claims on a failed bank should provide priority for depositors up to the specified *de minimis* amount, with deposits in excess of this amount ranked *pari passu* as in the current hierarchy. This would permit the statutory manager to observe the established priority of claims when exercising the recommended bail-in powers while at the same time exempting small depositors from loss.



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## Other Key Attributes

**113. It would also be useful to consider whether it would be consistent with New Zealand legal traditions to provide other specific powers to the statutory manager to address some of the other gaps between the current regime and the *Key Attributes*.** Currently the intention is that the power of a statutory manager to transfer some or all of the assets and liabilities to a new institution could be used to effectively impose losses on creditors. It would be preferable if the law were to expressly provide the statutory manager with bail-in powers, respecting the hierarchy of claims and subject to the no creditor worse off than in liquidation principle (Key Attribute 3). This would provide a more straightforward path from the freezing of a portion of accounts to the actual imposition of losses on creditors contemplated in OBR.

**114. Express bail-in powers could then be used to complete purchase and assumption type transactions.** While there is no deposit insurance fund to top up the difference between the value of the assets of a failed institution and the liabilities assumed by a purchaser, such a transaction could be completed by reducing the value of the liabilities. In this way, banking relationships and thus franchise value would be preserved, and depositors would likely find it preferable to have some large percentage of their deposits transferred to a new institution rather than going through a liquidation process.

**115. There are currently no safeguards to creditors respecting the hierarchy of claims (Key Attribute 5).** In fact, OBR as contemplated would expressly require some creditors to be made worse off to accommodate the *de minimis* exemption. A solution to this is to establish a specific hierarchy of claims for resolution in statutory management. As recommended above, the concept of a *de minimis* exemption should be established in law, with a limited depositor preference prescribed by legislation. Similarly, there should be provision for possible protection of assets of FMIs held in bank accounts to ensure that the operation of those FMIs was not disrupted. With such provisions established in law, the statutory manager would then respect the hierarchy of claims in exercising bail-in powers.

**116. There is currently no provision for exemption of information on resolution from the continuous disclosure applying to entities listed on the NZX (Key Attribute 5).** This has been noted in the trans-Tasman work, and the TTBC is considering similar issues in Australia. The FMA is currently leading work on a New Zealand solution, in consultation with ASIC, the RBNZ and NZX, to assess whether an additional legal mechanism is required for the public interest in effective resolution to take precedence over the disclosure requirements for listed entities when there is a conflict.

**117. There has been very little recovery planning for the large banks beyond looking to the parents for support (Key Attribute 11).** Resolution planning has focused on separation arrangements, and in particular the ability to operate without provision of services by the parent bank or group. Assurance that the subsidiaries will be able to operate independently is obviously critical if OBR is to be a credible option. The RBNZ should also pursue the possibility of reaching agreement with APRA pursuant to the MOC that the home supervisor would ensure continued provision of services by the parent or other group members throughout resolution.



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