Deposit Takers Bill: Legislative Statement - First Reading

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Introduction

The Deposit Takers Bill (the '**Bill**') is an omnibus Bill which modernises the legislative framework for prudential regulation and supervision of the deposit-taking sector. Deposit takers are financial firms that take deposits from the public and lend to individuals and businesses. Deposit takers include banks and non-bank deposit takers such as credit unions, building societies, and retail-funded finance companies. The Bill merges the previously separate frameworks for banks and non-bank deposit takers under a single regulatory regime, replacing the Banking (Prudential Supervision) Act 1989 and the Non-bank Deposit Takers Act 2013.

The main purpose of the Bill is to promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy by protecting and promoting the stability of the financial system. The Bill aims to protect society from the damage to New Zealand's financial system and wider economy that could potentially be caused by excessive risk taking by deposit-takers, the unmanaged failures of deposit takers, or unexpected external shocks to the deposit taking sector.

The Bill maintains the operational independence of the Reserve Bank within a prudential regulatory regime that seeks to promote transparency and public legitimacy, with appropriate safeguards, due process, and accountability arrangements.

Background

In 2017, the Government announced it would undertake a Review of the Reserve Bank of New Zealand Act 1989 (renamed on 1 July 2022 as the Banking (Prudential Supervision) Act 1989), (the '**RBNZ Act 1989**'). The Review had the objective of modernising the RBNZ Act 1989 to support the development of a New Zealand economy that is productive, sustainable, and inclusive. The Review had two phases.

Phase 1 of the Review focussed on changes to the monetary policy framework, and resulted in the Reserve Bank of New Zealand (Monetary Policy) Amendment Act 2018. The new legislation introduced an employment objective for monetary policy alongside price stability and provided for a Monetary Policy Committee as a decision maker.

Phase 2's focus has been on the financial policy aspects of the RBNZ Act 1989. The terms of reference for Phase 2 was partly motivated by the results of the International Monetary Fund's (**IMF**) Financial Sector Assessment Programme (**FSAP**) for New Zealand conducted over 2016-17. The IMF found New Zealand's light-handed regulatory regime for the banking sector to be unusual internationally, resulting in significant non-compliance with the global standard for effective supervision (the Basel Committee's core principles).

Phase 2 of the Review has resulted in two new pieces of legislation, the first of which was the Reserve Bank of New Zealand Act 2021 (the 'RBNZ Act 2021'). This modernised the institutional design and accountability requirements of the Reserve Bank, including by importing some of the transparency and accountability features of the Crown entity regime. It also introduced a new, and clearer, financial policy objective focussing on protecting and promoting the stability of New Zealand's financial system. Amongst other things, the RBNZ Act 2021 establishes a new governance model for the Reserve Bank's non-monetary policy functions (a shift away from the single person decision-maker to a board), and requires the Minister of Finance to issue a *Financial Policy Remit* that the board must have regard to when fulfilling its prudential responsibilities. It also gives statutory recognition to the Council of Financial Regulators, emphasising the importance of cooperation and coordination across the regulatory system.

The Bill is companion legislation to the RBNZ Act 2021, and also results from Phase 2 of the Review. The Bill aims to address many of the IMF's FSAP recommendations to update the broader framework for the regulation and supervision of deposit takers. In particular, the Bill:

- provides clear objectives for the new regime,
- modernises the licensing process,
- provides for a range of prudential standards,
- expands the suite of supervisory and enforcement tools,
- improves the crisis management and resolution framework, and
- establishes the Depositor Compensation Scheme (the 'DCS')

The Bill provides clear objectives for the Reserve Bank as the prudential regulator

The Bill elaborates on what the RBNZ Act 2021's new financial policy objective of promoting financial stability means in the context of the sectoral regulation of deposit takers. To that end, the Bill has additional purposes to promote the safety and soundness of each deposit taker, to promote public confidence in the financial system, and to avoid or mitigate the adverse effects of risks to the financial system. There are also other part-specific purposes and objectives for DCS (Part 6) and crisis management and resolution (Part 7), which provide further clarity around Parliament's expected outcomes in those areas. The *Financial Policy Remit* is another feature of the RBNZ Act 2021 framework that will influence how the Reserve Bank will go about achieving the primary objective of financial stability.

The purposes of the Bill are tempered by a number of decision-making principles. The Reserve Bank must take these principles into account when exercising its functions. These principles include the desirability of taking a proportionate approach, the need to maintain competition and avoid unnecessary compliance costs, and the desirability of deposit takers effectively managing their capital, liquidity, and risk. The principle of proportionality is especially important because it allows the Reserve Bank to maintain the diversity of the deposit-taking sector. Other principles also play an important role in ensuring the Reserve Bank takes into account the importance of efficiency in the financial system.

The Bill modernises the licensing process

All deposit takers that carry on deposit taking activity (broadly speaking, carrying on the business of borrowing and lending) are required to have a licence, thereby defining the perimeter of prudential regulation for this sector. The Bill sets out the licensing requirements the Reserve Bank will use to evaluate potential applicants, and provides the Reserve Bank with the power to impose specific licence conditions on any deposit taker. The Reserve Bank will use licence conditions to differentiate between deposit takers and take a proportionate approach to prudential regulation. Licence conditions may impose particular prudential requirements on firms (for example, fixing a minimum capital ratio), and make other firm-specific restrictions on the nature of a deposit taker's business. The Bill outlines when a deposit taker will need to obtain approval from the Reserve Bank for changes of control and other significant transactions, and when the Reserve Bank may cancel a licence.

The licensing regime includes fit and proper requirements for directors and senior managers of deposit takers. The Bill provides the Reserve Bank with a power to remove a director or senior manager on grounds stipulated in Part 7 of the Bill.

The Bill strengthens the range of prudential standards

Prudential requirements for deposit takers will primarily be set out in 'standards', buttressed by licence conditions as appropriate, and subject to various process and procedural requirements. Standards are secondary legislation issued by the Reserve Bank under the Legislation Act 2019. The Reserve Bank must also satisfy certain statutory prerequisites before making standards (including consulting with any parties that may be substantially affected by the proposed standard). As secondary legislation, standards are subject to disallowance by Parliament.

The Bill provides greater clarity for the Reserve Bank, relative to the RBNZ Act 1989, over the areas it may set prudential requirements for deposit takers. Areas of prudential regulation the standards may relate to may include:

- governance,
- remuneration of directors and senior managers,
- capital, liquidity, security interests, and credit ratings,
- loan concentration and risk exposures,
- risk management, business continuity planning, and problem assets,
- disclosure, and
- internal controls and assurance.

The Bill also includes a due diligence duty on directors to ensure the associated deposit taker complies with its prudential requirements.

The Bill expands the Reserve Bank's supervision and enforcement powers

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

Previously, the Reserve Bank approach to supervision relied on three pillars: self, market, and regulatory discipline. The Bill increases the weight of regulatory discipline in the three-pillar framework, enabling the Reserve Bank to adopt a more intensive approach to supervision through a range of new and improved powers. The suite of supervisory powers in the Bill includes powers to gather information, undertake onsite inspections, investigate non-compliance with prudential obligations, and require remedial action by deposit takers. The powers in the Bill signal a move away from a light-handed supervisory model to one that is inherently more sceptical and challenging, and based on greater verification. These changes also address gaps identified by the IMF's FSAP recommendations.

The Bill provides for a range of new Reserve Bank enforcement powers to sanction deposit takers for non-compliance. The penalty regime for contraventions in the Bill includes criminal offences, civil pecuniary penalty liability, and infringement offences. Enforcement provisions include the power to accept undertakings. The Bill further criminalises the making of false or misleading declarations or provision of false or misleading information. These changes address the IMF's FSAP recommendation to promote preventive action on the part of deposit takers and enhance sanction powers when deposit takers are found to be non-compliant with prudential requirements.

The Bill establishes the Depositor Compensation Scheme

One of the IMF's recommendations arising from the FSAP was to reconsider the merits of a formal depositor protection scheme in New Zealand. The absence of such a financial safety net has left New Zealand as an outlier among other countries (one of only two OECD countries without depositor protection). The Bill addresses this longstanding gap, and establishes the DCS as a major element of the legislative reforms.

The DCS aims to promote the stability of New Zealand's financial system, providing each eligible depositor with $100,000 of compensation protection for their protected deposits at each deposit taker. This is estimated to cover more than 90% of depositors. Broadly speaking, compensation will be payable when a deposit taker is in difficulty that causes disruption to the ability of eligible depositors to access their protected deposits.

The Bill sets up a DCS fund, which will be funded by charging levies to deposit takers. The fund is backed up by public funds should the balance of the DCS fund be insufficient to meet its compensation obligations. The target size of the DCS fund, and the expected time to achieve the target, will be included in the *Statement of Funding Approach*, published by the Minister of Finance at least every 5 years.

The DCS is a significant new function of the Reserve Bank, as the Reserve Bank has the role of collecting levies, managing the DCS fund, determining entitlements, and making compensation payments. The Reserve Bank can also use the DCS fund to support resolution measures when certain conditions are met, including protecting eligible depositors.

The Bill provides for crisis management and resolution powers

Crisis management refers to the use of powers and supporting arrangements to deal with events that seriously threaten a deposit taker's viability. Placing a failed deposit taker into ordinary insolvency can have damaging consequences for its customers, the rest of the financial system, and the wider real economy. The Bill introduces an enhanced framework to enable the Reserve Bank to address a deposit taker in financial distress. These powers enable resolution to be dealt with in an orderly manner, avoiding significant damage to the financial system.

Under provisions contained in the Bill, the Reserve Bank is tasked with efficient management of public financial resources and avoiding the need to rely on public money to deal with the financial distress. The Bill imposes important obligations on the Reserve Bank, including resolution plans for each licensed deposit taker, and a public *Statement of Approach to Resolution*. This resolution framework aims to avoid expensive publicly funded bailouts which are inequitable to society, and harmful to market discipline. It includes both powers to direct a distressed deposit taker, and a resolution regime for distressed deposit takers. This resolution regime has a number of components, including a moratorium on pre-resolution claims by creditors, powers to sell or otherwise dispose of some or all of the business of a deposit taker, and the ability to place the deposit take into liquidation.

The Reserve Bank must be mindful of the interests of all parties in a resolution scenario, not just the interests of eligible depositors, as any creditors made worse off because of a Reserve Bank resolution action will also be entitled to compensation. This 'No Creditor Worse Off' (NCWO) mechanism is a safeguard which should encourage the Reserve Bank to exercise resolution powers in a way that is at least as effective as a normal insolvency process. Such creditor safeguards in a resolution are now international best practice and a common expectation among creditors internationally.

Other matters covered by the Bill

The Bill includes provisions on the restricted words "bank", "banker", and "banking", including limiting their use in advertisements by financial service providers that are not licensed deposit takers.

The Bill also requires the Reserve Bank to cooperate with Australian financial authorities when performing its functions. This includes avoiding actions that are likely to have a detrimental effect on financial system stability in Australia. This carries over provisions from the existing prudential regime for banks in the Banking (Prudential Supervision) Act 2021, and is in line with the IMF recommendation to take a more proactive approach to trans-Tasman collaboration, given the important interdependencies between the two financial systems.