



**Submission of the
New Zealand Council of Trade Unions
Te Kauae Kaimahi
to the**

**Reserve Bank of New Zealand
on the**

**Consultation Document: Pre-positioning for Open
Bank Resolution (OBR)**

**P O Box 6645
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1. Introduction

- 1.1. This submission is made on behalf of the 39 unions affiliated to the New Zealand Council of Trade Unions Te Kauae Kaimahi (CTU). With over 330,000 members, the CTU is the largest democratic organisation in New Zealand.
- 1.2. The CTU acknowledges Te Tiriti o Waitangi as the founding document of Aotearoa New Zealand and formally acknowledges this through Te Rūnanga o Ngā Kaimahi Māori o Aotearoa (Te Rūnanga) the Māori arm of Te Kauae Kaimahi (CTU) which represents approximately 60,000 Māori workers.
- 1.3. We welcome the opportunity to make a submission on this matter and would like to remain involved in any further consultation. Some of the issues are technical but those concerning deposit guarantees and the soundness of banks are of public concern. The issues have been highlighted by the Global Financial Crisis which is the most recent and largest manifestation of the financial instability which followed the move to open financial markets and away from the Bretton Woods regime. The present proposal is of course only a small part of the response by New Zealand authorities to the changed reality, and there is much more that should be done, but on the whole this is a useful step.
- 1.4. While respecting the role of the Reserve Bank (RBNZ) to implement and monitor any deposit guarantee, we believe that this is an area that requires wider debate than the present consultation aimed principally at the banks.

2. The proposal

- 2.1. The essence of the proposal is to take the following steps following the identification of a problem at a bank:
- 2.1.1. The bank is placed under statutory management and closed.
Depositors no longer have access to their accounts and funds.
- 2.1.2. An assessment is made of the losses and remaining value of the bank.
The bank should have systems in place to ensure that this assessment takes no more than 24 hours (this capability is the key requirement banks are asked to respond to in this consultation).
- 2.1.3. A “haircut” is applied to depositors’ accounts and term deposits – that is, a portion of their funds is frozen leaving the remainder available to them. The haircut is designed so that the total funds available to depositors are covered by the remaining value of the bank. The government guarantees their remaining deposits (that is, their deposits after the haircut).
- 2.1.4. The bank is re-opened for core transactions business, with guarantees in place.
- 2.1.5. Following this, decisions are made on the future of the bank, which may range from ultimate closure to trading or restructuring out of trouble. The final position of depositors and other creditors will be affected by these decisions. Depositors may receive anything from the government guaranteed amount to their full original deposits depending on the outcome.
- 2.2. The principle the RBNZ is pursuing in proposing this process is that the bank’s shareholders should “in the first instance” bear the costs of failure, while minimising disruption to the banking system. We support this principle. If successful it will reduce the implied and explicit liability the government bears when there is a failure of the banking system, the consequences of which we see in the US and Europe today.

- 2.3. On that basis, the credit ratings of the New Zealand government should be strengthened and those of the banks weakened. A downgrading of the latter has already occurred.
- 2.4. However it does not disguise the fact that the government still bears a liability not only for the deposit guarantee itself (its actual cost will depend on the accuracy of the assessment of the remaining value of the bank) but potentially much more in the case of systemic failure going well beyond the failure of a single bank such as occurred in the US and UK. The consequences of a systemic failure are unpredictable and at worst could lead to a cascading collapse of many banks, invalidating any initial assessment of remaining value. Subsequent economic effects also place a heavy cost onto the government. We still face potential problems of “too big to fail” and of systemic collapse. The design of this proposal should try to minimise those risks for obvious reasons, and try to reduce the risk of large banks taking advantage of their status.
- 2.5. We mention this to emphasise that there is much more to be done to strengthen our banking system and substantially reduce the risk of it again threatening to become a burden on the public purse and the economy. As current events demonstrate, the global economy is still highly exposed to very serious financial instability and banking crashes from which we need to protect ourselves as well as we can. For example, we consider that more needs to be done to reduce the risks attached to the big four banks’ continuing high reliance on funding from overseas markets (though short-term exposure is reducing); the system is still vulnerable to the “too big to fail” problem; the payments system and clearing house operations are still susceptible to the failure of one or more large banks; and the banks are not sufficiently accountable to the public given their reliance on regulation, supervision and – in the end – government guarantees under both the OBR proposals and as described above. We recognise that OBR may give a degree of protection against unilateral action by the Australian owners of the big four banks to strip them of funds such as during a crisis in the Australian banking system (as long as they do not use insider knowledge to extract

funds in anticipation of statutory management), but that remains an area which should be closely monitored and may require further action.

- 2.6. We have found the paper “Deposit Insurance: A survey of Actual and Best Practices”, by GGH Garcia¹ helpful in considering options for deposit guarantees.

3. Depositor view

- 3.1. We represent wage and salary earners who will largely have small deposits (we use “deposits” to mean all forms of funds they may hold in a bank), and whose interactions with banks include not only deposits but housing and personal loans, and other payment services such as credit cards and EFTPOS on which they are increasingly dependent. They are also concerned about the cost and quality of services they receive from banks, which has loomed large in recent times as demonstrated in surveys and the success of KiwiBank.
- 3.2. From this point of view, it is important that careful consideration is given to the shape of the deposit guarantee. The great majority of households have relatively small financial savings in banks. Le, Gibson and Stillman² found for example that the *median* bank account for New Zealand households was just \$590 in 2004 and \$580 in 2006. The *average* bank account however was \$9,783 in 2004 and \$11,163 in 2006. This is consistent with the very large inequalities in wealth in New Zealand documented in their paper and elsewhere³. We are not aware of publicly available data to estimate the full distribution of deposits but the difference between the median and average indicates it is strongly weighted towards higher income and wealthier individuals and households. For those with a small amount of funds in their bank accounts, the loss of even a proportion of it may make a significant difference to their financial position and their standing with creditors.

¹ “Deposit Insurance: A survey of Actual and Best Practices”, by Gillian G.H. Garcia, International Monetary Fund, WP/99/54, April 1999.

² “Household Wealth and Saving in New Zealand: Evidence from the Longitudinal Survey of Family, Income and Employment”, by Trinh Le, John Gibson and Steven Stillman, Motu Working Paper 10-09, September 2010, Table 1.

³ For example “Wealth Disparities in New Zealand”, by Jit Cheung, Statistics New Zealand, April 2007.

- 3.3. We therefore strongly submit that the deposit insurance should be applied to guarantee a fixed minimum deposit that ensures that the majority of households do not lose any funds. David Tripe in his submission on this matter has suggested that a limit of \$50,000 would take no more than about 40% of a bank's liabilities. On the evidence from Le, Gibson and Stillman, that would also mean that many more than half of the banks' depositors would have their deposits fully guaranteed. A policy rule of fully guaranteeing say 80 percent of depositors may be possible. The cut-off would have to be determined based on evidence, and it would be valuable to have data on the distribution of deposits publicly available.
- 3.4. Such limits are common internationally and are clearly feasible here. They would ensure equity for depositors while achieving this policy's aims of leaving the primary loss with shareholders. They would also reduce the risk of flight from troubled banks in terms of depositor numbers if not in amounts of deposits.
- 3.5. There are subsidiary considerations such as whether the limit should be for an individual or household, and whether it should apply to one deposit, one bank, or the whole banking system. We suggest it should apply to an individual for simplicity and equity reasons, and on a per bank basis for simplicity and to encourage the spread of risk. However we recognise that any such choices have their advantages and disadvantages. For example, wealthy individuals may game the facility by spreading their accounts around household members and banks. However these disadvantages are outweighed by the advantages.
- 3.6. It is also important that the size of the guarantee is known in advance to the public. Otherwise all depositors have an incentive to participate in a run on the bank.
- 3.7. Private deposit insurance could be offered for deposits uncovered by the guarantee. There could be requirements for a specified notice of withdrawal of uninsured and unguaranteed funds to reduce the risk of runs on banks by holders of those funds.

- 3.8. We are also concerned about equity between retail and wholesale funders of a bank in sharing the pain of haircuts. One area which requires attention is that of “netting” (where a final net payment is made by one party to one or more other parties, rather than exchanges of a number of individual transactions between them). Unless the RBNZ and/or statutory managers are willing to unravel netting arrangements, which may involve netting of both funding and loans to a distressed bank, and may involve both international and domestic parties, wholesale funders may escape their fair share of haircuts. The OBR policy should make clear how this will be resolved.
- 3.9. Similarly, this discussion highlights the privileged position of those with covered bonds (which receive priority status in case of bank failure). The effect is to increase the size of haircuts required for other bank creditors. The RBNZ should review its policy of permitting such instruments.
- 3.10. It should also place controls on the sale/transfer of assets to related parties such as parent banks. Such sales run the risk of depleting the bank of its lowest risk assets prior to statutory management, again leaving less available to be shared among bank creditors.
- 3.11. The government guarantee should conceptually at least be paid for by the banks through a risk-weighted premium. We recognise that it would take some time before sufficient funds had been raised to cover the cost of a substantial failure, but premiums would ensure the costs lay closer to where they were generated, and would provide some discipline on banks’ behaviour and a signal of their credit status to the public.
- 3.12. Given that the objective of this policy is to ensure that the banks’ shareholders bear the primary responsibility for the cost of failure, they should also bear the cost of insuring against failure. At the least, the premium should be structured to make it difficult to pass on to customers. However regulation should also be considered to prevent banks directly passing on the costs.

- 3.13. While the theory has been that without a guarantee, depositors would be incentivised to take notice of the financial position of their bank and make rational judgements accordingly, that is absurd in reality. When an expert such as David Tripe says he no longer has the information required to make such judgements, and almost the entire population of financial experts, analysts, advisors and economists in Australia, New Zealand the US and Europe failed to make accurate assessments of the state of banks and other financial institutions globally, an individual New Zealander with little or no financial expertise let alone the time to analyse the accounts of multiple banks is hardly likely to do better.
- 3.14. It is in fact those with large deposits that are most likely to have the skills, or the resources to pay for them, to make such judgements. Again, the deposit guarantee structure we propose is appropriate to this situation.
- 3.15. There are other matters that will be of concern to depositors if their bank does get into trouble. For example, access to EFTPOS and other electronic payment facilities is crucial as many people no longer carry cash, or not sufficient cash for their daily or weekly needs. A recent survey by Visa found that “62 percent of us carry \$20 or less in cash, and 5 percent carry no cash at all”⁴. It is technically possible for these electronic payment services to remain available but with dollar limits on transaction values in a day thereby preserving the guarantee from the customer’s point of view while limiting any run capability. Such limits already exist in various forms. There may also be time-critical issues for debtors to the banks, such as a house purchaser tied into a sale and purchase agreement which is conditional on a bank loan.
- 3.16. A further requirement of the statutory manager should be the provision of timely and readily available information to customers and the public through advertising, and bank computer systems and call centres following it going into statutory management. For depositors who have suffered haircuts, there needs to be continuous and clear information on how much of their funds remain available to them.

⁴ “Notes and coins making less sense as smart cards take over”, by Rob Stock, *Sunday Star-Times*, 25 September 2011, p. D7.

- 3.17. Similar “OBR” arrangements should be put in place for any non-bank deposit takers who are engaged in transactional banking.

4. Technical issues

- 4.1. With regard to the capability of banks to put the systems in place required for OBR, our view is that given their technological sophistication, the banks are among the best placed of any business sector in New Zealand to do so.
- 4.2. There is however a credibility issue for both the banks and the RBNZ as overseer. The RBNZ must take an active role in monitoring the banks as to whether their systems are indeed robust and capable of what they are required to do. Banking systems, products and customer requirements are constantly changing, and their OBR systems must be constantly adjusted to the changes, and regularly tested.
- 4.3. The public needs to have confidence that the RBNZ is capable of overseeing those tests, and making a reliable judgement as to whether the banks' systems meet requirements. With due respect to the RBNZ, it is not immediately obvious that its expertise lies in these areas. However contracting out such oversight in a small country runs a high risk of those with the required skills also having an interest in working for the banks, such as in constructing or running their information systems. Credibility in this oversight is essential and the RBNZ must obtain and retain this capacity.
- 4.4. The determination of the size of the haircut should be the responsibility of the RBNZ in conjunction with the Statutory Manager. There are obvious conflicts of interest if banks were to determine this themselves. Given this, there needs to be continuous information to the RBNZ, not only in time of trouble, and the RBNZ should conduct spot checks on the state of the banks.