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# Open Bank Resolution – the New Zealand response to a global challenge

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The Reserve Bank supervises registered banks with the objective of promoting the maintenance of a sound and efficient financial system and avoiding significant damage to the financial system from the failure of a bank. In recent years, the Reserve Bank has been working on the implementation of the Open Bank Resolution (OBR) policy as an option for responding to a bank failure to minimise the costs and disruption to the financial system and the wider economy, while minimising the cost to the taxpayer. This is a key issue for supervisors worldwide following the global financial crisis. This article assesses the framework in New Zealand against the global standards that are driving developments in other jurisdictions.

## 1 Introduction

One of the key lessons from the global financial crisis (GFC) is the potentially enormous fiscal cost that can be associated with supporting troubled banks. Many countries found that either their tools for resolving large failing financial institutions were inadequate or they simply did not exist. As a result, many authorities faced the difficult choice between relying on ordinary corporate insolvency laws to deal with the failure of systemic and complex financial institutions, or providing public financial support.

This article outlines the work under way in New Zealand to provide the Government with resolution options for failing banks that do not burden the taxpayer with huge costs, at the same time as avoiding major disruption to the financial system. The main mechanism providing this option is the Open Bank Resolution (OBR). The article then describes the development of global standards in recovery and resolution frameworks, and analyses the arrangements being put in place in New Zealand against these standards.

## 2 Background to OBR

The Reserve Bank first began considering options for responding to a bank failure following the 1997 Asian financial crisis. This work led to the development of the OBR policy. The OBR is a tool for responding to a bank

failure, and is designed to allow a failed bank to be open for full-scale or limited business on the next business day after being placed under statutory management (most likely as the result of an insolvency event).

The OBR policy seeks to ensure that first losses are borne by the bank's existing shareholders. In addition, a portion of depositors' and other unsecured creditors' funds will be frozen to be available to bear any remaining losses. To the extent that these funds are not required to cover losses as a more detailed assessment of the position of the bank is completed, these funds will be released to depositors and creditors. At a high level, this is no different to an ordinary liquidation. The primary advantage of the OBR scheme, however, is that depositors would have access to a substantial proportion of their balances immediately after the failure event (i.e. at the start of the next business day). This contrasts with what would happen under a normal liquidation, where depositors might not have access to any of their funds for a significant period (which could be months, if not years).

In the event that a New Zealand bank were to come under solvency pressure, the Reserve Bank would undertake an initial assessment of the health of the troubled bank. Following this initial assessment it may make a recommendation to the Minister of Finance that the bank be placed under statutory management. The Minister of Finance is responsible for taking the decision whether to place the bank under statutory management, and whether to apply the OBR. As part of any recommendation for statutory management, the Reserve

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Bank (and the Treasury) will provide advice to the Minister on the appropriateness of activating the OBR policy.

While OBR is a central element of the New Zealand resolution framework, whether or not to use this tool will be assessed on a case-by-case basis. Therefore it is possible that there will be circumstances under which the government considers that an alternative option would be preferable, which may include liquidation, public support for a third party takeover, or an injection of public funds (often referred to as a 'bail-out').

Should OBR be the chosen solution, the first stage of the process is to freeze all access channels to the bank and establish the balance of each account at the point at which the bank was placed under statutory management.<sup>2</sup> A high-level assessment of the bank's losses will then be undertaken, and a conservative portion of liabilities frozen. These frozen funds are set aside to cover any losses beyond what the bank's capital position could absorb. The frozen funds are not cancelled nor written off, and the depositors and creditors continue to hold a legal claim to these funds. To the extent that all or some of the frozen funds remain available after all losses have been covered, they will be returned to depositors and creditors.

The bank will re-open for ordinary transaction business on the next business day after it is placed under statutory management. At this point, depositors will have full access to the unfrozen portion of their accounts. These funds, and any new funds that the depositor places with the bank, will be subject to a government guarantee.

The full assessment of the condition of the bank and the identification of the appropriate long-term solution to the failure are likely to take a number of weeks or months to work through. Additional frozen funds may be periodically released to depositors during this time, to the extent that it becomes clear that they will not be required to cover the bank's losses.

Other liabilities such as wholesale funding will have the same proportion of funds frozen, but will not be pre-positioned to allow the providers of the funding to have access to the unfrozen portion the next business day. However, as much of this funding will be held on term,

it is unlikely that a significant amount of it will be due to mature in the immediate aftermath of an OBR event, so it is probable that the statutory manager will typically be in a position to release the unfrozen portion in line with the original contractual maturity.

### 3 Implementation of OBR

Although the OBR is a long-standing policy of the Reserve Bank, one of the key observations from the initial policy development work was that in order to operate effectively, it needed to operate within an overarching and internally consistent policy framework. This has meant that, as prudential and payments policies and requirements have been put in place, one factor for consideration in the policy development process has been the facilitation of effective resolution tools, including OBR.

There have, for instance, been a number of changes aimed at increasing the certainty that banks will be able to continue to provide essential functions (i.e. the provision and circulation of liquidity) at times of distress. These changes include the local incorporation policy, corporate governance requirements aimed at strengthening the New Zealand focus of bank boards, and restrictions on the extent to which core business processes and activities can be outsourced. In addition, there have been a number of developments in the payment system, such as failure-to-settle rules and the introduction of settlement before interchange that should help to enhance efficiency and reduce risk in the financial system.

Another critical part of the framework is the legislation that enables effective crisis resolution. The OBR policy utilises existing powers in the Reserve Bank of New Zealand Act 1989 (the RBNZ Act), in particular, the statutory management powers under Part 5. These powers allow for a failing bank to be placed under statutory management, with a moratorium taking effect on all claims against the bank. The OBR simply provides the necessary functionality to release the assessed good value to creditors immediately after the failure.

The remaining key part of the implementation of OBR is therefore the pre-positioning of banks' internal IT systems and processes to ensure that the necessary

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<sup>2</sup> For a fuller description of the OBR process, see Hoskin, K and I Woolford (2011)

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functionality exists to freeze and then partially unfreeze accounts overnight. This will allow a failed bank to re-open at 9am the next business day to enable depositors and creditors to access a large proportion of their funds, while the authorities work towards a long term solution. The Reserve Bank has been working closely with registered banks for the last two years to put this functionality in place. The specific requirements are listed in the consultation document of March 2011.<sup>3</sup>

The OBR policy applies to all locally incorporated banks with retail deposits over \$1 billion. The Reserve Bank issued the formal requirements as a new chapter to the Banking Supervision Handbook for public consultation on 8 March 2013.<sup>4</sup> Subject to consultation, the intention is for the pre-positioning requirements to be in place by 30 June 2013. From that date, the OBR will be available to the Minister of Finance as a viable option for responding to a bank failure.

## 4 Global standards

As outlined above, the legislative framework and work on the supporting policies for bank failure resolution were already well advanced in New Zealand before the GFC. Many jurisdictions were not as well placed, and have been working to update their own legislative and policy frameworks to address the issues arising as a result of the GFC. As well as this work under way at the national level, there has also been considerable work undertaken at a regional and global level to identify appropriate policy responses.

The Financial Stability Board (FSB) has been at the forefront of this work (box 1 contains a brief description of the FSB). On 4 November 2011, the FSB released a document setting out key high-level features of an effective framework for responding to the failure of banks and other key financial institutions. This document, entitled "The Key Attributes of Effective Resolution Regimes for Financial Institutions" (the Key Attributes),<sup>5</sup> has been formally endorsed by the G20. The Key Attributes provide an

international framework for effective resolution regimes, and are intended to guide members in the establishment of their national resolution regimes and to foster cross-border cooperation for crisis management.

The Key Attributes present the objectives and essential features that resolution regimes should have, focused mainly on the powers available to effect the prompt and orderly resolution of a failed financial institution. The remainder of this article compares the features and substance of the Key Attributes with the Reserve Bank's own OBR policy, analysing the extent to which the OBR policy aligns with the essential elements set out in the Key Attributes.

The core objective of the Key Attributes is to minimise the systemic impact of a failing financial institution and avoid the use of taxpayer funds for bailouts. Through a well-designed resolution process backed up by statutory powers, the designated resolution authority in a particular jurisdiction should have sufficient authority and tools to ensure the continuity of systemically important financial services, and payments, clearing and settlement functions. The resolution authority should also have specific powers to impose losses on certain classes of creditors without putting the financial institution into liquidation.

Under the Key Attributes, an effective resolution regime should therefore be able to:

- ensure continuity of critical functions
- protect depositors covered by deposit protection schemes, where applicable (i.e., in jurisdictions that have such schemes)
- allocate losses to owners and creditors, not taxpayers
- not rely on public solvency support
- avoid value destruction and minimise the overall resolution costs
- provide for speed, transparency and predictability through legal and procedural clarity and advance planning
- provide a statutory mandate for cross-border cooperation
- ensure orderly exit of non-viable financial institutions
- provide incentives for market-based solutions

The Reserve Bank has been able to use its existing powers in the RBNZ Act to develop its own resolution

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<sup>3</sup> <http://www.rbnz.govt.nz/finstab/banking/4335146.pdf>

<sup>4</sup> <http://www.rbnz.govt.nz/finstab/banking/5175857.pdf>

<sup>5</sup> [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf)

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regime. Section 68 of the RBNZ Act sets the high level objectives for the prudential supervision of registered banks in New Zealand. It requires that the Bank exercise its prudential supervision powers for the purposes of:

- promoting the maintenance of a sound and efficient financial system; or
- avoiding significant damage to the financial system that could result from the failure of a registered bank.

The development of a robust resolution regime can be clearly linked to the second part of section 68 which deals specifically with a bank failure. The focus on continuity of critical functions, speed and predictability, orderly exit, cross-border co-operation, and the minimisation of costs in the Key Attributes would all contribute towards minimising the damage of a bank failure. However, the focus on allocating losses to owners and creditors, and providing market incentives, can also be expected to meet the first part of section 68 by creating a framework that incentivises firms to operate more prudently, thereby reducing the probability that a failure event will occur. Furthermore, a regime in which failure is handled in a predictable, streamlined way might also enhance the efficiency of the financial system.

So at a high level, there is a clear alignment between the prudential supervision objectives set for the Reserve Bank and the Key Attributes. This alignment continues through to the detailed design of the OBR framework in New Zealand. In practical terms, the primary objectives of the New Zealand resolution regime, and the OBR policy in particular, are to:

- ensure that, as far as possible, any losses are ultimately borne by the bank's shareholders and creditors (consistent with any legal obligations to them);
- provide a mechanism to enable the bank's customers (individuals and businesses) to continue to have access to most of their deposits (and to other banking facilities such as transactions facilities) so as to reduce the disruption to the economy that would otherwise occur;
- enable the core of the bank to be kept as intact as possible to minimise disruption to the payments system;

- ensure that the crucial objective of avoiding economic disruption does not dictate how the important matter of loss allocation is determined; i.e. to ensure the Government is not forced to bail out the bank simply because there are no acceptable alternatives; and
- preserve any remaining franchise value in the business to maximise the exit options.

Since the publication of the Key Attributes, the Reserve Bank has undertaken a detailed analysis to map the framework in New Zealand against them. This demonstrated a substantial level of alignment between the FSB framework and the arrangements in New Zealand. Table 1, overleaf, provides a summary of this assessment, focusing on the high-level objectives of the Key Attributes. (This table was originally published on the Reserve Bank's website in November 2012.)

The primary point of difference between the outcomes that may be expected under the Key Attributes in other jurisdictions and the New Zealand framework reflects the treatment of depositors. Under the Key Attributes, resolution frameworks are expected to protect any depositors covered by relevant insurance schemes and arrangements, and ensure the rapid return of segregated client assets.

Unlike many other countries, New Zealand deliberately does not have a depositor preference or deposit insurance framework in place. This means that depositors are not shielded from losses in a bank failure. The Key Attributes do not state that deposit insurance or depositor preference is a necessary element in an effective resolution framework, instead requiring that where deposit insurance is in place, the resolution regime needs to ensure that protected depositors get access to their full insured amount. The New Zealand framework is not therefore inconsistent with the Key Attributes. However, as a result of these differing broader policy settings, this is likely to represent a clear point of difference between the outcomes in New Zealand and many other jurisdictions.

New Zealand's overarching policy towards prudential supervision is to focus on stability at a system-wide level. As a result, the legislative framework in New Zealand does not include any explicit requirements to have regard to, or give preference to, depositors' interest as a separately

Table 1

## Assessment of NZ framework against objectives of the Key Attributes

FSB objective	NZ OBR framework	Alignment
Ensure continuity of systemically important financial services, and payment, clearing and settlement functions.	The core of the failed bank will be kept intact, re-opened for business the next day, with continued access to the payments system	Aligned
Protect, where applicable and in coordination with the relevant insurance schemes and arrangements, such depositors, insurance policy holders and investors as are covered by such schemes and arrangements, and ensure rapid return of segregated assets.	Depositors are exposed to losses once shareholders and subordinated creditors funds are exhausted. Access to available funds the day after failure.  There is no depositor preference or insurance in New Zealand.	Not applicable
Allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims.	OBR allocates losses according to legal ranking. Shareholders and subordinated creditors bear first loss. Unsecured creditors treated <i>pari passu</i> .	Aligned
Not rely on public solvency support and not create an expectation that such support will be available.	OBR freezes conservative proportion of liabilities with excess returned later if not required to cover losses. Government guarantees initial unfrozen portion. Government solvency support only if initial freeze is insufficient.	Substantially aligned
Avoid unnecessary destruction of value, and therefore seek to minimise the overall cost of resolution in home and host jurisdictions and, where consistent with other objectives, losses for creditors.	Bank continues to operate preserving business and core of the bank intact to preserve exit options. RBNZ has legal responsibility to have regard to impact on Australian financial system.	Substantially aligned
Provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution.	Clear framework set out in existing legislation. Systems are being pre-positioned to ensure process is timely and orderly.	Aligned

identified subset of the financial system. Therefore, while such matters are relevant to the extent that they impact on satisfying the systemic objectives under Section 68, there is no clear mandate or requirement to pursue such an outcome as there would be in some other jurisdictions, such as Australia.<sup>6</sup>

In 2010 the Reserve Bank and Treasury undertook a detailed assessment of deposit insurance undertaken by the Reserve Bank and Treasury. This work concluded that deposit insurance was not an appropriate policy setting for New Zealand. This assessment considered a range of factors including prevention of retail runs, protecting depositors, market discipline and moral hazard, and regulatory burdens and costs. The Government also concluded that it did not favour a deposit insurance framework.<sup>7</sup>

<sup>6</sup> Depositor preference is enshrined in the Banking Act 1959 and requires that depositors in Australia are first in line to recover their funds from the assets of a failed Authorised deposit-taking institution.

<sup>7</sup> <http://www.beehive.govt.nz/release/maintaining-confidence-financial-system>

The other main areas of difference between the New Zealand framework and the Key Attributes reflect the fact that the Reserve Bank has focused at this stage on the immediate steps to maintain financial system stability in the event of a bank insolvency. A number of jurisdictions, including Australia, have focused their attention on the development of broader recovery and resolution plans (RRPs) sometimes referred to as 'Living Wills'.<sup>8</sup> These plans generally include work to identify factors that could affect the resolvability of a banking group, such as its complexity, intra-group connections, and the separability of key functions.

In its cost benefit analysis of OBR<sup>9</sup> the Reserve Bank recognised that the OBR policy could be further strengthened by adopting some of these elements of Living

<sup>8</sup> The detailed proposals underlying the Key Attributes are broken down into 12 essential features. These include elements focused on recovery planning, information sharing and cross-border cooperation that go wider than mechanisms for resolving failed banks, which is the primary focus of the OBR policy.

<sup>9</sup> <http://www.rbnz.govt.nz/finstab/banking/5014272.pdf>

## Box 1

### What is the FSB?

The Financial Stability Board (FSB) is the successor institution to the Financial Stability Forum (FSF). The FSF was established in 1999 following the 1997-1998 Asian financial crisis. It was intended to serve as an informal channel for international cooperation on stability and regulatory issues. In 2009, the G20<sup>10</sup> transformed the FSF into a formal international institution with a broader mandate, namely the FSB. Its membership was expanded to 24 nation-states and a range of international financial institutions (IFIs) and standard setting bodies (SSBs).<sup>11</sup>

As part of its mandate, the FSB:

- Assesses vulnerabilities affecting the global financial system and identifies and reviews on a timely and on-going basis the regulatory, supervisory and related actions needed to address them, and their outcomes;
- Provides advice on and monitors market developments and best practice in meeting regulatory standards;
- Promotes coordination and information exchange;
- Undertakes strategic reviews of the policy

development work of international standard setting bodies;

- \* Supports contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and
- Collaborates with the International Monetary Fund (IMF) to conduct Early Warning Exercises.

The FSB has positioned itself to be a standard-setting body focused on economic and financial standards. The development of internationally accepted standards promotes sound domestic financial systems and international financial stability. There are various standard-setting bodies focused on areas such as banking supervision, payments and settlement systems, international accounting standards, insurance supervision, etc.<sup>12</sup> The FSB publishes a Compendium of Standards which is a joint initiative with other standard-setting bodies.

The standards set by the FSB are not binding and New Zealand is not under any legal obligation to implement them. However, the Reserve Bank generally seeks to align with international standards where it considers that they are appropriate for New Zealand conditions.

Wills. The reason for this is that OBR merely allocates the losses and keeps the entity in statutory management open – the various exit options that are then available are aided by, for example, clear information about interconnections and the separability of the entity such that it could be on-sold. The Reserve Bank will be working further on these measures as it completes the narrow pre-positioning work for OBR.

## 5 Conclusions

The combination of previous policy development work, and the wide-ranging powers in existing legislation, means that New Zealand has been well placed to respond to the issues exposed by the GFC. As at 30 June 2013, the OBR policy will be fully operational and will be available to the New Zealand government as a viable option in the unlikely event that a registered bank became insolvent.

While it is not intended to be the default solution to a bank insolvency, the OBR does represent a valuable addition to the New Zealand government's toolkit if faced with such a scenario. Furthermore, the existence of the OBR policy as an alternative to bail-out is expected to have a positive impact on strengthening incentives to

<sup>10</sup> The G20 is made up of the finance ministers and central bank governors of 19 countries and the European Union. Country members are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russian, Saudi Arabia, South Africa, the Republic of Korea, Turkey, the United Kingdom, and the United States. "Institutional Members" include the European Central Bank, the International Monetary Fund (IMF), the World Bank, and the Financial Stability Board (FSB).

<sup>11</sup> Full FSB membership details are available at <http://www.financialstabilityboard.org/members/links.htm>

<sup>12</sup> See: <http://www.financialstabilityboard.org/cos/wssb.htm>

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operate prudently, and thus reducing the probability that it will be necessary to use such a mechanism.

The objectives and outcomes under the OBR policy are well aligned with the standards being developed internationally. However, even once OBR can technically be implemented from June 2013, the Reserve Bank will continue to undertake further work on assessing, and where necessary improving, the resolvability of banks with a view to enhancing the resolution toolkit further.

## 6 References

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