

1 November 2012

Feedback on consultation on OBR pre-positioning

Introduction

1. This note contains a summary of the issues raised in the submissions to the Reserve Bank's consultation on pre-positioning requirements for Open Bank Resolution (OBR)¹. Fourteen submissions were received, of which eight came from banks.
2. The main themes in the submissions are that it would be desirable to have:
 - more time to submit an implementation plan;
 - a comprehensive communication strategy for investors in particular, in order to reduce unintended consequences;
 - harmonisation with Australia /global resolution approaches; and
 - further clarity on points of detail.
3. Under each section below, we first summarise the arguments put forward by submitters, and then outline the Reserve Bank's response.

Summary of comments

A. Coverage

4. There were divergent views on who should be covered by the policy. One bank recommended that it should only be mandatory for systemically important banks, inasmuch as other policies that were put in place to facilitate the implementation of OBR, like outsourcing and local incorporation, were targeted for large banks.
5. Others were of the view that OBR should apply to all NZ registered banks and even NBDTs to avoid possible negative public perception that major banks have the ability to freeze portions of deposits in case of failure, while smaller banks do not.

¹ <http://www.rbnz.govt.nz/finstab/banking/4335146.pdf>

Response

6. We do not see any compelling argument to scale back or expand the mandatory application of the OBR pre-positioning policy, which is for all locally incorporated banks with retail funding over \$1 billion, with opt-in ability for other banks. We recognise that a key benefit of the OBR is the uninterrupted provision of basic financial services to depositors whilst a failure is resolved. As a result, smaller banks (defined with a minimum threshold of \$1 billion in retail deposits) were included on the grounds that a more orderly failure would be preferable.

B. On-going IT projects

7. There are ongoing activities straining bank IT resources like compliance to Anti-money Laundering (AML) regime, Settlement before Interchange project (SBI), the US Foreign Account Tax Compliance Act, and obligations that may be imposed by the Payment Cards Industry for the Data Security Standards, and the Financial Advisers Act. Some banks are currently implementing IT projects that have taken up a substantial amount of their IT resources, thus it would not be efficient to introduce OBR system's changes whilst these projects are underway.

Response

8. The Reserve Bank agreed to delay the implementation deadline. Originally the deadline for pre-positioning functionality to be in place was February 2012: this was changed to 30 June 2013. The Reserve Bank is also taking a flexible approach where possible, to accommodate significant bank IT projects.

C. Market impact

9. Some submitters noted that New Zealand could be perceived as pursuing this resolution scheme ahead of the rest of the world and ignoring calls for a harmonised and coordinated approach to failure resolution, particularly for systemically important banks that operate globally. They argued that OBR should not be implemented in advance of the work currently being undertaken internationally on bank resolutions.
10. There was a feeling that investors and the market in general must be well informed about the objectives and mechanics of OBR so as not to fuel further doubt and uncertainty, particularly about how specific creditor classes will be treated. If there is uncertainty or lack of understanding about OBR, investors may choose to avoid investing in New Zealand. This will impact on the availability and cost of funding in New Zealand. The introduction of OBR could cause a ratings downgrade to banks' deposit and debt ratings and impact on the cost of funding for banks and the New Zealand economy in general.
11. There should be consideration of the impact of such actions not only for New Zealand banks and economy but also for stakeholders in Australia.

Response

12. OBR is not unique insofar as what it intends to achieve. In fact, a common theme in the discussions on bank resolution regimes worldwide is to develop resolution tools that would limit recourse to public funds and creditors absorbing part of the burden arising

from bank failure. Pre-positioning by banks would make the OBR policy a useable resolution option in the event of failure.

13. Many of the policy attributes and objectives of OBR are broadly consistent with the Financial Stability Board (FSB)² recommendations. For example, one is that the financial stability objectives of a resolution authority should be to preserve the financial institution's vital services to the financial system and economy and to ensure that losses are borne by shareholders and creditors—rather than taxpayers. OBR clearly does preserve the transactional and other services to the financial system and the economy. Moreover, it is not intended to alter or disrupt the rights of creditors such as secured or preferred creditors.
14. The introduction of OBR pre-positioning improves the ability of authorities to resolve bank failures. More importantly, it restrains expectations of implicit guarantee and its unintended consequences such as excessive risk-taking by banks, which in turn reduces moral hazard. The potential impact on credit ratings in line with reduced scope for sovereign support has been factored in by the ratings agencies.
15. We continue to engage with relevant Australian authorities in order to promote coordination particularly in the event of acute distress of a trans-Tasman banking group.

D. Clarity in treatment of liabilities, detailed specifications and deposit guarantee

16. Submitters noted that there is inherent complexity in the OBR concept that demands that technical requirements be defined to a certain standard across a range of product, access channel, payments and customer scenarios. Thus, further work and detailed business requirements/specifications are needed before an implementation plan can be prepared. Banks say they need clearer specifications for accounts subject to pre-positioning, or a principled approach as to how classes of liabilities will be treated in an OBR-setting, that could be used as a basis for system changes not only today, in order to accommodate the OBR functionality, but for future use as well.
17. Some submitters argued that the inclusion of *de minimis* functionality, as part of core OBR requirements adds further complexity and cost which is not justified by the benefits. The nature and frequency of the testing and assurance regime should be specified as this could affect the design and choice of IT solution.
18. Further work needs to be done in reviewing and analysing the shut-down of payment switches, in the same manner that the processes and rules for a failed bank to re-enter the payments system must be revisited. Development of industry protocols for the payments processes in an OBR setting should be undertaken.
19. Some non-bank submitters proposed a deposit guarantee threshold of \$50,000 noting that depositors, particularly small depositors, are hardly able to exert market discipline on banks. The size of the guarantee should also be known in advance so depositors do not have an incentive to run. Another submitter cautioned however that the policy must not be perceived as a backdoor way of putting in place a retail deposit priority arrangement.

²

http://www.financialstabilityboard.org/publications/r_110719.pdf

Response

20. Details of what is in-scope or out of scope for pre-positioning are covered in the proposed Implementation Plan. The Reserve Bank provided a draft outline of the required content for implementation plans to banks to guide their development (as attached at appendix A). The Reserve Bank will issue new section of the Banking Supervision handbook on OBR that details the pre-positioning outputs banks will be required to meet in order to comply with the policy.
21. The cost and complexity of having a *de minimis* option built into the OBR functionality was discussed with banks as they prepared their OBR design solutions. A practicable solution was identified by all banks.
22. Regarding the testing and assurance regime, OBR is likely to be embedded into the bank's Business Continuity Planning (BCP) exercise and as such will be tested alongside regular BCP tests.
23. We agree that some rules may need to be modified to accommodate payments processes in an OBR setting. These rule changes/protocols are being worked out with Payments NZ and industry.
24. The threshold value for *de minimis* discussed in the consultation paper was not designed to be a *de facto* deposit insurance limit. The retail deposit guarantee scheme expired at the end of 2011 and the Government has announced that it does not favour compulsory deposit insurance.
25. One purpose in having the *de minimis* rule is to reduce transaction cost and be able to deal administratively with many small accounts. At the same time, it would help depositors who are reliant on their bank balances to pay their bills and to get by even if their bank has failed. However, the relative merits of the argument for or against activating the *de minimis* rule and the judgement as to the cut-off point will have to be made by the government of the day.
26. We hosted three industry forums with banks in May and August 2011 and July 2012, to discuss various operational matters and issues relating to OBR. These discussions informed general rules on products that should be in or out of scope for pre-positioning (see appendix B), leading to the development of a high-level industry compendium of in-scope products. We also have regular bilateral meetings with each bank to review the progress of their OBR Implementation Plans. As part of these discussions, we have agreed the treatment of bank specific products that do not fall neatly within the industry compendium.

E. Agency banking and special accounts

27. Agency banks are second-tier participants who use the clearing and settlement services of a settlement bank or a participating bank that directly participates in the payment system. It maintains a clearing and settlement account (current account) with the participating bank. How OBR would impact on these relationships should be assessed.

Response

28. If the participating bank fails, the statutory manager shall be directed to continue providing the service to the agency bank in order to prevent further disruption. However, the clearing account of the agency bank (if it has a credit balance) will have a portion of the balance frozen in line with all other creditors of the participating bank. The agency bank will need liquidity to make up for the frozen portion so that its own customers are not adversely affected by the situation. Or the agency bank could transfer to other service providers if they wish to, without disrupting clearing and settlement for its own customer base.
29. If the agency bank fails, it will be guaranteed when it re-opens and the participating service provider is expected to continue the service.

F. Director liability

30. Two banks have raised the matter of providing safe harbour for directors in the period between being directed to close down customer channels by the RBNZ and the appointment of a statutory manager.

Response

31. The Reserve Bank has given careful consideration to the question of directors' liability for actions taken by the bank during the time between the insolvency of the bank and appointment of the statutory manager, when complying with directions from the RBNZ. OBR is a prudential policy that has been developed by the Reserve Bank for managing bank failure and which banks will be required to implement under their conditions of registration.
32. In these circumstances we note the following. We do not consider that a claim under the Companies Act provisions, in particular sections 135 and 136 when a bank continues to trade just ahead of the appointment of a statutory manager, is likely to be successful, considering that the Reserve Bank is exercising its prudential responsibilities and where banks are required to comply as part of this regulation. We also note section 114 of the RBNZ Act creates criminal liability for a failure to comply with a direction. This reinforces our view that a Court is unlikely to impose liability under the Companies Act when directors would otherwise be exposing themselves to explicit criminal liability under the RBNZ Act. However, the Reserve Bank recognises that it is unhelpful to have legal uncertainty at a stressed time, and will review this matter with the aim to put beyond doubt any potential liability that could fall on directors arising from actions taken to comply with a Reserve Bank direction. This will be a matter for consultation in the future.

G. Cost

33. Cost estimates and completion timetables are affected by the following factors:
- age, configuration, set-up and number of systems
 - availability of staff given other ongoing IT projects

- testing and assurance regime

34. The cost estimates ranged from \$3-5million up to \$10-20 million for large banks; and \$20,000 to \$750,000 for smaller banks. Annual testing cost was estimated at \$80,000 to \$100,000.

Response

35. The wide cost differential may be attributed to the vastly disparate systems among banks and to a certain extent the range and complexity of bank products available. We have however limited pre-positioning to customer accounts in order to simplify installation of the functionality.

36. The upper range of the estimated cost of IT solution is \$10 to \$20 million. This amounts to around 0.03% of total assets of a systemic bank. In the absence of OBR, or additional resources from shareholders, losses from bank failures would potentially be borne by the public. The Reserve Bank completed a cost benefit analysis on the pre-positioning for OBR, demonstrating that the cost of pre-positioning is manageable and relatively small compared to the costs associated with failure if banks are not pre-positioned.

Timelines

37. We have written to the relevant registered banks informing them of a new deadline of 30 June 2013 for OBR pre-positioning functionality. We have also informed them that we intend to consult on a draft OBR standard, and the related draft Condition of Registration towards the end of 2012. We intend putting OBR Conditions of Registration in place by the end of 2012.

APPENDIX A – DRAFT IMPLEMENTATION PLAN

Matters to be addressed in the OBR Implementation Plan

1. The OBR Implementation Plan provides a high level overview of the bank's proposed design solution to develop and install the capacity to execute OBR.
2. Submission of the Implementation Plan should demonstrate your bank understands the OBR pre-positioning requirement, and what it must deliver when called upon.
3. The Plan can be relatively brief (perhaps as little as 4 to 5 pages) and need not contain detailed technical specifications of system's changes or extensive Gantt charts, but rather a description of how each piece of functionality will be achieved.
4. The bank remains ultimately responsible to ensure that its OBR functionality will achieve the expected outcomes. Processes and controls will need to be developed to ensure the ongoing integrity and reliability of OBR functionality.
5. The deadline for the submission of the Implementation Plan is end February 2012.

A. Plan Content

6. A mapping of bank products and their characteristics for purposes of classification as in-scope or out of scope for pre-positioning. Refer to Annex A for guidance.
7. Design Description
 - (a) High-level description or design features of the proposed solution. The bank may also present several design options and explain the advantages and disadvantages of each option for subsequent discussion with the Reserve Bank.
 - (b) List of systems and applications that will be affected or introduced and features of the required changes.
 - (c) Other considerations
8. Key deliverables and stages/milestones in the design process, timelines and resource/budget requirements. Target date of project completion is 30 June 2013.
9. Testing and assurance that will be built into the bank's regular Business Continuity Planning (BCP) regime.
10. Engagements and expectations from the Reserve Bank, e.g. frequency of meetings.
11. Clarification of costs

APPENDIX B – SCOPE FOR PRE-POSITIONING

1. As a general rule, when considering whether products are in-scope or out-of-scope, the consideration should be weighed against the intentions behind the use of OBR which are:
 - to provide liquidity to depositors and other customers promptly via immediate access to a proportion of their funds; and
 - to minimize adverse liquidity effects on the financial system and reduce disruption to payment systems.

2. In-scope pre-positioning
 - (a) Pre-positioning is limited to unsecured liabilities represented by products and instruments used by customers to access banking and payments related services.
 - (b) Examples of these liabilities are deposits and other borrowing by the bank include: transaction and call accounts, savings accounts, term deposits, PIE holding accounts, credit balances on credit cards/mortgage/investment loans, credit balance in revolving credit facilities, foreign currency accounts, vostro balances, agency accounts, and liabilities of a similar nature.
 - (c) Because these banking services are critical for customers' day-to-day operating requirements, interrupting such services potentially carries high economic cost for the customer and the economy. The pre-positioning is essentially an early release mechanism to ensure that those who are unlikely to have an alternative source of banking service and/or dependent on their funds in the failed bank have continued access to their accounts whilst the failure is resolved.
 - (d) The accounts may be individual or joint. For purposes of freezing a portion of deposits, each account is treated separately, i.e. 2 or more accounts held by the same person in the same right and capacity are not combined or aggregated before a portion is frozen.

3. Out-of-scope for pre-positioning
 - (a) Out-of-scope liabilities will generally involve more sophisticated creditors or counterparties who can better manage temporary illiquidity. They also cover liabilities entered into by the bank essentially to manage its market risk positions. Some of these arrangements are complex in nature like derivative financial instruments that require specific valuation with the counterparty involving calculation of the net position of the bank particularly if there is a binding netting agreement, and decisions made by counterparties, for example, to exercise close out clauses or not.

- (b) Examples of such liabilities are: bonds and notes, debentures, commercial paper, accrual of interest coupons, derivative financial instruments, trading liabilities, obligations owed to related parties, liabilities related to securitisation activities, accounts payable to suppliers, taxes payable, wages and salaries payable and employee benefit program, and other liabilities of a similar nature.