Submission by

BusinessNZ

GROWING PROSPERITY AND POTENTIAL

to the

Reserve Bank Act Review

on the

Third Round Consultation on Phase 2 of the Reserve Bank Act Review Consultation Paper

October 2020

THIRD ROUND CONSULTATION ON PHASE 2 OF THE RESERVE BANK ACT REVIEW CONSULTATION PAPER SUBMISSION BY BUSINESSNZ[1]

1.0 INTRODUCTION

1.1 BusinessNZ welcomes the opportunity to comment on the Third Round Consultation on Phase 2 of the Reserve Bank Act Review Consultation Paper dealing with the prudential framework for deposit takers and deposit protection ("the Consultation Paper").

1.2 BusinessNZ and its members have a vital interest in this review and have previously submitted on the December 2018 Reserve Bank Act review.

1.3 Without revisiting the contents of our 2018 submission in any detail, BusinessNZ's two principal recommendations were that (1), the Reserve Bank's high level policy objective should remain focused on promoting the maintenance of a sound and efficient financial system, and (2), any moves towards the adoption of a Deposit Insurance scheme should be made with caution, given the potential for unintended consequences.

1.4 It is of some concern that the Government has chosen to make an in principle decision to remove "efficiency" of the NZ financial system as an objective of the Reserve Bank Act and not include "prosperity and well-being" in the overarching purpose of the proposed Deposit Takers Act.

1.5 In BusinessNZ's view, potentially, the changes referred to will, as noted, have unintended consequences, removing from the Reserve Bank any requirement to constrain its natural tendency to focus on financial stability without adequately considering the cost in terms of the efficiency implications of its actions.

1.6 Notwithstanding the above, BusinessNZ is supportive of the Government's and the Reserve Bank's decision to delay and/or slow down a number of other regulatory initiatives planned for the financial sector (including the potential imposition of bank capital adequacy requirements), allowing stakeholders to deal with the immediate challenges posed by Covid-19. Now is not the time to go full steam ahead with regulatory impositions ultimately likely to increase costs for both businesses and households.

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[1] Background information on BusinessNZ is attached as Appendix 1.

1.7 BusinessNZ would welcome the opportunity to meet again with the Review Team to discuss the content of this submission, if the Review Team felt that this would be useful.

2.0 <u>SPECIFIC COMMENTS ON CONSULTATION PAPER</u>

2.1 Given this organisation's broad membership, members of the wider BusinessNZ network will have a range of views on specific issues and/or points of interest covered in the Consultation Paper. Many will provide their own separate submissions on matters of concern and areas where they have specific expertise.

2.2 This submission focuses specifically on Chapter 2 (Purposes of the Deposit Takers Act) and Chapter 8 (Depositor protection)

Chapter 2: Purposes of the Deposit Takers Act

2.3 While it is entirely appropriate for the Reserve Bank to look seriously at the soundness of its current prudential management systems with a view to determining whether anything more can be done to manage risk successfully, in doing so it should keep in mind that there is an optimal amount of resource to be used in reducing risk. Risk cannot be completely eliminated or if it can, not without great cost. For example, requiring greater financial stability could come at the significant expense of increasing the aggregate cost of capital.

2.4 It is important for any changes to macro-prudential policy the Government might make to the Reserve Bank Act to reflect the above points. This is particularly so where a proposed change may have an unintended impact, including on economic efficiency or equity.

2.5 To take a current example. One of the perhaps unintended consequences of having historically low interest rates and plentiful capital looking for a home is that the gap between the "haves" and "have nots" will likely increase as asset prices (particularly housing) are forced up. This is unfortunate for those who want to obtain a first home and get on the housing ladder.

2.6 It is noted that the Reserve Bank in a number of recent proposals is looking to take a least regrets approach. Running the risk of providing too much stimulus is therefore considered less costly than doing too little. While no doubt the Reserve Bank will be cognisant of the risk from rapidly rising asset prices, specifically house prices, perhaps a fragile economy is seen as more of a risk to financial stability than locking out first home buyers from the market.

2.7 The purpose and objectives of the proposed Deposit Takers Act have the potential to undermine the Act's efficiency. Specific problems include:

1. The absence of any reference to "prosperity and well-being" as these currently apply to the purpose of the Reserve Bank Act.
2. A lack of clarity with respect to the proposed purpose of protecting and promoting financial stability.
3. The lack of a clear efficiency objective for which the proposed decision-making principles are not a substitute.

2.8 Fleshing these issues out a little, a focus on financial stability without any requirement to consider New Zealanders' prosperity and well-being, together with a lack of any efficiency objective, will eliminate the need for the Reserve Bank to try and mitigate the cost of actions taken in respect of financial stability and economic outcomes.

2.9 In the absence of an efficiency objective, the financial stability objective on its own could be in conflict with promoting the prosperity and well-being of New Zealanders, requiring the Reserve Bank to choose financial stability over and above its prosperity and well-being purpose.

2.10 While the Consultation Document talks about decision-making principles, it is not clear how the proposed principles are intended to be traded off against each other. Consequently, BusinessNZ sees them as a weak alternative to having a clear efficiency objective, or as an inferior product.

Chapter 8: Depositor protection

2.11 It is noted the Government has made an in-principle decision to establish a deposit insurance scheme, funded by levies on deposit takers, with a maximum coverage of $50,000 per-depositor, per-institution.

2.12 It is estimated that under the scheme more than 90 percent of depositors are likely to be fully covered by the $50,000 coverage limit; those seeking more insurance coverage will be able to acquire it by placing deposits at multiple deposit takers.

2.13 The Consultation Paper outlines potential reasons for protecting depositors and some of the risks associated with same. The pros and cons are clearly set out and so are not repeated here; suffice it to say BusinessNZ considers the risks to be potentially significant. Protection for bank depositors could open the floodgates to requests for protection from all other kinds of investments that happen to go wrong. In short, where do the boundaries start and end?

2.14 The Consultation Paper states there will be a clear boundary between deposits for insured products and other types of investment products tending to offer both higher risks and higher returns. But with financial literacy in NZ not particularly high, as surveys evidence, there is a risk many people who think they are protected, might, in reality, not be.

2.15 It has to be asked why the focus is on mandatory insurance when individuals are not required to obtain compulsory insurance for other activities which could impose significant costs on them personally, on their families, and ultimately on the general public (taxpayers) via social welfare benefit payments and public health expenditure. Individuals can, and often do, insure for risks of this kind but taking out insurance is still entirely voluntary.

2.16 Many people fail to obtain appropriate cover for a whole host of possible risks such as loss of employment income, health difficulties, property damage caused by storms and so on. All these events can impose significant costs. Taken to the extreme, one could argue that those who undertake any risky activity, e.g. such as becoming obese or adopting a sedentary lifestyle, should have to take out mandatory health insurance to minimise the cost to taxpayers in case expensive health treatment is needed later in life. Voluntary insurance is available both for health-related and many other risks but is not generally compulsory (apart from ACC levies covering workplace accidents, accidents to earners outside the workplace and motor vehicle accidents, with the taxpayer picking up the bill for personal injuries to non-earners).[2]

2.17 While it is accepted the purpose of mandatory depositor insurance is to ensure (specified) individuals are adequately compensated should a bank fail, the same can be argued of any individual activity that imposes significant costs on third parties (generally taxpayers). But in the latter case the costs are dispersed among all taxpayers, not sheeted home to particular individuals. And for a variety of reasons, government has not seen fit to require individuals or households to obtain insurance to cover all the real or perceived risks they could face.

2.18 Chapter 8 of the Consultation Paper also seeks feedback on whether to introduce a "preference" for depositors, meaning that depositors would be given priority over other unsecured creditors of a failed deposit taker.

2.19 Arguably it is appropriate that given (at least indirectly) depositors will be paying for the cost of mandatory insurance for the first $50,000 deposited, they should receive the maximum $50,000 coverage as per the rules developed in the Consultation Paper.

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[2] There may be cases where insurance is also required in respect to membership of some professional associations and in respect to some occupational regulation.

2.20 However, giving depositors greater security for their investments will see this preferential treatment for some (first cab off the rank as it were) leaving less security for other investors. As with anything in life – there is no such thing as a free lunch here.

2.21 People and organisations often lose monies owed when companies collapse (or in the rare case where a bank gets into difficultly). They generally consider themselves more deserving of payment than others are.

2.22 But the simple fact is priority for one group will be at the expense of other creditors who will have even less chance of recovering what they are owed. Preferential treatment in the case of a bank collapse automatically increases the risk for remaining creditors for whom debt recovery will be far less likely. This will force a change in wholesale investors' and other shareholders' behaviour to compensate for the increased risk.

2.23 Wholesale investors and other shareholders will likely require security over their investments or alternatively higher returns to compensate for a real or perceived risk of bank failure. While many factors impact on the cost of credit, including financial sector competitiveness, in general the greater the security over deposits a bank can offer, the lower the interest rate. Vice versa, the lower the level of security, the higher the interest rate to compensate for the risk of non-payment. There will be instances where the risk might be too high for wholesale depositors or other bank shareholders to manage cost-effectively, hence they will restrict their bank lending and the cost of credit will increase. So, in essence, safeguarding some investors over and above what is required under the Deposit Insurance scheme will see risks popping out in the form of reduced returns to deposit holders as well as high costs through mandatory insurance charges. The cost of credit to householders and businesses will likely increase as wholesale investors and others perceive an increased risk of losing monies owed should a bank collapse.

2.24 Leaving other creditors in a less secure position would typically have three adverse outcomes. First, the cost of credit would increase (on the margin) to compensate for risk. Second, credit availability would diminish. Third, pressure would likely be placed on government either to underwrite or require mandatory insurance for a whole host of other inherently risky events.

2.25 On balance, BusinessNZ does not support the introduction of a Deposit Insurance scheme, irrespective of the amount of coverage.

2.26 But notwithstanding BusinessNZ's opposition to a Deposit Insurance scheme, the position of some submitters in earlier consultation rounds and the difficulties associated with depositor preference, there are reasons why, were such a scheme to be introduced, it would be necessary and desirable also to introduce a preference for insured depositors as part of the scheme.

2.27 With the banks only nominally financing a Deposit Insurance scheme and the cost ultimately falling on depositors, it is the depositors who should expect to receive the benefits of insurance availability. Otherwise, were a bank to fail (however remote the likelihood of that happening might be), depositors would ultimately be paying the scheme's costs but not necessarily receiving any benefit.

2.28 In short, BusinessNZ considers:

1. That as mandatory depositor insurance will have the unintended consequences outlined above, such a scheme should not be introduced, but

2. If the Government intends to proceed with its proposals for a Mandatory Depositor Insurance scheme, then the first option (Option 1 - page 128) should be adopted. That is, introduce a preference for insured depositors as part of the deposit insurance scheme.

Appendix One - Background information on BusinessNZ

BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups EMA, Business Central, Canterbury Employers' Chamber of Commerce, and Employers Otago Southland
- Major Companies Group of New Zealand's largest businesses
- Gold Group of medium sized businesses
- Affiliated Industries Group of national industry associations
- ExportNZ representing New Zealand exporting enterprises
- ManufacturingNZ representing New Zealand manufacturing enterprises
- Sustainable Business Council of enterprises leading sustainable business practice
- BusinessNZ Energy Council of enterprises leading sustainable energy production and use
- Buy NZ Made representing producers, retailers and consumers of New Zealand-made goods

BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and the Business and Industry Advisory Council (BIAC) to the Organisation for Economic Cooperation and Development (OECD).