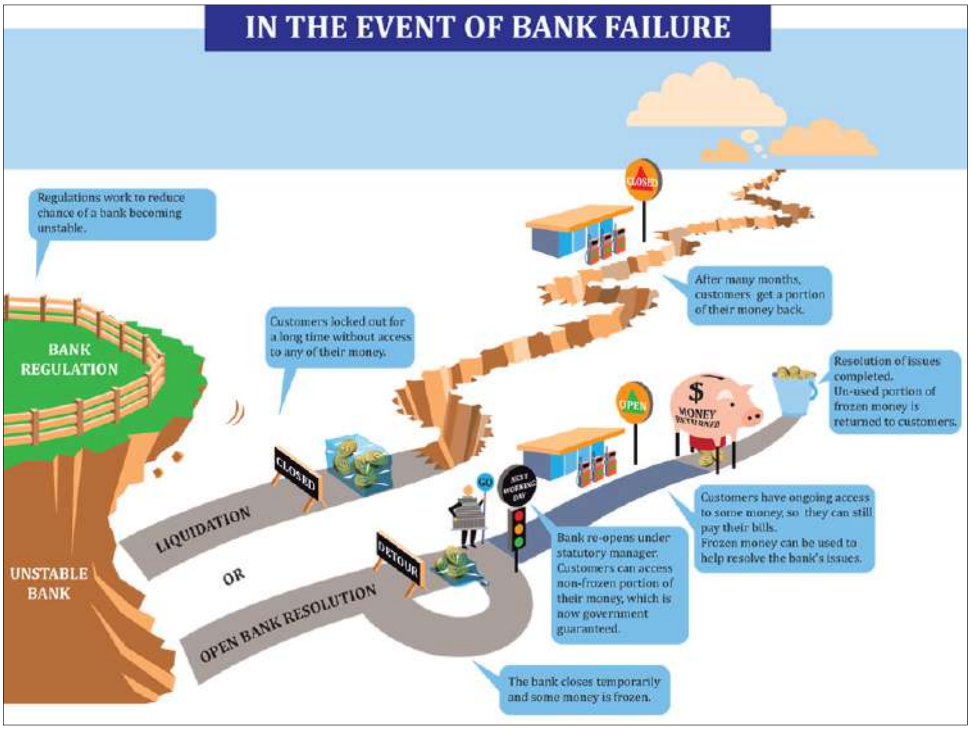
How New Zealand pioneered 'bail-in'

By *Elisa Barwick*

New Zealand is reshaping the laws governing its Reserve Bank through a review of its monetary policy framework ongoing since 2017. The *Reserve Bank of New Zealand Act 1989* was updated in August 2021 and a new *Deposit Takers Act*, which includes a deposit insurance scheme guaranteeing NZ$100,000 per account, is in the works.

But don't be fooled, these reforms are not aimed at protecting depositors. Quite the opposite: It is part of a transition to a more explicit "bail-in" regime, outside of the control of elected politicians, as is demanded for Australia. Bail-in is an alternative to government bailouts which confiscates a portion of bank obligations (such as bonds and deposits) in order to recapitalise the failing institution. It is a mechanism dedicated to saving the financial system as a whole, a.k.a. "financial stability", at the expense of individual citizens.



RBNZ graphic depicting bail-in. Photo: RBNZ

In February 2019, one year after Australia passed its bail-in legislation, the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018*, the International Monetary Fund (IMF) demanded Australia explicitly put financial stability ahead of depositor protection and give the Australian Prudential Regulation Authority (APRA) the power to conduct bank resolutions without the approval of government, or parliamentary interference. (Media Release, 4 Mar. 2019, "IMF demands end of democracy in Australia's banking system, full 'bail-in'.")

New Zealand was advised by the IMF in 2017 to adopt a scheme to mitigate against bank runs by depositors panicked about having their savings bailed in, and in June 2019 RBNZ made clear that the deposit insurance scheme was offered to smooth the way for a broader, statutory bail in power.

Prior to the ongoing review, New Zealand already boasted the most transparent bail-in scheme in the world, known as Open Bank Resolution (OBR), which was prepared in the late 1990s following the Asian Financial Crisis (box, "Basel rules, Asian financial crisis precipitates bail-in", p. 11). While the scheme was based on the same precepts as today's internationally adopted version, the world has dramatically changed since OBR was devised, and enhancement is expected.

The new *Reserve Bank of New Zealand Act 2021*, states RBNZ, "provides a clearer financial policy mandate for the Reserve Bank *focused on promoting financial stability*" (emphasis added). While under OBR the RBNZ would recommend bail-in, subject to approval by the Minister of Finance, the *Deposit Takers Act* provides direct powers for RBNZ to act as the "resolution authority" under "emergency powers". This upgrade was supposed to include a statutory, or legislative version of bank resolution powers, but within five months of announcing this intention the NZ Cabinet revoked the decision, opting to maintain the current contractual approach to bail-in, to prevent possible controversy or delay in getting the new legislation passed. ("New Zealand backflips on statutory bail-in", *AAS*, 19 Jan.) This decision will be reviewed two years after passage of the Act, which is expected to be introduced into parliament soon and pass into law mid-to-late 2023. Currently the power to impose losses on creditors requires exercising contractual terms relating to various categories of holdings, in a similar way to Australia's bail-in regime. Additionally, RBNZ has "broad transfer powers" that it can use within the resolution process to impose losses, shifting assets off the failing bank's books to a separate legal entity.

Enshrining *caveat emptor*: the history

A 2011 Consultation paper published by RBNZ, "Pre-positioning for Open bank Resolution (OBR)" stated the origin of the policy: "The Reserve Bank developed the OBR policy following a review of its crisis management policies and instruments subsequent to the 1997 Asia financial crisis." The discussion paper spelled out that the challenge, in the aftermath of the Asian crisis, was "how to deal with the failure of a large bank in a way that would be consistent with the Reserve Bank's general approach to banking supervision", namely, "*one which requires shareholders and creditors to bear the cost of a failure*, consistent with the market incentive approach ... This resulted in the development of the OBR policy." (Emphasis added.)

The consultation paper indicated a decision by the NZ Ministry of Finance on 11 March 2011 to "fully operationalise" the Open Bank Resolution policy, whereby a bank is resolved while remaining (largely) open, as opposed to a "closed bank resolution".

Throughout the literature on bail-in, New Zealand banking authorities consistently stressed the need to develop an approach to bank supervision and to the rescue of failing banks that fits with the nation's *caveat emptor* approach to regulation. This term is Latin for "let the buyer beware"—if you are swindled it's your own fault, not the person who hooked you in. (Box, "Bank of England starts an NZ bank", below.) The initial proposal was known as Bank Creditor Recapitalisation (BCR), becoming a topic of discussion from 2001.

Economist Dr Alan Bollard was RBNZ governor in 2002-12 and secretary to the New Zealand Treasury (1998-2002) during the Asian crisis (with numerous other roles, including representative to the IMF and World Bank). In a 23 March 2005 speech to the Australasian Institute of Banking and Finance, Bollard said: "BCR addresses some of the same issues as deposit insurance, which is currently receiving attention in Australia, in that it quickly restores liquidity for depositors. However, with BCR the costs of imprudent risk management and monitoring *are borne by depositors*, management and shareholders, thus reinforcing the market and self-discipline that underpins our regulatory culture." (Emphasis added.)

Ian Harrison, former RBNZ official and Special Advisor to RBNZ, expressed the same idea in a 2005 paper, "The Reserve Bank of New Zealand's Creditor Recapitalisation (BCR) project: an option for resolving large banks?": "For the market-incentive approach to banking supervision to work", he wrote, "the possibility that a large bank could fail, and that *depositors could lose some of their money*, has to be credible." (Emphasis added.) Harrison called for "an intermediate option between some form of bank bailout and a liquidation, which places the cost of a failure on shareholders, depositors and other creditors, but reduces the cost of the failure by minimising disruptions to the payments system and bank customers' access to liquidity."

"The proposed solution to the problem", he said, "is the 'haircut', or BCR (bank creditor recapitalisation), option." The bank is recapitalised with money shorn from the top of creditor accounts and can quickly reopen, with customers able to access unaffected funds. "Creditors would retain a residual claim on the haircut portion of their funds and would eventually receive back the portion that was not absorbed by losses and other expenses connected with the failure." Wildly, Harrison claims this regime will "provide more certainty to survivor banks and other creditors and reduce the potential for widespread systemic disruption and adverse reaction by depositors and investors."

Many of Harrison's formulations are recounted almost verbatim in the 2011 RBNZ consultation paper, but with the word "creditors" instead of "depositors" in most instances.

At this point—early 2005—New Zealand had "spent considerable time working on the concept" of BCR, and had even conducted a pilot scheme with one of NZ's systemically-important banks, including IT pre-positioning and a review of payment system structures, to confirm that it would be technically possible to apply a haircut and reopen the bank within 24 hours. The New Zealand Bankers' Association participated in the process. At the same time, New Zealand was increasing its cooperation with Australia, including a secondment program for senior staff members between APRA and RBNZ, and establishment (Feb. 2005) of the Trans-Tasman Council on Banking Supervision involving the respective Reserve Banks, Treasuries and APRA.

The 'haircut' defined

In a bank resolution, Harrison explains, a percentage of funds to be haircut from bank creditors is calculated based on the estimated amount required to recapitalise the bank plus a suitable buffer, which is then deducted from all applicable accounts and transferred to a "shadow account". Remaining funds can be accessed thereafter and would be guaranteed by the government, says RBNZ (2011 paper), "to avert a further run by creditors".

As per Section 121 of the *Reserve Bank Act 1989*, the 2011 RBNZ paper states:

"Once a bank is placed in statutory management, creditors' rights against the bank are essentially frozen. The statutory manager is vested with wide-ranging powers and must have regard to the following considerations in exercising his powers:

• the need to maintain public confidence in the operation and soundness of the financial system;

• the need to avoid significant damage to the financial system; and

• to the extent that it is not inconsistent with the considerations listed above, the need to resolve as quickly as possi-

Bank of England starts NZ's central bank

In the RBNZ's history file, the bank recounts how New Zealand was initially reluctant to set up a central bank when it was first suggested by the British on the model of the Bank of England. "But that changed during the 1920s", says the history, "and in 1930, visiting British expert Otto Niemeyer recommended a New Zealand central bank." At the time, Niemeyer was not only with the BoE, but was a director of the BIS. His visit followed on from his infamous Australian trip, where he had been dubbed "the bailiff", as local NZ press reported. He was in town to tell Australia to "cut spending, stop borrowing and balance their budgets immediately".

Though still somewhat reluctant, the economic turmoil "sharpened by the Great Depression" led then Finance Minister and economist, Bernard Ashwin, to begin developing legislation for such a bank.

Niemeyer's report, the "Report on Banking and Currency in New Zealand", recommended a central bank "entirely free from both the actual fact and the fear of political interference", because without it, a central bank would "do more harm than good". Niemeyer was fresh from the effort to set up independent central banks across Europe, which were actually satellites of the BoE, a critical factor in formation of the BIS, the central banks' bank. He recommended the government sell its shares in the Bank of New Zealand, which acted as the bank of note issue, once the central bank got going.

It took three years for legislation to be passed and the RBNZ came to life in 1934. The bank was partly privately owned, but with the election of a Labour government in 1935 it was nationalised and given authority to underwrite loans as the state began to play a greater role in the economy. BoE head Montagu Norman had sent one of his own senior staff to become the bank's first governor. His efforts to operate independently, in defiance of government demands, were thwarted by the economic benefits of government banking in the midst of depression. As in Australia, government control was unwound in the 1980s, especially as supressing inflation became the top priority for monetary policy, and the BoE's longed-for "independence" became the hallmark of central banking. (Source: "The policy origins of the Reserve Bank of New Zealand", RBNZ Bulletin, Vol. 69, No. 3) ble the difficulties of that registered bank.

"*If it is not inconsistent with the preceding considerations*, the statutory manager is required to have regard to preserving the position of creditors and maintaining the ranking of their claims." (Emphasis added.)

The paper continues: "The OBR scheme is designed to ensure that first losses are borne by the bank's existing shareholders. However, it could also impose losses on depositors and other unsecured general creditors of the failed bank, consistent with the nature of the contract they have entered into." The report specifies that all unsecured liabilities will be subject to haircut, including "transaction, savings and other retail accounts (e.g. term deposits) and small business accounts".

By the time the 2011 paper was released, RBNZ was able to cite powers of the US Federal Deposit Insurance Corporation, the Canada Insurance Corporation, the Special Resolution Regime in the UK, and a European Commission scheme, to keep banks open whilst resolving them. These powers were based on 2010 recommendations of the Financial Stability Board—hosted by the Basel-based Bank for International Settlements (BIS)—and included putting provisional holds on accounts, implementing "resolution tools" such as bridge institutions, regulators taking control of a failing bank, and bank sale or restructuring. But these examples did not exist when NZ first began discussing BCR in 2005 and as we will now see, as early as 2001.

Creditors, take your punishment!

On 27 June 2001, RBNZ Deputy Governor and Director (1998-2003) Roderick Carr, who was previously a senior executive at National Australia Bank in Melbourne and went on to become Chair of the RBNZ Board of Directors in 2013, gave an address to the NZ Association of Economists at Christchurch, entitled "Banking on capital punishment". He opened by saying he wanted to highlight "why it is essential to the efficient allocation of resources that providers of bank capital and even bank creditors must stand ready to take their punishment when things go wrong and the unexpected happens."

Spelling out his "antidote to moral hazard", Carr stated: "For bank creditors (all senior unsecured creditors) to have incentives to monitor the soundness of the bank, they must face the prospect of a loss of some or all of their investment." This recalls the RBNZ definition of unsecured creditors, including depositors, as *investors,* who have "freely invested in a private institution and [have] enjoyed a return on that investment whilst accepting the risks associated with the investment".

Carr said a preferable alternative to bank liquidation or nationalisation is "to recapitalise the bank using depositor's and other creditor's money". It is all the clearer that Carr's allegiances lay with the market and not NZ citizens when he said that an effective creditor recapitalisation option may avoid the need for "inefficient" deposit insurance regimes and for "intrusive regulatory oversight".

Too much regulation displaces market forces, he argues. In response to claims the market approach had failed (pre 2008!), he posed the question: "Has the market failed or simply not been allowed to operate?" In his ideal framework, "the role of the regulator is to protect taxpayers [read, relatively well-off people], current and future, from being exploited by bank shareholders and depositors"!

Basel rules, Asian financial crisis precipitates bail-in

In the 1980s, Japan was viewed much like China today. Asian nations had already emulated its progress, but a program Japan initiated for the industrial development of Africa as an alternative to the IMF and World Bank, with concessional loans, development assistance, training programs and technology transfer, was a bridge too far. It was portrayed by western leaders and establishment media as the first step in a plan to take over the world. Suddenly Japan was to be feared, its shoddy products to be rejected. The project was uprooted before Japan could create "a Japan in Africa" as one of the program's leaders, former Japanese Ministry of Finance official Daisuke Kotegawa has said.

The yen doubled in value against the US dollar after the 1985 Plaza Accord which was aimed at artificially correcting the massive US trade deficit with Japan (another parallel with China-USA today). The stronger yen meant Japanese products were more expensive overseas, but it had another important impact. As Kotegawa told the 18-19 June 2022 Schiller Institute conference held under the banner "There can be no peace without the bankruptcy reorganisation of the dying trans-Atlantic system": "Japanese financial institutions started to penetrate the London financial market against the backdrop of a stronger yen." The profits of the world's biggest banks began to tumble, and "Negotiations were held [at the BIS] in Basel to stop such Japanese financial institutions, and the so-called 'Basel Rules' were agreed to in 1988.

"At the end of the 1990s", continued Kotegawa, "Southeast Asian countries and Japan faced the problem of nonperforming loans stemming from the Basel regulations. Consequently, the Asian economic crisis and the Japanese financial crisis led the manufacturing industry in these regions to stagnation. Only China was able to survive…."

However, when the Lehman shock hit the USA in 2008 "the United States and the United Kingdom did not dispose of their bankruptcies in accordance with the Basel Rules, which they demanded of Asian countries…. Since then [Asian countries] have had serious doubts about the Western-led international financial order."

RBNZ Deputy Governor Roderick Carr, in a 2001 speech (main article), acknowledged a similar timeline, adding that the new Basel standard actually accelerated speculation by inducing banks to bundle and on-sell loans (bank assets) to get them off the balance sheet:

"In my view, the 1988 Basel Accord arose mainly from a desire to promote competitive neutrality and to avoid arbitrage between differing national capital requirements for banks, as it did not seek to determine a socially optimal level of bank capital. In the 1980s, highly leveraged Japanese banks had been aggressive participants in the previously lucrative US municipal bond underwriting market. US banks responded to what they saw as unfair competition by pressing for an internationally agreed definition of capital standards for credit risk and a uniform methodology for the measurement of capital. While the 1988 agreement addressed the issue of minimum bank capital, it created a whole new industry in arbitraging [exploiting the difference] between bank and non-bank capital requirements. Widespread securitisation of bank assets is perhaps the best example. Today the case is made that the 1988 Accord promotes regulatory arbitrage of this type, rewarding risk-shifting which may undermine the soundness of financial systems around the world."