BUDDLEFINDLAY

Depositor Protection in New Zealand

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As part of the phase two review of the Reserve Bank of New Zealand Act, New Zealand is having its first formal public debate on whether there should be depositor protection in New Zealand – with public submissions open until 25 January 2019.

New Zealand is one of only a few countries in the world that does not have depositor protection. In fact, New Zealand and Israel are the only OECD countries without depositor protection and Israel is in the process of introducing depositor insurance. New Zealand is one of the few countries in the world with a policy aimed at having "mum and dad" depositors, rather than taxpayers, bail out failed banks.

The Reserve Bank's traditional justification for refusing to introduce deposit insurance is that it would weaken self-discipline by banks and market discipline by depositors, reducing the incentives on depositors to monitor banks. Instead, the Reserve Bank's emphasis has been on "reducing the moral hazard attached to any public perception of government backstopping … the financial system". In AUT senior lecturer, Helen Dervan's view, this justification is flawed in relation to retail depositors as they are unlikely to provide effective market discipline, lacking sufficient information and the high level of financial literacy required to monitor a bank's complex financial position and risk profile.

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The weakness in the Reserve Bank's position was exposed during the 2008 global financial crisis when New Zealand was forced to establish temporary deposit guarantee schemes almost overnight. While those schemes proved reasonably effective, a review by the Auditor-General highlighted a number of significant design flaws (although this was unsurprising given the haste with which the schemes were put together).

The IMF's 2017 review of New Zealand's financial system recommended that deposit insurance should be introduced, noting that almost all other advanced jurisdictions recognised that the perceived advantages of a well-designed depositor protection scheme counterbalanced any disadvantages arising from moral hazard. This reflects the view that households are not well equipped to understand bank financial statements and monitor risk and that the benefits of deposit insurance in preventing the flow-on effects of bank failure, outweighs any perceived value to the taxpayer of avoiding the bail-out of a failed bank.

Against this backdrop, it seems likely that pressure is going to be on New Zealand to introduce some form of depositor protection. While this may not mean the end for the Reserve Bank's controversial Open Bank Resolution (OBR) policy (because there may be some circumstances where a bank is simply either too big to save or too small to care about) it does make it significantly less likely that the OBR will ever be used.

As a consequence, at this stage, the question is not whether New Zealand has a deposit insurance scheme, but what that deposit insurance scheme should look like. This is more likely to be addressed in the next phase of the consultation on the Reserve Bank Act. Some of the issues which will be important to consider are:

- Whether New Zealand should have deposit insurance prefunded like normal insurance premiums or simply paid out on a loss sharing basis as needed
- If deposit insurance is prefunded, whether prefunded amounts can be used to prevent a bank failure or only used to pay out depositors once a bank has failed
- The dollar value of deposits that should be covered – the Reserve Bank suggested $10,000 in its OBR policy (albeit that this is funded by other depositors of the failed bank who will need to take a bigger haircut to make the pay-out, rather than part of a prefunded insurance scheme). Based on a common rule of thumb (of two to three times per capita GDP), the right value for New Zealand is approximately $150,000
- Whether any depositor protection scheme should also be accompanied by statutory depositor priority for retail depositors

(as is the case in a number of other countries, including Australia)

- How the costs of deposit insurance should be allocated between large higher credit rated banks, which are more systemically important, and the smaller lower credit rated banks
- What mechanisms should be used to protect wholesale depositors (eg in relation to lender of last resort facilities).

The debate on whether New Zealand should have depositor insurance is well overdue. It seems unlikely that New Zealand can continue to justify its "outlier" position on deposit insurance and we should now turn our minds to what the most effective design for a deposit insurance scheme would be.

This article was co-authored by Simon Jensen, partner at Buddle Findlay and Helen Dervan, senior lecturer at AUT.

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