

## Legal alert - Does Cyprus provide lessons for New Zealand's open bank resolution

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After 15 years of working on its Open Bank Resolution (OBR) Policy, the Reserve Bank of New Zealand (RBNZ) finally released its draft policy for consultation entitled "Open Bank Resolution Prepositioning Requirements Policy" on 14 March 2013.

During much of the period when the RBNZ was working on the OBR Policy it received little attention, other than from banks and academics. However, the recent events in Cyprus have now made the OBR Policy topical.

For the first time in the world, retail depositors' money has been explicitly used to recapitalise banks. The outrage of Cypriot depositors has received worldwide attention and, even though Cyprus only has approximately one million people, the bail out of its banking system (and associated "haircutting" of deposits) has affected markets globally.

Inevitably what has happened in Cyprus has been compared to what could happen in New Zealand if the RBNZ were ever to use its OBR Policy (either for a single bank or in the event of a systemic collapse like in Cyprus).

In practice what has happened in Cyprus is very similar to what the OBR Policy is asking New Zealand banks to preposition for here. In essence, as in Cyprus:

- Deposits of up to an undetermined amount (called "the de minimis") may be protected in a bank failure (or, as in Cyprus, potentially a banking system failure); and
- Amounts over the de minimis can be frozen in whole or in part (the RBNZ call this the "haircut") and these amounts are effectively used to absorb losses in the failed bank or, as in Cyprus, banks.

The table below shows how the freeze would work but picks a much lower de minimis balance than the €100,000 ultimately agreed as politically acceptable in Cyprus – which seems to be consistent with the RBNZ's intentions to have a relatively low de minimis.

*De minimis is \$5,000. Freeze/haircut is 25%.*

Account	Opening balance	De minimis	Frozen	Available
Customer 1	\$4,000	5,000	Nil	\$4,000
Customer 1	\$6,000	5,000	\$250	\$5,750

While providing for an undetermined and arbitrarily selected "de minimis" amount to have priority over all creditors of the failed bank is an anathema to insolvency lawyers, the application of the haircut is not. The haircut is a simple application of insolvency principles.

Once capital has been exhausted, losses are borne by creditors (in this case bank depositors). Aside from some technical issues about how to distinguish between cleared and uncleared funds at the time of the appointment of the statutory manager, this aspect of the OBR Policy simply relies on the existing powers of a statutory manager granted under the Reserve Bank of New Zealand Act 1989 (RBNZ Act).

Indeed, there is not an OBR Policy, as such, because the power for a statutory manager to suspend all or part of a debt already exists as one of a statutory manager's powers under the RBNZ Act. The policy which is being consulted on is simply a policy which requires banks to preposition their systems, so that part of a customer's deposit can be suspended (or haircut) within the first 24 hours of statutory management. This is so that the bank can continue to operate in the payment system the next day, with customers able to access, at least some of, their money.

This is sensible, given the huge damage which could be done to the economy (witness what is now happening in Cyprus) if the customers of a failed bank (or worse still, a whole banking system) could not access their money for an extended period of time.

However, the debate which has arisen as a result of the Cyprus crisis does raise a number of broader issues in relation to how a bank, or banking system, failure should be resolved in New Zealand, and whether using retail depositor money to do this is fair. In particular:

- Will it ever be politically acceptable to impose a "haircut" on retail bank depositors?
- Could OBR, if applied, actually create financial instability by causing a run on surviving banks?
- Should bank depositors, particularly retail depositors, bear the risk of a bank failure, or should this risk be borne by all taxpayers generally – given:
  - bank depositors probably do implicitly rely on the RBNZ to prudentially supervise banks (given the complexity of bank balance sheets it is difficult to expect retail depositors (mums and dads) to judge the soundness of their particular bank); and
  - we are trying to encourage a savings culture
- Why is New Zealand the only country in the OECD which does not have deposit insurance? Is the rest of the world wrong? Would deposit insurance actually enhance the feasibility of OBR?
- Should New Zealand have a statutory priority for depositors, as exists in Australia?
- If we intend to give retail depositors priority up to a certain amount, should we agree this now so that the markets can have some certainty and to avoid politically motivated actions at the time of crisis?
- Are the RBNZ's prudential supervisory powers set in 1989, in very different economic times, still appropriate today – and, in particular, should the RBNZ like most other central banks, have a mandate to protect the interests of depositors?

#### **Conclusion**

The position in Cyprus has highlighted the political difficulties of OBR where retail depositors end up absorbing the losses of a bank failure.

It also raises the question of whether New Zealand really has looked at deposit insurance closely enough. We believe that a well constructed "ex ante" deposit insurance scheme that protected deposits up to a politically acceptable level is not only sensible, and would bring New Zealand in line with all other OECD nations, but also might actually be what OBR needs to work in practice. The consultation on OBR should be widened to consider these broader issues.

The RBNZ has extended the submission date from 15 April 2013 to 30 April 2013.

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