



Consultation Document:

Pre-positioning for Open Bank Resolution (OBR)

Consultation Paper

The Reserve Bank invites submissions on this Consultation Paper by 30 June 2011.

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Consultation Document: Pre-positioning for Open Bank Resolution (OBR)

1 INTRODUCTION

1.1 Background

- 1 The Reserve Bank is consulting registered banks on pre-positioning banks' systems to ensure compatibility with the Open Bank Resolution (OBR) policy. This represents an important step in a government wide process to fully operationalise the OBR policy, as noted in the statement from the Minister of Finance on 11 March 2011.
- 2 An open bank resolution is an option whereby the bank is open for (full-scale or limited) business on the next business day after its temporary closure following an insolvency event or an event that triggered putting it under statutory management, and is able to provide customers with full or partial access to their accounts and other bank services.¹
- 3 Recent international developments in the field of bank resolution have focussed on enhancing authorities' capacity to respond and resolve large or systemic failures without straining fiscal resources. One of the key lessons emerging from that crisis is the potentially enormous fiscal costs associated with supporting troubled banks. Some governments that chose to guarantee their banking system's liabilities are now faced with a sizeable public debt burden. The alternative is to make bank shareholders and creditors shoulder the losses of a failing bank whilst ensuring that the payments system continues to function. Developing alternative solutions for dealing with failing banks has thus become a key priority for many governments and the global regulatory community.
- 4 OBR is intended to act as a resolution tool that puts the cost of bank failure primarily on the bank's shareholders and creditors rather than the taxpayers, minimises moral hazard and provides continuity of core banking services. The Reserve Bank developed the OBR policy following a review of its crisis management policies and instruments subsequent to the 1997 Asian financial crisis.²
- 5 Significant work has been undertaken in recent years to ensure that the structures of financial institutions in New Zealand and the payments system are consistent with the implementation of OBR as a live policy option. Major Reserve Bank policies such as

¹ In contrast, a closed bank resolution is any resolution where the bank remains closed after the insolvency or trigger event and customers no longer have access to their bank accounts.

² The following are some materials where OBR (previously called Bank Creditor Recapitalisation or BCR) have been discussed: (a) Harrison, I, S Anderson and J Twaddle (2007), "*Pre-positioning for effective resolution of bank failures*", Journal of Financial Stability, volume 3, Issue 4, December 2007, pages 324-341; (b) Harrison, I., 2005, "*The Reserve Bank of New Zealand's Creditor Recapitalization (BCR) project: an Option for Resolving Large Banks?*" in: Evanoff, D., Kaufman, G. (Eds.), Systemic Financial Crises: Resolving Large Bank Insolvencies. World Scientific Publishing, pp. 397-406; (c) "*Vigilance and reinvigoration*", an address to the Australasian Institute of Banking and Finance by Dr. Alan Bollard, Governor, RBNZ, 23 March 2005 (<http://www.rbnz.govt.nz/speeches/1522447.html>) and (d) "*Banking on Capital Punishment*", (an address by Roderick M Carr, Deputy Governor of the Reserve Bank of New Zealand to the New Zealand Association of Economists, Christchurch, 27 June 2001), Reserve Bank of NZ Bulletin vol. 64 No. 2, June 2001.

outsourcing, local incorporation and governance³ were designed to facilitate the implementation of OBR. The pre-positioning of banks' internal systems represents the next stage in that implementation process.

- 6 Whilst the Reserve Bank has led the development of the technical aspects of the policy, the OBR itself is a wider government initiative. To this end, the Treasury is separately engaged in work to consider the appropriate form for government guarantees that will be required to support the on-going operations or any institution that is subject to the OBR process.

1.2 Consultation

- 7 Section 2 of this consultation paper contains a high level overview of the OBR. This summary is included as a reminder of the policy and the processes involved. The Reserve Bank has previously consulted on the policy (known at the time as Bank Creditor Recapitalisation). As such, while the Reserve Bank always welcomes relevant submissions, at this stage the focus of this consultation is not on whether there should be an OBR policy, rather the focus is on the pre-positioning requirements of the OBR policy.
- 8 We are interested in beginning a dialogue with relevant banks on the appropriate approach for their bank to the pre-positioning of banks' internal systems to ensure that OBR can be implemented within the necessary timescales to achieve an effective open bank resolution. Section 3 of the paper discusses the Reserve Bank's proposed approach and outlines the nature of engagement that it expects to have with registered banks. Section 4 then sets out the specific outputs that the pre-positioning exercise is designed to achieve, and asks respondents to provide initial views on the likely costs that may be associated with any necessary system modifications/upgrades.
- 9 In this paper we have identified a number of specific questions upon which we are seeking the banks' views. We expect to have more detailed engagement as the process develops. However, stakeholders are encouraged to identify, and comment on any areas that they consider are likely to be relevant to achieving the outputs set out in section 4.

³ See W. Chetwin, 'The Reserve Bank's Local Incorporation Policy', 69(4) Reserve Bank of New Zealand Bulletin (2006), and RBNZ 'Outsourcing Policy', January 2006 <http://www.rbnz.govt.nz/finstab/banking/regulation/0094291.html>

2 OVERVIEW OF OBR

- 10 Following the 1997 Asian financial crisis, one of the major issues 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 (i.e. one which requires shareholders and creditors to bear the cost of a failure, consistent with the market incentive approach), while keeping the cost of the failure within acceptable limits. This resulted in the development of the OBR policy.
- 11 For the market incentive approach to banking supervision to work, the possibility that a large bank could fail, and that creditors could lose some of their money, has to be credible. This policy has become even more relevant in the post 2008 crisis period where regulators around the world have begun to revisit the role of creditors in absorbing some of the losses when banks fail.
- 12 The 'too big to fail' perception will always have credence if people believe that a government will always bail out a large bank because the repercussions for the wider economy would be too great and uncertain, and/or the government would be unwilling to have the funds of several hundred thousand creditors tied up for months, or even years, in a conventional liquidation.
- 13 Bank failures can be resolved in a number ways, including take-over, forbearance, liquidation, or government bail-out. In the event of a large bank-failure, it is likely that market conditions, timing constraints or competitive concerns would make it more challenging for a rival institution to take-over the bank or to come up with other purely private sector solutions. Government bailouts would create expectations of support in future failure situations while outright liquidation creates further tension and stress, as depositors and other unsecured creditors would not have access to their funds until the assets have been sold.
- 14 What is required is an option which not only places the cost of a failure in the first instance on shareholders, but also provides flexibility to assign losses to creditors, without causing unnecessary disruptions to the payments system and bank customers' access to liquidity.⁴
- 15 The global financial crisis has renewed focus around the world on operationalising resolution mechanisms to deal with failing banks. Examples include:
- the US Federal Deposit Insurance Corporation (FDIC), in its capacity as receiver of failed banks, requires covered institutions with complex deposit systems (i.e. those with more than 250,000 deposit accounts or total assets over \$20 billion) to have in place an automated process for posting and removing provisional holds on

⁴ The Financial Stability Board recommends that resolution frameworks should ensure that financial institutions are resolved safely, quickly and without destabilising the financial system and exposing the taxpayer to the risk of loss. From "Reducing the moral hazard posed by systemically important financial institutions", FSB Recommendations and Time Lines, 20 October 2010.

accounts at a failed institution, in order to allow the deposit and other operations to continue functioning on the day following failure;⁵

- the Canada Deposit Insurance Corporation (CDIC) was given new powers⁶ in 2009 to establish a bridge institution as a resolution tool, where the bridge institution would become a CDIC member institution designed to preserve critical functions and help maintain financial stability in the event that an existing CDIC member is no longer viable;
- the Special Resolution Regime in the UK provides authorities with four key tools to respond to a failing bank:
 - the power to direct a transfer of part or all of a failing bank's business to a private sector purchaser;
 - the power to take control of part or all of a failing bank's business through a bridge bank owned and controlled by the Bank of England;
 - the power to place a failing bank into temporary public ownership; or
 - A bank insolvency procedure to close a failing bank and facilitate fast and orderly payout of depositors' claims under the Financial Services Compensation Scheme or transfer of their insured deposits to a healthy private sector bank.
- the European Commission has recently concluded a consultation on proposals for a bank recovery and resolution package for the European Union. These proposals would allow for a range of options including ordinary liquidation, an orderly wind-down featuring bridge banks or asset sales, and restructuring as a going concern using debt write downs.

16 Many of these arrangements have features similar to OBR, i.e. continuing critical business functions whilst authorities take control of the failing bank. The legal entity (i.e. the bank) may fail in a financial and legal sense, but the ability to continue critical functions should not be compromised by such failure. In other words, a solution is sought that solves the urgent liquidity problems associated with a bank failure, but does not force all of the losses to be borne by the government.

17 The primary objectives of the OBR are to:

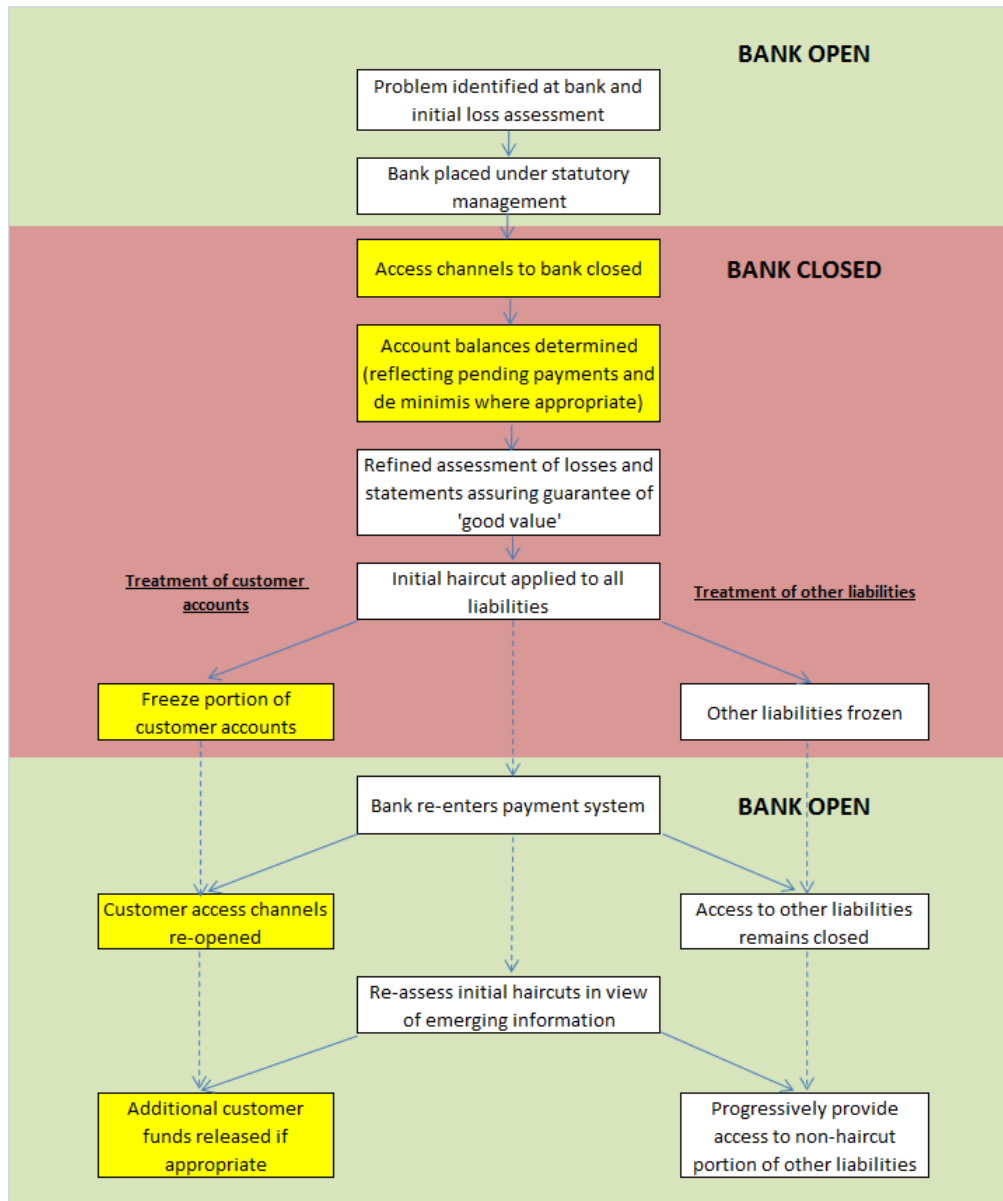
- provide a mechanism that ensures that the urgent matter of managing the liquidity impact on the economy does not dictate how the important matter of loss allocation is determined;
- allow the real possibility that creditors could suffer loss in a failure – consistent with obligations they enter into;
- enable the core of a failing bank to be kept as intact as possible to manage disruption to the payments and wider banking system; and

⁵ Refer to Federal Register notice (Vol. 73; No. 138; July 17, 2008) pertaining to the Large-Bank Deposit Insurance Determination Modernization rule.

⁶ See the Budget Implementation Act 2009.

- preserve exit options enabling any new owner of the bank to carry on the business of the bank.
- 18 The key feature of the OBR is that creditors are able to access a portion of their funds immediately after the bank fails and is placed in statutory management. The proportion of their funds to be frozen or which remains inaccessible will be based on an estimation of the losses following a conservative assessment of the net asset deficiency incurred by the failing bank, plus a suitable buffer. Once the estimated losses are temporarily allocated to the accounts, the liquidity of the balance of the accounts is then rapidly restored. The bank can then quickly re-open with the unfrozen or accessible portion of funds (good part, i.e. backed up by good assets) guaranteed by government to avert a further run by creditors. Additional funds can be unfrozen at later dates as the final losses are determined.
- 19 By providing creditors with access to a portion of funds immediately, OBR avoids or minimises what has become a costly trade-off between protecting liquidity and enhancing market discipline. In effect, it mitigates the risk that urgent liquidity concerns dictate how losses are allocated between shareholders, creditors and (perhaps) government.
- 20 The key elements of a comprehensive OBR process can be broken down into the following phases:
- imposition of statutory management and closure of the bank;
 - imposition of the haircut on creditors' accounts and term deposits to freeze a portion of funds;
 - re-opening of the bank for core transactions business, with appropriate guarantees in place; and
 - determination of the final resolution of the bank involving decisions on future operations and restructuring.
- 21 Figure 1 (overleaf) presents the various steps in the OBR process in a stylised form. The stages that banks are required to pre-position for are highlighted in yellow.

Figure 1: Stylised example of the OBR



22 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 possible the difficulties of that registered bank.

- 23 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.⁷
- 24 It should be noted that the OBR itself does not resolve the future of the bank or allocate final losses. Rather it is a mechanism that ensures on-going liquidity for creditors whilst the government determines the appropriate strategy. However, before any final resolution is decided upon, an assessment of the final losses will have to be undertaken.
- 25 The haircut process has no impact on the ranking of creditors that would apply in a conventional liquidation. Secured creditors would be able to look to their security to ensure that they are, in effect, paid in full (assuming their security is adequate), while subordinated creditors would not receive any payment unless the senior creditors were paid in full. 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.
- 26 Haircuts shall also be applied to the failed bank's other liabilities, i.e. those which are not time-sensitive. The mechanism to execute the haircut on these other liabilities is not part of the minimum requirements for pre-positioning.
- 27 In practice, the OBR scheme is consistent with a range of exit strategies, including:
- sale to new owners, in whole or in part;
 - restructuring to become a stand-alone bank ;
 - repurchase by the parent;
 - government recapitalisation prior to restructuring and sale; and
 - liquidation.

⁷ The full listing of considerations that a statutory manager of a registered bank must have regard to in exercising his or her powers are in s.121 of the Reserve Bank Act.

3 PROPOSED IMPLEMENTATION PROCESS

3.1 Phasing of implementation

28 OBR pre-positioning is an essential feature of the Reserve Bank’s crisis management toolkit. In the light of its significant value in promoting financial stability and efficiency, we would be engaging closely with banks to ensure that OBR pre-positioning is successfully implemented. OBR is operationally robust if it can be quickly executed to a defined standard.

29 The Reserve Bank recognises that registered banks typically operate with bespoke systems. As a result, it is unlikely that there will be a single approach to pre-positioning that is applicable to all banks. For that reason it considers that its role is to specify the outcomes that pre-positioning should be designed to achieve, with each bank responsible for identifying and designing a solution best suited to meet those outcomes, given the existing structure of its internal systems.

30 To facilitate this process, the Reserve Bank’s preliminary thinking is that a two-stage approach be adopted, as follows:

Stage 1 – Planning and design:

- a) Systems identification and configuration: identify all systems which maintain records of customers’ account positions or balances;
- b) Determining any system’s changes required to pre-position core OBR elements; and
- c) Resource planning (staff, budget, timelines, project framework/assumptions).

Stage 2 – Implementation, documentation and testing:

- a) Implementing actual system changes and documenting the operating processes;
- b) Test and controls:
 - instituting controls to ensure that the statutory manager will have the ability to manage and direct the whole process;
 - trial runs, testing and reviews to ensure integrity of haircut process (provide evidence of successful implementation, e.g. show pre and post-haircut balances); and
 - reporting formats.
- c) Completion and acceptance/sign-off phase.

31 This consultation represents the first element of stage 1. Once banks have had a chance to reflect on, and provide initial comments on the issues raised in this document, the Reserve Bank expects to have a series of bilateral engagements with individual institutions to inform their design process. It is envisaged that maintaining the pre-positioning capacity will be a condition of registration.

- 32 The Reserve Bank has set a deadline of 30 June 2011 for banks to provide an initial response to this consultation document. Following the period of bilateral consultation, we would then expect banks to provide a detailed implementation plan to the Reserve Bank by 30 September 2011.
- 33 Following the stage one consultation, consideration will be given to the second stage. As a starting point, and in the interests of maximising the cost effectiveness of the implementation process, the Reserve Bank's initial thinking is that there would be a sufficient implementation period for pre-positioning so that it may be accommodated within routine system upgrades. The Reserve Bank would expect banks to be fully prepositioned by late 2012.

3.2 Coverage of OBR

- 34 One of the objectives of OBR is to enable customers to continue to access their transaction accounts whilst a failure is being resolved. This implies that even smaller institutions, would likely benefit from pre-positioning despite not being of systemic importance, on the grounds that a more orderly resolution of a failure event is preferable even in scenarios in which systemic concerns are limited. The case for including all locally incorporated banks as well as branches may not however be cost effective, given their size and the complexities associated with implementing OBR for branches.
- 35 On balance, it is recommended that all locally incorporated banks with retail funding over \$1 billion be required to pre-position. Other institutions that do not fall within the abovementioned category and take in retail funding may elect to be OBR-capable as well, despite the absence of a regulatory requirement to do so.
- 36 Notwithstanding the pre-positioning, there is no obligation on the part of government to use OBR in the event of failure as it is not intended to be a default option. Any banking failure carries with it a unique set of issues and concerns, with the specific factors of each case carefully weighted and studied before recommending a course of action. Any decision on applying OBR to specific entities will be assessed on a case-by-case basis taking account of specific bank and wider market issues.

Questions:

- 1 Should the requirement for mandatory OBR pre-positioning be wider than the proposed approach?
- 2 Is it appropriate for other institutions to have the opportunity to opt-in if they wish to do so?
- 3 What is your view on the recommended phased process and timetable for OBR implementation?

4 REQUIRED OUTPUTS

37 This section of the document sets out the requirements that the Reserve Bank expects banks to deliver through the pre-positioning process. The first part describes the high-level steps that make up the OBR process and sets out the material that the Bank expects the implementation plans to cover. The second section then provides a more detailed outline of the core functionalities that will make up OBR pre-positioning.

4.1 Matters to be addressed in implementation plans

38 The Reserve Bank is seeking the submission of proposals from banks that would enable them to deliver the outcomes from OBR pre-positioning. In particular, the proposals should contain information on:

- the feasibility of OBR pre-positioning given the banks' current operating systems;
- the costs of implementing pre-positioning; and
- the most efficient timing for the implementation for each bank given their own systems upgrade plans.

39 While OBR is simple in concept, it is not trivial to execute in a technical sense. The Reserve Bank is conscious of the cost of installing and maintaining the necessary systems and procedures that would make the choice of OBR in a crisis situation a practical option. Thus, the Bank focuses on a core set of outcomes as a minimum requirement. Pre-positioning is necessary for OBR to be a practical option. The broad expectations from OBR pre-positioning are for the bank to have systems and processes in place that in the event of failure would enable the following to be carried out:

- freeze accounts and process pending payments;
- prevent customers' access to their accounts;
- determine customers' account balances, on a per account basis, according to specified rules and as of a cut-off time;
- apply haircut as directed by the statutory manager, with the de minimis option if required, within a time frame of 24 hours or less;
- apply guarantees as directed by the Statutory Manager;
- resume customers' access to their transaction and other accounts (including debit and credit cards, and accounts in overdraft) the day following closure; and
- reinstate access by the customer to part or all of their frozen balance, as directed.

4.2 Core functionalities of OBR pre-positioning

40 The key to OBR is to impose the haircut on all unsecured liabilities, but pre-positioning is required only for the most time-critical liabilities⁸ to allow the bank to be re-opened

⁸ This includes transaction, savings and other retail accounts (e.g. term deposits) and small business accounts.

quickly. The level of operational certainty required to make these actions feasible make it impractical to seek to create this functionality at the time of the failure of the bank.

41 Most other unsecured liabilities are not so time-critical and can remain frozen until the haircut is applied at a later date. The extent of pre-positioning will depend on individual bank systems.

42 There are critical elements of OBR pre-positioning which must be installed in the bank's systems to make it OBR-capable. These elements are:

a) Application or coverage: Pre-positioning the ability to execute the haircut shall as a *minimum* apply to time-sensitive customers' accounts.

- the ability to impose a haircut on all liabilities depends on individual bank system configurations, hence the most time-critical liabilities shall be prioritised such that access to these accounts net of haircut are allowed to resume the day after closure.
- doing so would allow the bank to be re-opened quickly and thereby provide the customers most likely to be adversely impacted by lack of transaction capacity with continued access to liquidity. Most other liabilities are not so time-critical and can remain frozen until the haircut is applied at a later date.

b) The haircut module: Setting the size of the haircut involves making a quick assessment of the current value of the bank's assets and setting an allowance for prospective losses and other expenses. A substantial buffer would be added because of uncertainty about the value of the failed bank's assets. The haircut module should be capable of the following:

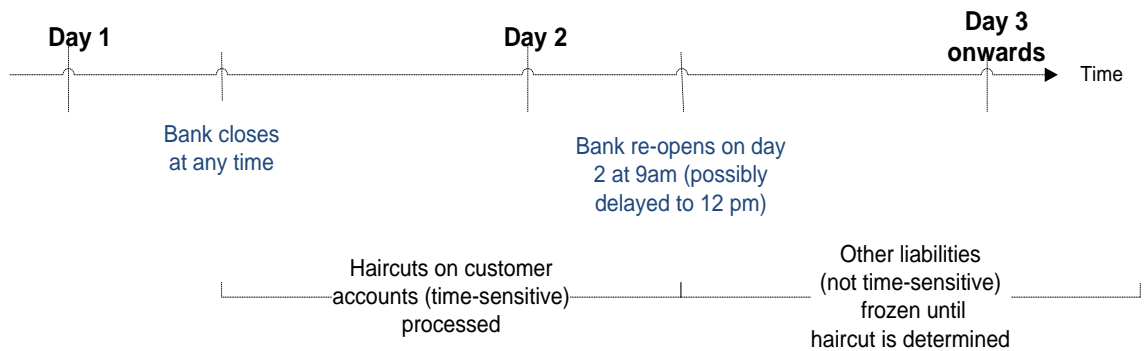
- *de minimis (if specified)*. The *de minimis* threshold would be a set value of retail depositors' funds. Only deposits above this value would be subject to the haircut. The threshold value, if any, would be established by the government of the day, which the statutory manager will then execute.
- *percentage of balance after de minimis (if any)*. The haircut is expressed as a percentage (x percent) of each account in positive balance at the failed bank, rather than as an absolute amount. Creditors would potentially bear full losses up to the haircut value.

c) Effectiveness of cut-off of transaction flows: The statutory manager is empowered to carry on the business of the failed bank. This requires effective legal and practical ability to control and execute the bank's key business processes inclusive of any outsourced services, consistent with the requirements under the outsourcing policy. Operational arrangements need to ensure that pre- and post-statutory management obligations do not become intermingled before the haircut is imposed.

d) Haircut processing time: The bank should have the ability to process the haircut within a cycle that will enable customers to access their accounts by 9am of the day after closure. It is possible that the opening at the next banking day may be delayed for a limited time but this cannot be relied upon.

- this time frame requires that the bank is able to execute the haircut module (i.e. de minimis and the percentage of the account balance).
- the haircut is expected to be applied as part of the conventional customer account processing update and the freed-up accounts would be available to depositors the next business day. This implies a very tight timeframe and the need for a high level of confidence in the ability to execute, as outlined in the timeline representation in figure 2:

Figure 2: OBR process – timeline for bank closure and re-opening



Reference is to banking days

- e) Re-establishing customer access to their accounts: Once the haircut is executed, the bank would re-open to allow customers access to their accounts, thereby giving them liquidity and transaction capability. To be able to provide transaction services, the bank will need to remain in the payment system.
- f) Reinstatement or release of frozen balances: The haircut represents that portion of the accounts that is effectively frozen, but is not legally cancelled, i.e. they are still obligations of the bank, but the bank has no capacity to repay them. The pre-positioning should provide for the capacity to return any 'excess' haircut to customers' accounts upon instruction by the statutory manager, in subsequent days or weeks as the bank's financial status becomes clearer.
- 43 The Reserve Bank is aiming for a level of pre-positioning that OBR will work sufficiently well and that it will be perceived to be credible before and after the failure event. OBR is operationally robust if it can be quickly executed to a defined standard. The bank's people and systems need to be available to the statutory manager so that the statutory manager can haircut the bank and reopen it the next day and keep it operating, albeit on a more limited scale than before its failure. The outsourcing policy was designed to ensure that the statutory manager has access to the relevant people and systems to carry out OBR.

- 44 Banks should be mindful that the OBR functionality would be implemented at a very critical time and tolerance level for delays or malfunctions would be very low, particularly during the first 24 hours after failure/ appointment of a statutory manager.
- 45 As noted above, the Reserve Bank recognises that each bank's operating platform and systems' configuration is different. As a result, there will be flexibility in designing a cost-effective and efficient way of pre-positioning OBR capability.
- 46 On top of the one-off cost of implementing pre-positioned arrangements for OBR, there would be on-going costs for banks to maintain and regularly test the arrangements.

Questions:

- 4 What is the bank's current capability to pre-position the critical OBR functions?
- 5 What would you see as the key impediments to pre-positioning capacity to haircut time sensitive customer account balances in your bank? What are the likely costs (including on-going testing costs) and timing to make your bank OBR-ready?
- 6 What issues/concerns at each step of the process do you think need to be clarified/resolved to enable you to achieve a design plan for OBR pre-positioning?