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DEPOSIT INSURANCE: FRIEND OR FOE?

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Abstract

Following the Global Financial Crisis many governments have undergone reform to ensure stability in financial markets. One mechanism adopted throughout many jurisdictions is deposit insurance. The Reserve Bank of New Zealand has chosen not to adopt such regulation. This essay criticises this decision. The current regulatory framework leaves depositors vulnerable to losses upon bank failure. Upon bank failure recovery is largely subject to the discretion of the Minister. This provides uncertainty in the markets, and consequently aggravates the risk of banks runs and a contagion risk. Adopting a suitably designed deposit insurance scheme will remove this uncertainty, create confidence, and increase the stability of the banking sector.

Key words: “Deposit Insurance”, “Global Financial Crisis”, “Prudential Regulation”, “Banking Sector” “Financial Markets”

I Introduction

Following the Global Financial Crisis (GFC) many politicians and economists have sought answers to the cause of the GFC, and what regulatory changes should be made to ensure future crises can be avoided. One regulatory scheme that seeks to ensure depositor protection is deposit insurance. The premise of deposit insurance is that deposits in deposit taking institutions are insured, fully or up to a prescribed limit, this produces depositor confidence in the event of financial instability. Resultantly this promotes a level of confidence in the market, theoretically reducing the risk of bank failure and a full scale crisis. The New Zealand Government has followed the advice of the Reserve Bank of New Zealand not to adopt deposit insurance. This results in New Zealand being an anomaly. Israel and New Zealand are the only OECD countries without deposit insurance. This is surprising in an area such as financial regulation, where international uniformity is expected. This expectation arises from the international nature and interconnectivity of financial markets.

This paper criticises the Reserve Bank’s decision and argues that without deposit insurance New Zealand’s financial safety net is inadequate. The current framework results in depositors being vulnerable, and their safety subject to the whim of the Government and financial markets. This essay advocates for regulatory change through the adoption of a deposit insurance scheme. In order to justify this conclusion, it is necessary to directly assess the effectiveness and viability of deposit insurance.

The aim of this paper is to develop a clear and robust understanding of deposit insurance and highlight why it is a useful, and necessary mechanism to combat the threat of financial instability in New Zealand. In order to achieve this, the structure is as follows. First, the background to deposit insurance, including the benefits and costs will be outlined to demonstrate the utility of deposit insurance. Second, New Zealand’s prudential regulation will be summarised to portray how the current regulatory system fails to adequately protect deposits upon bank failure. Third, two alternative mechanisms to deposit insurance will be analysed and later dismissed as inferior to deposit insurance at removing depositor vulnerability. Fourth, a comparative analysis with the United Kingdom’s (UK) prudential regulation will be undertaken. This will highlight issues that can arise within deposit insurance schemes, while also providing a sturdy framework to which the adequacy of New Zealand’s financial safety net can

be contrasted against. Fifth, New Zealand's experience of the GFC will be explained to highlight the particular vulnerabilities in our regulatory environment. Finally, deposit insurance will be discussed against New Zealand's circumstances, this will outline why the scheme is beneficial and suggest an appropriate design.

This essay will focus on deposit insurance for retail deposits, as opposed to insuring wholesale funding, or commercial investments. The premise is that deposit insurance should target unsophisticated depositors, those unable to protect themselves from losses that occur upon bank failure. Future research could focus on whether it is appropriate for New Zealand to have multiple insurance schemes.

II Background

When determining whether deposit insurance should be adopted in a jurisdiction, it is first necessary to understand why deposit insurance is required. This section will outline how the relationship between banks and customers result in customer vulnerability and therefore deem insurance appropriate. The relationship between the bank and depositor is one of debtor and creditor.¹ Once money has been deposited into a bank, it becomes the bank's property, and they have the ability to invest as they wish.² Banks have autonomy over the customer funds. A major implication of this relationship is that if a bank becomes insolvent, depositors, as unsecured creditors, are not guaranteed their deposits. Autonomy is increased because banks, as debtors owe no fiduciary duties to depositors. There are two major curtailments on such autonomy. First, banks have an obligation to pay on demand. This restricts what can and cannot be done with deposits. Secondly, curtailment occurs through company law principles. Bank directors owe the company fiduciary duties.³ Therefore the directors must act in good faith and in the best interests of the bank. If a bank is in financially troubled waters, this duty extends to directors having to act in the best interests of the creditors.⁴ Therefore, having to take into account the interest of depositors. Despite these curtailments on bank autonomy, if banks fail, depositors are left with minimal protection. Recovery is limited to what can be obtained through insolvency proceedings. Depositors being unsecured creditors are subject to the *pari passu* principle.

Deposit insurance seeks to remedy this. The most common schemes are government organised and involve the government insuring, or guaranteeing deposits in financial institutions up to a prescribed limit.⁵ There are various ways the scheme can be structured to manage different sorts of risks. These risks and alternate designs will be discussed below.

¹ *Foley v Hill* [1848] 2 HLC 28, at 1002 and 1005–6.

² Dalvinder Singh and John Raymond LaBrosse "Northern Rock, Depositors and Deposit Insurance Coverage: Some Critical Reflections" (2010) 2 JBL 55 at 59.

³ Companies Act 1993, s 131.

⁴ *Robb v Sojourner* [2007] NZCA 493, [2008] 1 NZLR 751 at [25].

⁵ The insured limit in Australia is AUD 250,000 and in the United Kingdom £75,000; Australian Government "Questions and Answers about the Guarantee on Deposits" Guarantee Scheme for Large Deposits and Wholesale Funding <www.guaranteescheme.gov.au>; and Financial Services Compensation Scheme "What we Cover – Banks and Building Societies" <www.fscs.org.uk>.

A *Benefits of Deposit Insurance*

Deposit insurance provides depositors with a minimum standard of protection in the event of a bank failure. Depositors are insulated from loss up to a certain limit.⁶ When market instability arises participants are confident that they will recover their deposits, therefore decreasing societal panic. In turn, this reduces the risk of bank runs. If deposits are not guaranteed, then upon imminent bank failure, depositors are likely to withdraw their deposits to decrease the likelihood of losing their funds. Due to the limited level of bank liquidity, if all parties undergo this risk avoiding behaviour, banks are likely to become insolvent.⁷ Putting governments in the difficult position of determining whether to fund a bail out. Deposit insurance promotes confidence in the system and therefore minimises this behaviour. Parties are less likely to run banks if they know their funds are protected. Deposit insurance also reduces the danger of a contagion risk.⁸

Having confidence in the banking system increases the manageability of banks in times of crisis.⁹ Depositor confidence means governments and troubled banks have more time to take necessary steps to minimise losses, such as seeking new capital or negotiation with buyers.¹⁰ It increases the internal manageability of banks during a crisis, while also reducing the political pressure on governments to craft a solution to the failing bank. If bank failure occurs the depositor protection provided is likely to result in minimal pressure on governments to bailout failed banks, therefore saving taxpayer funds.¹¹

B *Costs of Deposit Insurance*

As noted, one of the main benefits to depositor insurance is that it promotes confidence in financial markets. Unfortunately, this confidence merely contains the crisis in the initial stages. It does not provide rehabilitation to failing banks.¹² Nor is it guaranteed to prevent bank failure. Additionally, deposit insurance is believed to have detrimental flow on effects into the market.¹³ The existence of a guarantee reduces market discipline,¹⁴ and is likely to decrease the internal management of financial institutions. Financial institutions become less motivated to avoid potential failure because they have a lifeline. Furthermore, since depositors are less worried about loss, the creditor pressure on banks to undergo sound governance decreases. Customers are not motivated to ensure reasonable financial decisions are made.¹⁵ Naturally the behaviour of banks will reflect that of the creditors, if there is no creditor pressure to undergo

⁶ Geof Mortlock and Doug Widdowson *Deposit Insurance: Should New Zealand Adopt it and what Role does it play in a Bank Failure* (Reserve Bank, May 2005), at [14].

⁷ Charles Calomiris and Matthew Jaremski “Deposit Insurance: Theories and Facts” (April 2016) at 4.

⁸ A contagion risk is the spreading of risk adverse behaviour between banks, even if other banks are not at risk of failure.

⁹ RBNZ Internal Memo “Deposit Insurance Work and other work with Treasury” (31 March 2010) Ref #3913547 at [21].

¹⁰ At [21].

¹¹ Mortlock, above n 6, at [16]–[17].

¹² RBNZ Internal Memo (31 March 2010), above n 9, at [25].

¹³ Calomiris, above n 7, at 9.

¹⁴ Mortlock, above n 6, at [19]; and RBNZ Public Information “Deposit Insurance” (September 2008) at [8a].

¹⁵ Andreas Wesemann *The Abolition of Deposit Insurance: A Modest Proposal for Banking Reform* (Centre for Policy Studies, Surrey, 2016) at 19.

responsible lending and investing, then responsible lending will not occur.¹⁶ This is aggravated by the creation of an implicit guarantee. During the GFC Governments set a precedent of providing unlimited governmental protection during financial instability.¹⁷ This results in a moral hazard for both depositors and the bank.¹⁸ The protection given to banks encourages them to increase their leverage, and take on riskier investments.¹⁹

Another cost of deposit insurance is monetary. This can arise from payouts upon failure, and through compliance and administration costs. Dependent on the scheme's structure, deposit insurance may also create distortions in financial sectors. Either between banks, where riskier banks are subsidised. Or if only banks are included, between banks and non-banking deposit taking institutions (NBDTs).²⁰ Investors are likely to migrate towards the insured institution.

This analysis outlines the complexity of deposit insurance. Adoption depends on a mixture of both economic and political factors. When adopting deposit insurance, these concerns must be acknowledged and reflected in the structure of the scheme.

C Deposit Insurance Design

The costs and benefits of deposit insurance are dependent on its design. The design must be crafted to fit the country's circumstances. One significant characteristic of New Zealand is the small economy, currently having only 25 registered banks,²¹ and a concentrated banking sector. Currently 95% of residential mortgages and 90% of total sector assets are held by ANZ, Westpac, ASB Bank and Bank of New Zealand.²² These four banks are all subsidiaries of Australian banks. This characteristic must be factored into the design of deposit insurance. One implication of this concentrated system is an increase in systemic risk. If one bank enters into financial difficulty, the shock is more disruptive to surrounding banks. In turn, banks may become too big to fail, forcing government intervention.

The first design aspect to be considered is the coverage of the scheme. Deposit insurance can apply solely to banks, or extend to NBDTs.²³ In order to reduce distortion and ensure equality in financial markets especially in a small market, one argument is that deposit insurance ought to include NBDTs.²⁴ As noted below upon analysis of the collapse of South Canterbury Finance Ltd, NBDTs often involved riskier lending, and therefore inclusion may be inappropriate. Second, participation should be compulsory. If participation is voluntary, then institutions carrying significant weight in the financial

¹⁶ Wesemann, above n 15, at 21.

¹⁷ At 20.

¹⁸ Mortlock, above n 6, at [20]; and RBNZ Public Information, above n 14, at [8b].

¹⁹ Calomiris, above n 7, at 9 and 12.

²⁰ RBNZ Internal Memo (31 March 2010), above n 9, at [34].

²¹ Reserve Bank of New Zealand "List of Registered Banks in New Zealand - Past and Present" (24 November 2014) <www.rbnz.govt.nz>.

²² Wesemann, above n 15, at 113.

²³ Examples of NBDTs are building societies, and finance companies; OECD *OECD Banking Statistics: Methodological Country Notes 2010* (OECD Publishing, 2011) at 118.

²⁴ RBNZ Internal Memo (31 March 2010), above n 9, at [34].

system are likely to opt out.²⁵ The failure of these institutions would likely result in obligatory government intervention to prevent systemic risk. The institutions being too big to fail. Consequently, large institutions could reap the benefits of deposit insurance whilst avoiding contributing to the scheme. Resulting in market distortion.²⁶

Another design feature is whether deposit insurance should solely protect retail depositors, or extend to wholesale funding. As aforementioned, this essay will primarily focus on the protection of retail deposits, deposits made by unsophisticated investors. In order to develop a full understanding and an in-depth analysis protection of wholesale funding will be briefly discussed. The segregation between retail and wholesale funding may be an explicit decision to exclude wholesale funding, or the practical effect because the limit set is too low to adequately protect sophisticated investors. Therefore, in a potential financial market crash, wholesale creditors may run the bank. This defeats one of the main purposes of deposit insurance. This is particularly prominent in New Zealand because banks have significant wholesale funding.²⁷ The flipside of this is that because wholesale creditors are effectively unprotected by depositor insurance, they are motivated to exert pressure on financial institutions to undergo internal governance. This ensures market discipline.²⁸ One method of providing protection to wholesale funding, while also acknowledging that difference risks are involved and therefore different designs may be appropriate is to have multiple insurance schemes, one for retail depositors and one for wholesale funding.

Funding for deposit insurance has two main designs, ex ante, or ex post. An ex ante design is based on forecasts.²⁹ Under this approach fees or premiums are charged to banks. These premiums may be assigned according to the proportionate risk of the financial institution. Risk-based premiums aim to reduce moral hazards, however they are inherently hard to assess.³⁰ If systematic failure occurs, the premiums set may be inadequate to cover the total loss.³¹ Therefore not all deposits may be protected and customers nonetheless suffer. Alternatively, an ex post design is based on actual not forecasted losses.³² Surviving institutions are charged levies to ensure a failed bank's deposits are guaranteed.³³ For this reason, the design is known as a 'survivor pays' system. Generally, governments are also required to fund the payout. A survivor pays system can incentivise risky behaviour, because failed banks are unaccountable for their loss. Therefore, an ex ante system, or hybrid approach is considered more equitable.³⁴ Hybrid schemes are also more capable of covering systematic failure. Along with having an insurance fund to contribute to the loss, surviving institutions are required to cover any shortfall. In a pure ex ante system, the government/taxpayer would bear this loss.

²⁵ Shen Wei "Is China's new deposit insurance scheme a panacea? And why now? A functional analysis" (2016) 31(2) BIBLR 80, at 80.

²⁶ Andrew Campbell, John R LaBrosse, David G Mayes and Dalvinder Singh "A New Standard for Deposit Insurance and Government Guarantees after the Crisis" (2009) 17(3) JFRC 210 at 214.

²⁷ Mortlock, above n 6, at [15].

²⁸ At [15].

²⁹ Campbell, above n 26, at 215.

³⁰ Mortlock, above n 6, at [11].

³¹ Campbell, above n 26, at 230.

³² At 224.

³³ Mortlock, above n 6, at [11].

³⁴ Campbell, above n 26, at 227.

An additional complication is quantification of the deposit protection limit. A common estimation is that the limit should not exceed two times per capita GDP.³⁵ Last year New Zealand's per capita GDP was NZD 53,000.³⁶ Therefore prima facie, an appropriate limit could be around NZD 100,000. Various other factors ought to be analysed alongside this limit. First, ensuring sufficient funds are raised to adequately protect deposits. A limit should be set that strikes a balance between avoiding onerous costs on the banking system and ensuring that the Government is not heavily relied upon in a crisis.³⁷ Too much governmental reliance would unduly burden taxpayers. Second, the limit should represent the division between unsophisticated and sophisticated depositors. The majority of depositors should gain protection to ensure market confidence. But the limit must be low enough to encourage large depositors and creditors to discipline banks.³⁸ Sophisticated depositors, such as wholesale creditors are expected to manage their own risk.³⁹ A balance must be struck between depositor protection and prohibiting significant erosion of market discipline. This quantifying process should not be arbitrary assigned. This was one large issue with the failure of deposit insurance schemes during the GFC.⁴⁰ Beyond this analysis the prescription of an appropriate limit falls outside the scope of this essay.

Another design feature is the role of the insurer. First, the insurer could play a minimalist role, with minimal responsibilities. Here deposit insurance is simple pay box system, and the government (or agency) collects and manages premiums and upon the insurance event they pay out. Under this approach the insurer carries the bulk of the risk. The insurer is unable to manage the risk because they have little supervision over the insured. Governments are required to pay out even if banks conduct their affairs poorly. Alternatively, the scheme could be comprehensive. The insurer having broad powers of management and/or control. This can include introducing comprehensive prudential supervision.⁴¹ The latter approach is significantly more expensive because of the necessary government administration. This will be exacerbated in a small market like New Zealand, because costs are split between fewer financial institutions.⁴² However, such an expense could be justifiable if it leads to sensible management, and therefore a decreased risk in failures.

These factors are useful when designing a scheme, however they are unhelpful in ensuring financial institutions operate within these limits.⁴³ Prudential supervision is necessary to ensure effective operation.⁴⁴ As noted, this is necessary in New Zealand's concentrated system, as the failure of a major bank could have major ripple effects throughout the system.⁴⁵ Increasing the likelihood of systematic failure. Additionally,

³⁵ Mortlock, above n 6, at [11].

³⁶ Statistics New Zealand "Top Statistics" <www.stats.govt.nz>.

³⁷ Campbell, above n 26, at 224.

³⁸ At 224.

³⁹ At 215.

⁴⁰ At 224.

⁴¹ Mortlock, above n 6, at [11].

⁴² RBNZ Public Information, above n 14, at [8f].

⁴³ Campbell, above n 26, at 224.

⁴⁴ At 231.

⁴⁵ RBNZ Public Information, above n 14, at [8f].

the New Zealand Government has traditionally taken a minimalist approach to supervision,⁴⁶ meaning such supervision may be resisted.

III *New Zealand Prudential Regulation*

The successfulness of a deposit insurance scheme depends on the wider financial safety net. Deposit insurance alone, should not be viewed as a one-stop-shop for ensuring depositor protection. It is important to examine the adequacy of the regulatory framework in New Zealand. If the current framework prevents depositor vulnerability, then deposit insurance is unnecessary. This section will outline the existing prudential regulation in New Zealand. This analysis will highlight how currently the framework is insufficient to protect depositors. This suggests that deposit insurance is a beneficial addition to New Zealand's framework.

A *The Reserve Bank*

The Reserve Bank is the primary body in New Zealand that is involved in regulating banks and the financial system. It was established by the Reserve Bank of New Zealand Act 1989 (RBNZA) and is responsible for:⁴⁷

- (a) Formulating and implementing monetary policy designed to promote stability in the general level of prices while recognising the Crown's right to determine economic policy; and
- (b) Promoting the maintenance of a sound and efficient financial system; and
- (c) Carrying out other functions, and exercising powers, specified in this Act.

Part 5 gives the Reserve Bank the ability to undertake prudential supervision of registered banks. Section 68 outlines dual purposes that govern how the Reserve Bank exercises their powers:⁴⁸

- (a) Promoting the maintenance of a sound and efficient financial system or
- (b) Avoiding significant damage to the financial system that could result from the failure of a registered bank.

These sections outline that the Reserve Bank is an independent advisory body for the Government. They are tasked with assessing the state of New Zealand's financial system, with a primary focus on the banking sector. What is evident from ss 1A and 68 is that there is no explicit purpose for the Reserve Bank to implement policy for depositor protection. The Reserve Bank's powers are premised around the financial system as a whole. Due to New Zealand's concentrated banking sector being dominated by four large banks. The instability of either of these banks could adversely affect the wider economy. Resulting in a systemic risk. Arguably, this justifies the Reserve Bank commenting on, and suggesting the implementation of deposit insurance or other regulatory methods to ensure stability in banking systems. A corollary of the Reserve Bank's responsibilities is that if the failure of a bank does not result in systemic risk,

⁴⁶ Auditor General *The Treasury: Implementing and Managing the Crown Retail Deposit Guarantee Scheme* (Controller and Auditor-General, Performance Audit Report, September 2011) at 12.

⁴⁷ Reserve Bank of New Zealand Act 1989, s 1A.

⁴⁸ Section 68.

then it would likely be left to fail. This places the loss on depositors. As outlined below, this risk is real, and should be removed through the implementation of deposit insurance.

Below are six key prudential requirements introduced by the Reserve Bank to ensure financial stability. These will be outlined to portray the current regulatory environment.

1 *Open Bank Resolution*

The Open Bank Resolution (OBR) is an implementation introduced by the Reserve Bank in 2013.⁴⁹ It provides the Government with tools applicable in the event of bank failure. Upon bank failure, the Minister of Finance has discretion to invoke an OBR.⁵⁰ If exercised the concerned bank is closed down for 24 hours and put into statutory management, according to s 117 of the RBNZA.⁵¹ During this temporary closure the statutory manager assesses the bank's financial situation. If the bank's total losses cannot be accounted for then a proportion of depositor funds are set aside and frozen.⁵² The bank is then reopened and resumes normal functioning, with depositors getting access to the remainder of their funds.⁵³ These accessible funds are Government guaranteed. The frozen funds may be later recoverable dependent on the successfulness of the bank's resolution. Depositors' retain their legal right to these funds as unsecured creditors.⁵⁴

The objective of the OBR is first to ensure that the loss caused by bank failure is put on the shareholders and creditors (according to their legal obligations) as opposed to a Government bailout.⁵⁵ Second, to ensure that failed banks continue to operate, therefore reducing wider market disturbance and economic disruption.⁵⁶ The OBR only provides a temporary resolution. It is still necessary to adopt long-term resolutions.⁵⁷ The framework has the effect of temporally stabilising bank failures. One major issue with the OBR is that depositors are still vulnerable to loss, there is no guarantee that they will recover their funds. Additionally, the OBR only applies to large banks, therefore the protection given is not available to a smaller bank in financial difficulties. The implications of this will be outlined in section 7.

2 *Disclosure Regimes*

Banks are required to disclose certain information. Disclosure is required for two reasons, "to strengthen the incentives for banks to maintain sound banking practises; and to assist depositors and other investors to make well-informed decisions on where to put their money".⁵⁸ This requirement seeks to ensure depositor protection through

⁴⁹ Reserve Bank of New Zealand "Open Bank Resolution" <www.rbnz.govt.nz>.

⁵⁰ Reserve Bank *OBR Made Simple* (Reserve Bank of New Zealand, Information Release) at [6].

⁵¹ Reserve Bank of New Zealand Act, s 117.

⁵² *OBR Made Simple*, above n 50, at [3]; and Aide Memorie "Open Bank Resolution: Context and Work Plan Summary" (1 May 2012) Treasury: 2326633v1 at 2.

⁵³ Reserve Bank of New Zealand "Open Bank Resolution" <www.rbnz.govt.nz>.

⁵⁴ *OBR Made Simple*, above n 50, at [4].

⁵⁵ Memorandum for FSO "Alternatives and Complements to OBR" (14 February 2012) Ref #4674576 at [6].

⁵⁶ At [6].

⁵⁷ At [12] and [67].

⁵⁸ Reserve Bank of New Zealand "Registered Banks Disclosure Regime" <www.rbnz.govt.nz>.

the provision of transparency.⁵⁹ There are various disclosure requirements for full year, half year and quarterly statements. Section 81 of the NZRBA enables the Reserve Bank to make orders requiring banks to publish information. A failure to publish the required information,⁶⁰ or publication of misleading information, amounts to an offence under the NZRBA.⁶¹ Since bank directors are required to sign disclosure statements,⁶² both the bank and directors are liable to pay compensation for any loss sustained due to reliance on the false or misleading information.⁶³ This liability strengthens the incentives on directors to ensure sound management of the bank.

The requirements for disclosure statements are set out in an Order in Council.⁶⁴ The objective is to ensure that investors can obtain corporate, financial and other risk related information about the bank.⁶⁵ The Reserve Bank's role is to monitor compliance with disclosure requirements, point out mistakes and recommend amendments as necessary.⁶⁶

Theoretically disclosure statements are sound. They provide transparency, and provide depositors with information about their bank's financial position. This enables informed decisions to be made on where to deposit retail funds. However, it is doubted whether a standard, unsophisticated customer takes any notice of such statements.⁶⁷ The provision of actual protection is therefore questionable. Regardless as to whether the majority of customers read disclosure statements, they do outline strict procedures that banks must follow, and potential liability for directors. This strengthens corporate governance and reduces the likelihood that banks will be managed poorly. Since the provision of actual protection to unsophisticated depositors is unlikely to be provided, deposit insurance is needed to rectify this vulnerability. Having disclosure statements in tandem will help combat the erosion of market discipline.

3 *Capital Adequacy Requirements*

Banks in New Zealand have certain capital adequacy requirements that they must adhere to. The New Zealand framework is based on the Basel capital framework.⁶⁸ Capital requirements buffer bank losses.⁶⁹ Relative to the previous framework, the Basel III standards introduce higher capital requirements in order to increase the loss absorption ability of banks. The Basel framework has two tiers of capital. Tier 1 capital

⁵⁹ Reserve Bank of New Zealand "Key Prudential Requirements" <www.rbnz.govt.nz>.

⁶⁰ Reserve Bank Act, s 89.

⁶¹ Section 89A.

⁶² Section 82.

⁶³ Section 90.

⁶⁴ Registered Bank Disclosure Statements (21 February 2014) 21 *New Zealand Gazette* 451.

⁶⁵ Prudential Supervision Department *Registered Bank Disclosure Regime – Explanatory Information on Orders in Council* (Reserve Bank, September 2014) at [6]. See [26]–[30] for examples of necessary disclosures, such as the disclosure of a bank's credit rating, capital adequacy, liquidity and the bank's exposure.

⁶⁶ At [46].

⁶⁷ Gareth Vaughan "Gareth Vaughan argues that the RBNZ has inadvertently made a case for deposit insurance as disclosure statements don't cut the mustard for the average depositor" (26 January 2016) *Interest* <www.interest.co.nz>.

⁶⁸ Reserve Bank of New Zealand "Information relating to the Capital Adequacy Framework in New Zealand" <www.rbnz.govt.nz>.

⁶⁹ Reserve Bank of New Zealand "Your Bank's Disclosure Statement: What's in it for You?" <www.rbnz.govt.nz>.

is capital that is freely and permanently available for the absorption of losses without any need to cease trading. Tier 1 is split into Common Equity Tier 1 Capital, which includes common shares, stock surplus, and income, and Additional Tier 1 Capital.⁷⁰ Tier 2 capital is capital that will only absorb losses upon winding up, it is supplementary capital.⁷¹ Registered banks are required to have minimum capital ratios. Capital ratios represent the percentage of the bank's capital against its total risk weighted exposure.⁷² Following the Basel III requirements Common Equity Tier 1 must be at least 4.5% of risk-weighted assets at all time and the total Tier 1 capital must be at least 6% of risk-weighted assets at all times.⁷³ The total tier capital, Tier 1 plus Tier 2 capital, must be at least 8% of risk-weighted assets at all times.⁷⁴ These capital adequacy requirements compel banks to meet minimum standards of capital. This aims to allow a bank's capital structure to account for on and off balance sheet risks, therefore increasing the likelihood that shocks can be absorbed during market instability.⁷⁵ As a result, the risk of depositor loss decreases. One issue with these requirements is that they are based off the Basel framework, which has been criticised for not being sufficiently robust to prevent depositor loss upon bank failure.⁷⁶ This suggests that despite minimum standards being set, depositor loss is foreseeable, therefore deposit insurance is appropriate.

4 Liquidity Requirements

Not only is it important for banks to have sufficient capital to absorb losses. It is also necessary for them to have substantial liquidity to ensure short-term resilience and avoid liquidity risks. A liquidity risk arises when a bank cannot meet its financial obligations as they fall due.⁷⁷ The Reserve Bank has implemented prudential requirements surrounding liquidity standards to ensure the "smooth functioning of financial systems by reducing the likelihood of liquidity problems affecting registered banks and promoting registered banks' capability to manage such problems".⁷⁸ This involves three main components; introducing minimum ratio requirements, guidance, and rules on risk management processes with respect to liquidity risks and reporting requirements.⁷⁹ These will be discussed in turn.

Registered banks must comply with one-week and one-month mismatch ratios. Mismatch ratios aim to reduce risks brought about by a short-term loss of confidence. Mismatch ratios require registered banks to hold sufficient liquidity to cover the

⁷⁰ Basel Committee on Banking Supervision *Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems* (Bank for International Settlements, December 2010, Reviewed June 2011) at [50].

⁷¹ Reserve Bank of New Zealand "Basel III Capital Adequacy Requirements" <www.rbnz.govt.nz>; and Basel Committee on Banking Supervision, above n 70, at 12–19.

⁷² Reserve Bank of New Zealand "Your Bank's Disclosure Statement: What's in it for You?" <www.rbnz.govt.nz>; note, risk weighted exposures are a measure of the bank's exposure to operational risks, market risk and credit risk.

⁷³ Basel Committee on Banking Supervision, above n 70, at [50].

⁷⁴ At [50].

⁷⁵ At [11]–[13].

⁷⁶ Wesemann, above n 15, at 36; and Independent Commission on Banking (UK) *Final Report: Recommendations* (2011) at 9.

⁷⁷ Reserve Bank of New Zealand "Liquidity Policy" <www.rbnz.govt.nz>.

⁷⁸ Prudential Supervision Department *Liquidity Policy* (Reserve Bank of New Zealand, Document BS13, July 2014) at [6].

⁷⁹ Reserve Bank of New Zealand "Liquidity Policy" <www.rbnz.govt.nz>.

mismatch between the expected cash inflows and outflows.⁸⁰ Banks must also comply with the core-funding ratio. The core-funding ratio is the total amount of core funding, divided by the total amount of core lending. At the end of each business day the bank's core funding ratio must be no less than 75%.⁸¹ This requirement minimises the vulnerability of the banking sector in periods of market disruption.

Second, banks must abide by internal mechanisms surrounding liquidity risk management.⁸² This this requires banks to have clearly documented and appropriately communicated mechanisms about the management of liquidity risks. There must be structures in place to ensure the approval, oversight and implementation of a liquidity risk framework and policy. This includes the identification of the principal methods used for monitoring, measuring and controlling liquidity risk, and the material sources of liquidity risk that the bank may face. A contingency funding plan must also be available to manage stress as necessary.⁸³ The Reserve Bank has issued supplementary guidelines to ensure that these requirements are met.⁸⁴ The final requirement is for banks to issue monthly reports to the Reserve Bank on their liquidity position and risk.⁸⁵

Similar to the capital adequacy requirements, these liquidity requirements seek to minimise the risk of bank failure that may arise from sudden shocks in the market. In turn, this therefore promotes depositor protection.

5 Governance Requirements

The Reserve Bank has also issued requirements surrounding corporate governance of registered banks incorporated in New Zealand. Banks incorporated outside of New Zealand with branches in New Zealand fall outside the scope of these requirements, but are still required to follow the disclosure regime.⁸⁶ This requires the disclosure of director information. Namely their level of independence, expertise, and relationship to the bank or other related businesses.⁸⁷

The corporate governance standards largely involve the imposition of requirements on board composition. There must be at least five members, the majority must be non-executive, with half being independent, and half of these independent directors must ordinarily reside in New Zealand.⁸⁸ The chairman of the board must also be independent.⁸⁹ To ensure the integrity of the bank's reporting systems, financial controls and internal audit standards, an independent committee must audit the board.⁹⁰ Finally, the board must collectively and individually have the appropriate competencies, experience and personal qualities.⁹¹ These requirements seek to uphold

⁸⁰ Prudential Supervision Department, above n 78, at [33]–[37].

⁸¹ At [38]–[40].

⁸² At [69].

⁸³ At [71].

⁸⁴ At [72]. See s D2.2 for the guidelines.

⁸⁵ At [131]–[132].

⁸⁶ Prudential Supervision Department, *Corporate Governance* (Reserve Bank of New Zealand, Document BS14, July 2014), s 3.

⁸⁷ Prudential Supervision Department, above n 86, s 18.

⁸⁸ Section 9.

⁸⁹ Section 11. See s 10 for the definition of independence.

⁹⁰ Section 14.

⁹¹ Section 17.

the responsible operation and management of banks. Resultantly this should reduce the likelihood of bank failures.

6 *Credit Ratings, Outsourcing Policy, and Connected Exposures*

(a) Credit Ratings

Banks are required to obtain and maintain independent credit ratings. Credit ratings outline the banks willingness and capability to repay its debt. It signifies a bank's credit worthiness.⁹² As aforementioned these credit ratings must be disclosed in quarterly disclosure statements. This ensures that depositors can make informed decisions.

(b) Outsourcing Policy

The Reserve Bank also has the power under s 74 of the Reserve Bank Act to impose conditions on outsourcing arrangements made by banks. Outsourcing occurs when banks use other parties to perform business functions that would normally be conducted by the bank itself.⁹³ The Reserve Bank permits outsourcing provided that it is consistent with stipulated outcomes.⁹⁴ These outcomes are premised around the bank having the legal and practical ability to control and execute the core outsourced functions. This includes clearing and settlement obligations, financial positions, monitoring and managing financial risks and ensuring access to customer payment facilities.⁹⁵ The purpose of these objectives is to ensure that the bank can continue to provide core liquidity, payment and transaction services if one of the bank's service providers fails.⁹⁶

(c) Connected Exposures

The Reserve Bank also monitors the level of exposure that banks can have to those closely connected. The level of exposure permitted is dependent on the level of connection to the bank, and the bank's credit rating. A person will be connected to the bank if they are the owner, entity that an owner has a substantial interest, a person who has a substantial interest in an owner, or a director of the registered bank.⁹⁷

These prudential interventions are all premised around ensuring that banks are managed and operated responsibly and without potential conflicts. This increases bank stability and therefore decreases the likelihood of bank failures, ultimately decreasing the risk of depositor loss.

B *Crown Retail Deposit Scheme*

Deposit insurance has temporarily existed in New Zealand. In accordance with powers under the Public Finance Act 1989, in 2008 the Minister of Finance adopted the Crown Retail Deposit Guarantee Scheme,⁹⁸ which applied to retail deposits in banks and

⁹² Reserve Bank *Explaining Credit Ratings* (Reserve Bank of New Zealand, November 2008) at 1.

⁹³ Reserve Bank of New Zealand "Outsourcing Policy" <www.rbnz.govt.nz>.

⁹⁴ Financial Stability Department *Outsourcing Policy* (Reserve Bank of New Zealand, Document BS11, January 2006) at [11].

⁹⁵ At [4].

⁹⁶ Reserve Bank of New Zealand "Outsourcing Policy" <www.rbnz.govt.nz>.

⁹⁷ Financial Stability Department, above n 94, at [4].

⁹⁸ Auditor General, above n 46, at 5.

NBDTs.⁹⁹ Deposits were guaranteed up to NZD 1-million.¹⁰⁰ The Government introduced the scheme during the GFC because they were concerned that deposits would be transferred into Australian banks where they would gain protection by the recently adopted Australian scheme.¹⁰¹ At its peak the scheme guaranteed NZD 133-billion worth of deposits, this was two-thirds the country's GDP, and double the Government's usual annual spending.¹⁰² Ninety-six financial institutions were included, twelve banks, sixty NBDTs, and twenty-four collective investment schemes.¹⁰³ During the GFC no banks failed, there were no bank runs and the New Zealand economy remained stabilised. However, nine finance companies failed, which resulting in NZD 2-billion being paid out to more than 42,000 depositors.¹⁰⁴ The scheme expired in 2011 and has since not been reintroduced. This is predominately because the Reserve Bank believed the costs created, such as an increased moral hazard, and reduced market discipline outweighed the benefits.¹⁰⁵ As outlined below in section seven, in relation to banks, the deposit insurance scheme can be seen as a success. This supports the proposition that deposit insurance should be adopted in New Zealand to insure retail deposits.

C Conclusion

New Zealand's prudential regulation largely focuses on ensuring that banks do not enter into financial difficulty. The standards set aim to promote healthy financial markets. This is beneficial, but fails to account for the fact that financial instability can occur rapidly, and is influenced by a multitude of factors. New Zealand's financial safety net lacks mechanisms to provide depositor protection in the event that instability does occur. As outlined below, the OBR is insufficient to do this. Deposit insurance, if designed sensibly, can provide such protection.

IV Alternative Schemes to Deposit Insurance

Deposit insurance is not the only mechanism that pursues depositor protection. This section will address two alternative mechanisms that aim to provide similar protection.

A Self-Regulation

Andreas Wesemann, a UK financial advisor, believes that the UK banking sector regulation is inadequate, and advocates for the abolition of deposit insurance in the UK. His belief is that this will encourage bank capital structures to have more equity, less leverage, and resultantly greater stability.¹⁰⁶ Wesemann's criticism will be outlined, followed by an analysis of his proposed alternative scheme.

Wesemann believes that the inadequacy of the Basel III requirements justifies the UK departing from the Basel framework. The capital requirements are regarded as too

⁹⁹ Auditor General, above n 46, at 5.

¹⁰⁰ At 5.

¹⁰¹ At 13.

¹⁰² At 10.

¹⁰³ At 12.

¹⁰⁴ At 12.

¹⁰⁵ RBNZ Internal Memo (31 March 2010), above n 9, at [2].

¹⁰⁶ Wesemann, above n 15, at summary.

lenient and allow the banking industry to become highly leveraged relative to other financial and non-financial institutions.¹⁰⁷ These lax regulatory requirements contribute to the skewed incentives in the banking industry. Banks being incentivised to create liability, as opposed to decrease their risk profiles.¹⁰⁸ Additionally the complexity of the Basel III requirements aggravate the information asymmetry in the industry. Customers are required to interpret complicated financial statements in order to attempt to understand a bank's financial position, and then try protect themselves.¹⁰⁹ Deposit insurance is also regarded as an inadequate regulatory mechanism. The shortcomings, such as the creation of a moral hazard and the reduction in market discipline, are believed to aggravate the vulnerability in the banking system.¹¹⁰ Therefore, Wesemann recommends that deposit insurance should be abolished.

The abolition of the Basel framework and deposit insurance is believed to result in industrial change leading to improvements in bank capital structures and the encouragement of institutional innovation. For this to occur it is important that the government clearly educates the public on the consequences of reform. In particular, that depositors have the potential to lose their deposits and should invest in banks with sufficient capital bases to absorb losses.¹¹¹ This will increase market discipline. It is also recommended that the government explicitly sets capital requirements (higher than the Basel III requirements) so that capital bases are not subject to the whim of the market.¹¹² Or alternatively, the government could extend the government state owned savings bank to offering retail accounts and a comprehensive range of savings products.¹¹³ This will result in a market floor being set that other banks have to compete with in order to retain customers. In turn creating market consolidation. Due to increased competitive nature in the market, and higher level of capital required, smaller companies will be unable to compete with larger banks.¹¹⁴ The proposed changes will also encourage innovation because only companies that can generate sufficient revenue will remain.

Another consequence of abolishing deposit insurance is self-regulation in the banking sector. One self-regulatory mechanism that may be adopted is a mutual guarantee scheme.¹¹⁵ Mutual guarantee schemes are similar to government deposit insurance schemes,¹¹⁶ the major difference is a mutual guarantee scheme has no government involvement. The premise is that each institution insures the other's deposits. This is advantageous over government schemes because rather than decreasing market discipline it increases it. It is in the interest of banks to ensure that those within the group operate sensibly. Typically a bank board will be appointed to investigate member banks and set appropriate rules, such as capital and liquidity requirements.¹¹⁷ It is important that the board has sufficient intervention ability to ensure banks operate

¹⁰⁷ Wesemann, above n 15, at 4–5.

¹⁰⁸ At 5.

¹⁰⁹ At 6–7.

¹¹⁰ At 60.

¹¹¹ At 35.

¹¹² At 36.

¹¹³ At 39–41.

¹¹⁴ At 65–66.

¹¹⁵ At 73.

¹¹⁶ At 12.

¹¹⁷ At 74–76.

within sensible risk profiles.¹¹⁸ Liability should be both joint and several to ensure sufficient funds are available following a large crisis. The likely result of the various risk profiles between retail banks and investment banks is the creation of a mutual guarantee scheme for each category. Otherwise the lower risk profile banks will have to cover the short fall for their riskier counterparts.¹¹⁹

A mutual guarantee scheme will increase depositor confidence. Depositors can rely on the joint capital of all the institutions as opposed to merely the capital of their bank.¹²⁰ To ensure autonomy governmental intervention should be minimal. The government should undertake a supervisory role over the sector and only intervene to prevent systemic risk.¹²¹ The presence a floor rate that the market has to account for ensures competitive lending. And if regulation is set by the industry, this will increase market discipline and decrease the moral hazard. Wesemann's argument is that a mutual guarantee scheme paired with appropriate minimal capital and liquidity requirements will allow for the efficient and responsible operation of the banking sector. One underlying issue with this approach is that institutions may become too big to fail. The result being that if the capital requirements set are insufficient, and bank failure is imminent, a taxpayer bailout would be required.

The applicability of self-regulation providing depositor protection in New Zealand will be outlined in section 7.

B The Vicker's Report

Following the GFC the UK Government issued an inquiry into reforms necessary in the banking sector to ensure financial stability. In 2011 the UK Independent Commission of Banking released their recommendations in the Vicker's Report.¹²² Three main factors were outlined to ensure financial stability in the banking industry; banks must be able to absorb losses, make it easier and less costly to sort out troubled banks, and curb incentives for excessive trading.¹²³ As discussed below the inability for banks to absorb losses was evident following the GFC. Banks were highly leveraged and had insufficient equity capital relative to their risk profile. Resultantly upon erosion of equity capital, the banks were in very dubious positions.¹²⁴ In order to rectify these issues the Commission recommended wholesale structural reform.

The Commission proposed to ring fence the banking sector by separating retail and investment banking.¹²⁵ Retail activities should be carried out independently and subject to different regulation to investment activities. This would insulate retail banks from shocks in the wider financial market, while also increasing the ability for the resolution of failing banks.¹²⁶ Ring fencing should isolate services where the continuous provision

¹¹⁸ Wesemann, above n 15, at 79.

¹¹⁹ At 77.

¹²⁰ At 74.

¹²¹ At 82.

¹²² The US have implemented a similar yet less restrictive regime, the Volcker Rule, however it falls outside the scope of this essay. See Alan Brainbridge, David Shearer, James Atkinson, Kenneth Gray and Simon Lovegrove "The Banking Reform Act 2013" (2014) 114 COB 1 at 3.

¹²³ Independent Commission on Banking above n 76, at 8.

¹²⁴ At 8.

¹²⁵ At 10.

¹²⁶ At 31.

is vital to the economy and bank customers.¹²⁷ Domestic retail banks should fall within the ring fence, while investment/wholesale banks fall outside. The Commission left open whether large domestic non-financial companies should be included.¹²⁸

The Commission also recommended that the minimum regulatory requirements surrounding capital, liquidity, funding, and exposure should be increased.¹²⁹ This would strengthen the ability of banks to absorb losses. The Commission perceived the Basel III requirements as inadequate to ensure financial instability. Ring fenced banks equitable capital should be at least 10% of their risk weighted assets.¹³⁰ While larger banks should have loss-absorbing capacity of at least 17-20%.¹³¹ Similarly, liquidity risks should be reduced through introducing stricter liquidity requirements for both ring fenced and non-ring fenced banks.¹³² Furthermore, in insolvency, insured deposits should be given preferential treatment over other unsecured debts. This structural reform results in increasing the ability for ring fenced banks to absorb losses and increases the incentives on retail banks to monitor risk.¹³³ As a result depositors are given greater protection over the security of their deposits.

These recommendations add more evidence to the inadequacy of the Basel framework. It also suggests that relying liquidity and capital requirements to ensure banks can buffer losses can be risky. The applicability of a ring fence in New Zealand will be outlined in section 7.

V *United Kingdom Comparative Analysis*

Over the last decade the UK banking sector has undergone turbulence and substantial reform. For this reason, an analysis of the UK regulation pre and post the GFC can help bring to life the issues that can arise in the banking sector, particularly surrounding deposit insurance. An analysis of the UK scheme is particularly useful because the failure of Northern Rock provides a good example of the consequences of a poorly designed deposit insurance scheme. Additionally, due to the UK's experience of the GFC being costly, vast research and time has gone into subsequent reform. The result of this reform is that post GFC UK financial regulation provides a polished and well researched structure that New Zealand's framework can be weighed against. Since New Zealand is both a common law country, and former UK colony, this strengthens the applicability and appropriateness of a comparative analysis between the two jurisdictions.

The structure of this section is as follows. First the UK banking regulation prior to the GFC will be outlined. Second, the failure of Northern Rock will be used to illustrate the framework's deficiencies. Finally, the reforms post the GFC will be highlighted, focusing on the implementation of the Financial Service (Banking Reform) Act 2013 and the introduction of the Special Resolution Regime (SRR). This analysis will help outline problems that can arise in prudential regulation, and provide a comparative

¹²⁷ Independent Commission on Banking above n 76, at 11.

¹²⁸ At 12.

¹²⁹ At 12.

¹³⁰ At 31.

¹³¹ At 123.

¹³² At 31.

¹³³ At 16.

framework that New Zealand's regulation can be contrasted against. This contrast will display the inadequacy of New Zealand's framework to protect retail deposits.

A Summary of Bank Supervision Prior to the GFC

Historically the UK had three authorities involved in regulating financial markets, the Bank of England, the Treasury and the Financial Services Authority (FSA). As noted below, the FSA has been replaced. The old framework will be briefly outlined to provide context for the Northern Rock case study.

The Bank of England is responsible for monitoring monetary payment systems in financial markets and monetary policy functions.¹³⁴ If problems are discovered within the financial market, then the Bank of England passes their concerns to the FSA. The FSA is required to monitor and regulate financial institutions.¹³⁵ The final regulatory authority is the Treasury, which is responsible for structuring legislation to regulate the financial system and also to inform Parliament of major concerns within the financial market.¹³⁶ The Financial Services Commission Scheme (FSCS) is another body involved in ensuring the stability of the financial markets. The FSCS encapsulates the UK deposit insurance scheme. It has no regulatory power,¹³⁷ and is reliant on the FSA for rule making power.¹³⁸ The FSCS was created by the Financial Services and Markets Act 2000 in order to protect depositors.¹³⁹ It is a simple pay box insurance scheme. Funding is ex post, meaning that upon bank failure the FSCS collects levies from surviving banks and then makes payments to eligible depositors.

This brief summary outlines that the supervision of banks and financial markets occurred by a tripartite of authorities. These authorities are tasked to ensure that the banking sector is regulated efficient and runs smoothly. The FSCS is intended to act as a safeguard, protecting depositors if bank failure occurred.

B Northern Rock

Prior to analysing Northern Rock, it is useful to provide a brief outline of the GFC to understand the cause of the instability and the interconnectivity of financial markets.

The collapse in the subprime mortgage market is believed to have triggered the GFC.¹⁴⁰ In the lead up to the GFC many U.S. institutions increased the number of risky mortgages issued. These mortgages were bundled up and sold off as securities.¹⁴¹ These securities would be repacked, tranced and then resold. This securitisation process resulted in decreasing the incentives to screen borrowers, because those issuing the loans were largely not holding the risk of failure. Illiquid loans were being converted

¹³⁴ Singh and LaBrosse, above n 2, at 67.

¹³⁵ At 67.

¹³⁶ At 67.

¹³⁷ Paula Moffatt and Andrew Campbell "UK Depositor Protection in the Aftermath of the Banking Crisis" (2010) 25(10) JIBLR 486 at 489.

¹³⁸ Singh and LaBrosse, above n 2, at 74–75.

¹³⁹ Moffatt and Campbell, above n 137, at 489.

¹⁴⁰ Yuliya Demyanyk, and Iftexhar Hasan "Financial Crises and Bank Failures: A Review of Prediction Methods" (2010) 38 Omega 315 at 316.

¹⁴¹ At 316.

into liquid securities; as a result the number of subprime mortgages increased rapidly.¹⁴² These securities were also sold internationally. This behaviour was only sustainable if house prices continued to increase. If they plummeted, then upon foreclosure the sale would be insufficient to furnish the loan. Because of the risk profile of the issued mortgages, there was a high number of foreclosures and therefore the housing supply became larger than demand. House prices plummeted.¹⁴³ Financial institutions around the world were stuck with securities that were valueless leading to international financial concern in the market, and consequently, bank failures.

Northern Rock was one of many banks that felt the shock following the sub-prime mortgage crisis.¹⁴⁴ One large issue with Northern Rock was that the majority of their funding was wholesale, which includes the aforementioned securities.¹⁴⁵ When this market froze Northern Rock experienced liquidity issues due to a mismatch between borrowing and lending. This led Northern Rock to approach the Bank of England as a lender of last resort to seek liquidity support.¹⁴⁶ Northern Rock disclosed to the market that financial arrangements were in place in case financial conditions did not improve.¹⁴⁷ This led to panic by Northern Rock depositors over the safety of their deposits. The result being that they ran the bank.¹⁴⁸ Not only was confidence lost in Northern Rock, but concern also spread throughout other domestic and international banks, depositors were worried and were unable to predict what banks were safe.¹⁴⁹ In order to restore confidence, and halt the bank run, the Government implemented a blanket guarantee over existing deposits in Northern Rock.¹⁵⁰ It was not until the implementation of this blanket guarantee that the bank run stopped.¹⁵¹ This provided the authorities with time to find solutions to deal with the failing bank, namely to pass the Banking (Special Provision) Act 2008 (BSPA). The BSPA was a temporary measure that enabled the Treasury to nationalise banks in financial difficulty and gave the Treasury powers in relation to property rights to ensure financial stability.¹⁵² Consequently, Northern Rock was nationalised and then a private sector solution was found.

Four main observations can be made following this crisis. First, the structure of the deposit insurance scheme strongly determines the provision of depositor confidence. When the run on Northern Rock occurred, the insurance limit was 100% for the first £2000 and 90% protection up to £35,000.¹⁵³ If failure did occur, then depositors would not be compensated for at least 90 days and in some instances up to 6 months after failure.¹⁵⁴ Therefore, despite this protection many depositors chose to run the bank to

¹⁴² Demyanyk, above n 140, at 317.

¹⁴³ At 316.

¹⁴⁴ Singh and LaBrosse, above n 2, at 56.

¹⁴⁵ Independent Commission on Banking above n 76, at 32.

¹⁴⁶ Singh and LaBrosse, above n 2, at 57.

¹⁴⁷ At 57.

¹⁴⁸ At 57.

¹⁴⁹ At 58.

¹⁵⁰ At 65.

¹⁵¹ Moffatt and Campbell, above n 137, at 490.

¹⁵² Adrienne Coleton "Banking Insolvency Regimes and Cross-Border Banks – Complexities and Conflicts: Is the Current European Insolvency Framework Efficient and Robust enough to effectively Resolve Cross-Border Banks, Can there be a one Size Fits all Solution?" (2010) 27(2) JIBLR 63 at 12.

¹⁵³ Singh and LaBrosse, above n 2, at 77.

¹⁵⁴ At 82.

ensure they would be fully compensated straight away, as opposed to having to wait a significant portion of time for partial compensation. This split recovery scheme was complicated and confusing to understand. The public had no confidence in the insurance scheme and it failed to achieve one of its fundamental purposes, preventing bank runs. Following the GFC these deficiencies in the FSCS have largely been ironed out, with the limit in the UK now set at £75,000 and a recovery delay of 7 days.¹⁵⁵ This new limit seeks to ensure that a significant proportion of deposits are protected, while also aiming to avoid an excessive moral hazard.

Second, there was insufficient public education and awareness over the structure of the scheme and the level of protection available. Many depositors did not know that deposit insurance existed,¹⁵⁶ and many who did were unsure whether their deposits would be protected.¹⁵⁷ Better systems need to be in place to ensure the FSCS or the FSA disseminated information about the compensation scheme, the stability of banks and the position of depositors.¹⁵⁸ Third, because the banking system lacked transparency, this meant healthy banks could lose confidence, and unhealthy banks could go unnoticed for a significant period of time.¹⁵⁹ Transparency is extremely important in fast moving markets because financial instability can occur rapidly. Here, Northern Rock was informed of the risks flowing from the US sub-prime mortgage crisis prior to their instability. However, because of the pace at which the impact occurred, and the sudden loss in confidence in the market, Northern Rock was unable to change their business model fast enough.¹⁶⁰

Fourth, not only is it important to have a well-structured deposit insurance scheme, it is also important that other regulatory mechanisms and tools are available to allow the Government to deal with the crisis. Otherwise the Government may be forced to bail out the bank or undergo nationalisation. At the time of Northern Rock's instability, the UK Government had inadequate mechanisms to deal with Northern Rock. They had to implement new legislation to adequately deal with the failing bank. Moreover, a clear understanding between various authorities regarding their comparative roles is essential. Here, both the FSA and the Bank of England failed to adequately perform their roles. The FSA failed to appropriately supervise Northern Rock and the Bank of England hesitated when implementing their lender of last resort powers.¹⁶¹ These two parties were aware of Northern Rock's financial difficulties for a whole month prior to the bank run occurring, yet no adequate measures were taken.¹⁶² Another benefit of having pre-existing mechanisms in place prior to a crisis is a reduction in the need for governments to introduce guarantees to ensure stability. Guarantees may be helpful in the short term, but in the long term they can increase moral hazards, and result in institutions thinking that they will be bailed out in times of crisis.¹⁶³

¹⁵⁵ Adrienne Coletton above n 152 at 12; Moffatt and Campbell, above n 137, at 490; and Bank of England Prudential Regulation Authority "Banking Information" Bank of England <www.bankofengland.co.uk>.

¹⁵⁶ Singh and LaBrosse, above n 2, at 77.

¹⁵⁷ At 75.

¹⁵⁸ At 82.

¹⁵⁹ At 58.

¹⁶⁰ At 66.

¹⁶¹ Moffatt and Campbell, above n 137, at 487.

¹⁶² Hyun Song Shin "Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis" (2009) 23 JEP 101 at 102.

¹⁶³ Moffatt and Campbell, above n 137, at 487–488.

This analysis outlines the importance of ensuring that deposit insurance design is suitable to the environment, and that there is sufficient transparency and public education to ensure confidence in the scheme. It also displays the importance of the financial safety net having a broad range of mechanisms to ensure that failing institutions are smoothly resolved and that the various authorities involved know the boundaries of their responsibilities. The learnings from the run on Northern Rock should be taken into account when designing New Zealand's deposit insurance scheme.

C The Current State of Affairs

Since the GFC UK prudential regulation has undergone large reform. As evident from the run on Northern Rock, this was necessary. This section will outline the current state of affairs of the UK banking regulation, primarily focusing on regulator bodies involved and the reforms introduced by the Banking Reform Act. This framework can then be contrasted with New Zealand's to determine whether the latter is adequate. Ultimately, the contrast between the jurisdictions outlines that deposit insurance is necessary in New Zealand.

The Bank of England and Treasury are two major parties involved in supervising and regulating banks. The third authority involved, the FSA, has been replaced due to flaws in its supervisory ability. In its place is the Financial Policy Committee (FPC), Financial Conduct Authority (FCA), and the Prudential Regulatory Authority (PRA).¹⁶⁴ These three regulatory bodies work with each other to supervise and regulate the financial industry. The latter two are both bodies within the Bank of England. The FPC is responsible for identifying, monitoring and removing systemic risks and ensuring resilience in the UK financial system.¹⁶⁵ This involves setting capital and leverage requirements. The FCA is responsible for monitoring what financial firms do, and how they carry out business.¹⁶⁶ Its objectives are to secure consumer protection, promote competition in the interests of consumers and to enhance and protect the UK financial system.¹⁶⁷ The PRA is responsible for the prudential regulation and supervision of banks, insurers, credit unions, building societies and major investment firms.¹⁶⁸

The Banking Reform Act enacted most of the recommendations made in the Vicker's Report. A ring fence is introduced around the retail banking sector, prohibiting engagement in activities that are perceived as the riskier elements in banking.¹⁶⁹ A distinction is made between retail and investing banking activities, with ring fenced banks being excluded from dealing in investments as the principal.¹⁷⁰ The main objective is to protect the continuity of the provision of the UK core services.¹⁷¹ To

¹⁶⁴ Timothy Edmonds *Banking Services: Reform and Issues* (House of Commons, Briefing Paper, Number 07234, 20 April 2015) at 12.

¹⁶⁵ At 10.

¹⁶⁶ At 12.

¹⁶⁷ At 12.

¹⁶⁸ At 11.

¹⁶⁹ Bank of England Prudential Regulation Authority *The Implementation of Ring-Fencing: Consultation on Legal Structure, Governance and Continuity of Services and Facilities* (Consultation Paper, CP19/14, October 2014) at 6.

¹⁷⁰ Financial Services and Market Act 2000, s 142D, as amended by Financial Services (Banking Reform) Act 2013, s 4.

¹⁷¹ Alan Brainbridge, above n 171, at 7.

ensure flexibility in readily changing markets, rather than fixing strict parameters of the ring fence, the Banking Reform Act creates a framework that allows the ring fence to be implemented and enforced. The PRA is the primary body responsible for implementing the ring fence around core UK financial services and activities.¹⁷² To be included in the ring fence institutions must be incorporated in the UK, have core deposits from individuals and businesses greater than £25-billion and carry out a core activity.¹⁷³ Core activities involve the reception of deposits.¹⁷⁴ The PRA's objective extends to ensuring the continuous supply of core services, which includes the operation of bank accounts, the availability of overdrafts and the acceptance of deposits.¹⁷⁵ The PRA is responsible for ensuring ring fenced banks are resilient to shocks in the wider financial system and ensuring the orderly resolution of troubled ring fenced banks or other members in the bank's group.¹⁷⁶ These new ring-fencing requirements must be complied with by 1 January 2019.¹⁷⁷

Another reform is the introduction of a Senior Manager Regime. Following the GFC it was observed that few individuals were deemed responsible. The Senior Manager Regime intends to rectify this by giving the FCA and PRA power to specify certain functions as senior management functions. This specification results in the need to outline the responsibilities and expectations on the individual.¹⁷⁸ Senior managers include members of the board, heads of key business areas and individual groups or parent companies.¹⁷⁹ This increase in the level of responsibility, and liability on managers will have ripple effects throughout the company structure, resulting in increased depositor protection.

Another instrument in the UK financial safety net is the Special Resolution Regime (SRR). Put simply, the SRR is an intricate version of the OBR, and gives the Government an arsenal of tools to deal with failing institutions. The SRR was implemented in the midst of the GFC through the Banking Act 2009 as a direct response to the Northern Rock crisis.¹⁸⁰ The SRR provides multiple mechanisms to deal with failing banks.¹⁸¹ The failure of authorities to adequately deal with Northern Rock outlines how this was necessary. Another issue evident from the failure of Northern Rock is that the authorities involved lacked a clear understanding of their respective responsibilities. The SRR clarifies the respective roles of each authority in order to ensure the an effective and efficient resolution occurs in the event of a bank crisis.¹⁸²

¹⁷² Bank of England Prudential Regulation Authority *The Implementation of Ring-Fencing: Reporting and Residual Matters* (Consultation Paper CP25/16, July 2016) at 5.

¹⁷³ Bank of England Prudential Regulation Authority, above n 169, at 6; Financial Services and Market Act, s 142A, as amended by Financial Services (Banking Reform) Act 2013, s 4. Note, building societies are exempt from the ring fence and the Treasury has power to exempt other UK institutions.

¹⁷⁴ Section 142B. The Treasury can choose to regulate further activities, or exempt certain activities from falling within the ring fence.

¹⁷⁵ Section 142C. The Treasury has discretion to make orders to include other specific services.

¹⁷⁶ Bank of England Prudential Regulation Authority, above n 169, at 7.

¹⁷⁷ Alan Brainbridge, above n 171, at 15; with the majority of the Act not coming into force until decided by the Treasury; Financial Services (Banking Reform) Act, s 148.

¹⁷⁸ Timothy Edmonds, above n 164, at 18.

¹⁷⁹ At 19.

¹⁸⁰ Moffatt and Campbell, above n 137, at 486.

¹⁸¹ Roman Tomasic "Creating a Template for Banking Insolvency Law Reform after the Collapse of Northern Rock" (2009) 22(5) *Insol Int* 65 at 67.

¹⁸² At 68.

During bank instability the SRR has three procedures available; stabilisation options, the banking insolvency procedure, and the banking administration procedure.¹⁸³ The Bank of England has discretion over when and what procedure is exercised. Prior to determination, all the relevant circumstances must be taken into account, and the decision must be approved by the FSA.¹⁸⁴ The stabilisation options available to the Bank of England include a private sector purchase,¹⁸⁵ undergo temporary public ownership of the bank,¹⁸⁶ or transfer to a bridge bank.¹⁸⁷ This final option allows the Bank of England to transfer all or part of the business to a bridge bank, a company that is wholly owned by the Bank of England.¹⁸⁸ This allows the business to continue to operate until a private sector solution is found. Once one is found, then the net profits are to be returned for the resolution of the residue bank.¹⁸⁹ There are specific conditions that the Bank of England must satisfy prior to implementing any of these options.¹⁹⁰

The next SRR mechanism is the bank insolvency procedure. This procedure is designed to ensure rapid FSCS payments are made to eligible deposits.¹⁹¹ This approach introduces modified insolvency procedures for banks. If the Bank of England deems liquidation appropriate then a bank liquidator is to be appointed by court order.¹⁹² The Bank Liquidator arranges for all the eligible depositors to receive compensation from the FSCS, or have their accounts transferred when reasonably possible.¹⁹³ Once this objective is completed then the bank liquidator is required to wind the bank up in the interests of the bank's creditors.¹⁹⁴ This procedure is not applicable to a residual company because the FSCS compensation would have been transferred to the bridge bank. For this reason, the bank administration procedure is created.¹⁹⁵ Under administration an insolvency practitioner is appointed as the residual bank administrator and controls the management and affairs of the residual company.¹⁹⁶ The primary role of bank administration is to keep the residual company running as long as necessary to support the bridge bank, or the commercial purchaser, and once the use is expired, to wind up appropriately.¹⁹⁷ The procedure is largely similar to the general insolvency regime, and sits alongside it, and the bank insolvency procedure.¹⁹⁸

¹⁸³ Banking Act 2009 (UK), s 1(2).

¹⁸⁴ Section 7. The FSA must be satisfied that the bank is likely to fail to meet the threshold conditions within s 41(1) of the FSMA, and that it is reasonably likely that a failure to exercise the stabilization powers will mean that no action will be taken by the bank to satisfy the threshold condition.

¹⁸⁵ Section 11.

¹⁸⁶ Section 13. The Treasury has the power to make share transfers to take the bank into public ownership.

¹⁸⁷ Section 12.

¹⁸⁸ Section 12.

¹⁸⁹ Bank of England, HM Treasury and FSA *Financial Stability and Depositor Protection: Special Resolution Regime* (The Stationary Office, CM 7459, July 2008) at [3.27].

¹⁹⁰ See sections 8 and 9.

¹⁹¹ Bank of England, HM Treasury and FSA, above n 189, at [3.81].

¹⁹² At [4.8].

¹⁹³ Banking Act (UK), ss 90 and 99.

¹⁹⁴ Section 90.

¹⁹⁵ Bank of England, HM Treasury and FSA, above n 189, at [3.81].

¹⁹⁶ At [3.86].

¹⁹⁷ At [3.89].

¹⁹⁸ At [3.83]; and Banking Act (UK), s 126.

UK banks also have to comply with the EU directives. The Deposit Guarantee Directive (DGD) and the Bank Recovery and Resolution Directive (BRRD) are the most relevant directives. The DGD imposes an obligation on member states to have a deposit insurance scheme that must meet minimum standards.¹⁹⁹ This aims to harmonise the deposit recovery throughout the EU, and ensure that appropriate limits are set in each jurisdiction.²⁰⁰ For the purposes of this essay there are two requirements from the DGD not yet mentioned that are worthy of discussion. First banks must comply with a single customer view and second the government must ensure a purchase and assumption resolution is available.²⁰¹ A single customer view requires that at any point in time a bank must be able to identify the aggregate deposits for each of their customers. Therefore, if a customer has multiple accounts, or shared accounts, they need to be able to assess their total liability. This promotes the ability to ensure all payouts occur within 20 days.²⁰² A purchase and assumptive resolution is similar to the bridge bank tool outlined within the SRR. A healthy bank purchases the assets of a failed bank, and assumes their liability. This means that after the delay period the customer could open up their full account with the new institution. This is a way of acquiring an industry resolution, without requiring the government to use the insurance fund or bail out the bank.

The BRRD seeks to ensure that all EU nations have tools available to deal with failing banks. It intends to harmonise recovery and resolution regimes.²⁰³ More specifically the BRRD seeks to ensure mechanisms exist to prevent bank failures, make early interventions and ensure adequate resolutions.²⁰⁴ Two bodies are created to aid these objectives, the Single Supervisory Mechanism (SSM), and the Single Resolution Mechanism (SRM). The SSM is a body that monitors all the large banks within the EU in order to ensure that the banking sector is operating sensibly. They have the power to ensure compliance and set requirements banks must adhere to.²⁰⁵ The SRM establishes a Special Resolution Board (SRB) that is required to ensure the swift and sensible resolution of a failing bank.²⁰⁶ This structure aims to ensure that banks throughout the EU are regulated via similar standards, therefore maximising protection and the ability to resolve failing banks.

This analysis of the UK regulatory scheme surrounding the banking sector outlines the multitude of mechanisms in place to ensure bank stability and depositor protection. These mechanisms also extend internationally, the framework recognises the interconnectivity of financial markets and the importance that there are systems in place to ensure cross-border resolutions. The UK economy is far greater than New Zealand's,

¹⁹⁹ EU Directive on Deposit Guarantee Schemes, Art 3.

²⁰⁰ Niamh Moloney *EU Securities and Financial Markets Regulation* (3rd Ed, Oxford University Press, Oxford, 2014) at 844.

²⁰¹ European Commission "Press Release Database: Deposit Guarantee Schemes" <<http://europa.eu>>; Directive 2014/49/EU on Deposit Guarantee Schemes [2014] L173/149; and Directive 2014/49/EU on Recovery and Resolution of Credit Institutions and Investment Firms [2014] L173/190.

²⁰² Financial Services Compensation Scheme "Single Customer View" <www.fscs.org.uk>.

²⁰³ Maloney, above n 200, at 420.

²⁰⁴ At 421.

²⁰⁵ European Central Bank "Single Supervisory Mechanism" Banking Supervision <www.bankingsupervision.europa.eu>.

²⁰⁶ European Central Bank "Banking Union" Banking Supervision <www.bankingsupervision.europa.eu>.

therefore this structure cannot be used as a direct benchmark for the regulation expected. However, what is blindingly obvious is that UK regulation involves more sophisticated measures in place to prohibit bank failure. It also has clear and intricate regimes to ensure that if bank failure does occur, it can be dealt with efficiently and with minimal loss on customers. As affirmed by the UK structure and EU directives, preventative mechanisms alone are not sufficient. If bank failure occurs, it is important that mechanisms exist to ensure depositor loss does not occur. Currently, New Zealand's framework does not ensure this. New Zealand's framework is based on preventative measures, there being no mechanisms to adequately deal with depositor loss. As noted below the OBR does not satisfactorily protect depositors. Deposit insurance is necessary to bring it into line with our international counterparts.

VI *New Zealand's Experience of the GFC*

The GFC outlined that the financial safety net in many jurisdictions was not adequate. New Zealand was no exemption. This section will outline the flaws in New Zealand's financial safety net, which will provide context to why deposit insurance is necessary.

A New Zealand Financial Sector

The financial downturn at the beginning of the 21st century severely diminished New Zealand's financial sector. In 2006 only a handful of financial institutions were still standing.²⁰⁷ These failures were largely a result of poor internal governance. Arguably these issues were acquiesced by the Government due to the lax regulatory environment created. Financial institutions, were subject to minimal regulation relative to registered banks.²⁰⁸ The Securities Act 1978 imposed the bulk of the regulatory requirements on the finance industry. This required finance institutions to have trust deeds, release prospectuses outlining the financial condition of the company prior to issuing securities, and also established the Securities Commission, which monitored financial institutions.²⁰⁹ Minimalistic regulation was founded on market discipline regulating the finance sector.²¹⁰ There are two main problems with this assumption. Firstly, the likelihood of investors providing sufficient discipline on institutions was slim. In New Zealand retail investors provided roughly two-thirds of the funding for finance companies, many investing their retirement funds.²¹¹ These investors largely lack financial literacy skills, many are gullible, ignorant, and often would not equate higher interest rates with higher risk investments.²¹² Therefore little scrutiny and discipline was provided by a large proportion of the market. Additional to a lack of financial literacy, the investor vulnerability is exacerbated because investors are often blind to the torn incentives within the financial sector. Investors are attracted to investments via brokers, whom, along with financial advisors, are paid upfront, and therefore their profit is independent to the long-term stability of the sale.²¹³ Further evidence of the skewed

²⁰⁷ David Mayes "Getting the Right Balance between Regulation and Governance in the Non-Bank Financial Sector" (2010) 1(3) JGR 186 at 187.

²⁰⁸ At 187.

²⁰⁹ At 188. The Securities Act has since been replaced by the Financial Markets Conduct Act 2013.

²¹⁰ David Mayes, above n 207, at 188.

²¹¹ At 189.

²¹² At 189.

²¹³ At 190.

incentives is the fact that trustees' responsible for an institutions trust deed are paid fixed fees, they therefore lack fiscal incentives to insure the institution remained afloat.²¹⁴ If investors are aware of these skewed incentives they may provide greater scrutiny or more reluctance over investing. A second issue that questioned the viability of the reliance on market discipline to regulate financial institutions was the rarity for financial institutions to discipline each other.²¹⁵ The result of these factors is that in practice little market discipline was provided.²¹⁶ Therefore, the premise of having minimal regulatory requirements is largely void. The combined effect of minimal regulatory requirements, poor corporate governance and little market discipline is that investors are inherently vulnerable. This environment further supports the fact that deposit insurance is necessary to counter this vulnerability.

B South Canterbury Finance Ltd

South Canterbury Finance (SCF) was one of nine NBDTs that failed in New Zealand during the GFC. It was put into receivership on the 31st of August 2010 having an asset value of NZD 1.6-billion. This triggered the largest payout under the Crown Deposit Insurance Guarantee Scheme.²¹⁷ The journey of SCF through the GFC will be outlined to display the flaws in New Zealand's prudential regulation during the GFC.

On 19 November 2008 SCF's application into the Crown Retail Deposit Guarantee Scheme was approved.²¹⁸ At this point the company looked stable, they complied with the necessary prudential requirements, and had retained a rating of BBB- from 2006.²¹⁹ This stability was short lived. After the first four months of inclusion in the scheme SCF deposit base increased by 25%. This risk profile continued to increase even after concerns of financial instability arose.²²⁰

After the collapse of Lehman Brothers in 2008 there was a large disturbance to the wholesale funding market. Wholesale funding is important for short term funding within financial institutions. This resulted in disruptions to Australian and New Zealand banks.²²¹ To ensure stability in the short term funding market, in addition to the retail deposit guarantee schemes, in 2008 both jurisdictions implemented a wholesale funding guarantee scheme that guaranteed wholesale deposits up to NZD 1-million.²²² SCF's application into the wholesale funding insurance scheme was denied by the Reserve Bank. SCF failed to attain suitable capital levels above the regulatory minima.²²³ Therefore, the Treasury and Reserve Bank decided not to include them in the wholesale funding guarantee.²²⁴ Notwithstanding this decision, alarms surrounding the stability of SCF were not raised until late March in 2009 when concerns arose surrounding

²¹⁴ David Mayes, above n 207, at 191.

²¹⁵ At 189.

²¹⁶ At 189.

²¹⁷ Auditor General, above n 46, at 102.

²¹⁸ The Treasury "Chronology of South Canterbury Finance Limited in the Crown Retail Deposit Guarantee Scheme" (October 2010) at 4.

²¹⁹ At 6.

²²⁰ Auditor General, above n 46, at 93.

²²¹ Mayes, above n 207, at 192.

²²² At 192. South Canterbury Finance's capital level was 6.73%, only just meeting the banking intuitional minima of 6%, and did not meet the 8% level expected of finance industries.

²²³ The Treasury, above n 218, at 6.

²²⁴ At 6.

corporate governance, asset quality and related-party exposure of the company.²²⁵ In April 2009 the Treasury discovered that SCF breached their trust deed because they failed to obtain Crown consent and expert opinion prior to entering into new transactions.²²⁶ It was at this point that the Treasury launched a detailed investigation into the financial position of SCF. This revealed that SCF was likely to fail.²²⁷ This investigation, paired with the breach of the trust deed gave the Treasury grounds to eject SCF from the guarantee scheme. Rather than doing this, SCF's application to enter into the extended deposit insurance scheme was accepted. This decision was made with knowledge that SCF would not meet the new prudential requirements, that the risk management and governance systems were insufficient for the size of the company and that it was likely to fail.²²⁸ This decision was founded on the hope that a private sector solution would eventuate. A failure to include SCF would destroy this eventuality and likely result in an immediate failure. SCF effectively became too big to fail.²²⁹ On 31st of August 2010 the inevitable happened and SCF failed, triggering a payout of NZD 1,580.3-million to roughly 30,000 depositors.²³⁰ This payout was complicated by the fact that the Government decided to make the full payout to creditors personally to avoid unnecessary interest costs. They then tried to recoup costs through insolvency proceedings.²³¹

Despite warning signs existing in the lead up to the GFC, little adequate governmental action was taken. This reflects the poor detection and management mechanisms in place. The Government did try to introduce mechanisms, such as including financial institutions within the scope of the Reserve Bank and introducing the Crown Deposit Insurance Scheme. However, due to the pressure, the scheme was rushed, poorly drafted, and implemented too late in the game to inhibit many failures.²³²

One major problem evident from the failure of SCF is the existence of poor governance, both externally and internally. Minimal regulation is often useful to promote growth, however this only works if there is a clear social contract between institutions that ensures ethical behaviour, transparency and sensible management. During the GFC, these principles were violated.²³³ Rather than the government creating an environment that promoted growth, an environment existed that promoted excessive risk taking, and high levels of exposure. There was a lack of adequate minimal capital requirements and a failure by the Government, as an insurer, to monitor and supervise the insured institutions. Had monitoring occurred earlier, it is likely that the moral hazard created from the insurance would not have had such an adverse effect.²³⁴ This risk taking environment was aggravated by poor internal management of institutions. Ultimately resulting in the risk profiles of institutions increasing rapidly.

C The GFC and Deposit Insurance

²²⁵ Auditor General, above n 46, at 103.

²²⁶ At 103.

²²⁷ At 103.

²²⁸ At 104.

²²⁹ At 104.

²³⁰ At 116.

²³¹ Mayes, above n 207, at 189.

²³² At 190.

²³³ At 194.

²³⁴ At 193.

During the crisis many nations relied on deposit insurance schemes to foster depositor confidence and ensure financial stability. Many governments with pre-existing deposit insurance schemes felt it necessary strengthen depositor protection. Generally through expanding the coverage and scope of deposit insurance.²³⁵ Namely, 96% of governments extended the coverage of the scheme, and 36% of government's introduced a government guarantee over the deposits.²³⁶ It is doubted whether these nations had the fiscal ability to honour their increased obligations, especially because the insurance premiums often remained the same. These decisions were largely politically motivated responses to a rapidly destabilising market. Seeking to ensure confidence and financial stability. The hope being that the contingent liability would never eventuate.²³⁷ This tendency of governments to act rash during financial stability further strengthens the importance of deposit insurance in New Zealand. Such protection should be provided at a time where markets are stable. This ensures that the scheme's design will not be rushed, and that proper consultation and planning can occur. Rather than having to adopt an urgent scheme mid crisis. As evidence by the failure of SCF, this approach is inadequate.

VII *Analysis*

Thus far this paper has sought to identify the various regulatory methods used to ensure financial stability, with a focus on the role deposit insurance has in a jurisdiction's financial safety net. This section brings together the aforementioned ideas and outlines why deposit insurance is necessary in New Zealand. To aid this discussion the Reserve Bank's concerns surrounding deposit insurance will be outlined, and a bench mark for deposit insurance will be set and contrasted against New Zealand's circumstances.

A *The Reserve Bank's Rhetoric*

Following the GFC the Government announced that they had no intention of implementing a new deposit insurance scheme. Put simply, the Reserve Bank felt that the costs outweighed the benefits. The costs mentioned include the weakening of market discipline provided by depositors, an increase in moral hazard on banks and depositors, and administration costs arising from the implementation and the running of the scheme.²³⁸ It was accepted that retail deposit insurance would not affect the market discipline supplied through wholesale funding nor the risk of bank runs by wholesale investors.²³⁹ Therefore, because of wholesale funding, a framework with deposit insurance will still have some market discipline and some risk of banks runs.²⁴⁰ The benefits acknowledged by the Reserve Bank include an increase in the manageability of a financial crisis, and a decrease in the risk of depositor bank runs.²⁴¹ There would be less pressure for a governmental bailout and therefore more time to provide an adequate resolution.

²³⁵ Asli Demircug-Kunt, Edward Kane and Luc Laeven *IMF Working Paper: Deposit Insurance Database* (International Monetary Fund, 2014) at 14.

²³⁶ At 14.

²³⁷ At 17.

²³⁸ RBNZ Internal Memo, above n 9, at [31]–[39].

²³⁹ At [20] and [32].

²⁴⁰ At [34].

²⁴¹ At [21].

In the alternative to deposit insurance the Reserve Bank implemented the OBR to provide a mechanism to deal with bank failures. The Reserve Bank felt that the OBR paired with the implementation of the Basel III requirements and the increase of the core funding ratio, meant the risk of depositor loss was low. The OBR ensured that loss is borne primarily on the creditors and shareholders. This essay argues that such a decision is reckless because it gambles on the magnitude of the future financial instability. If financial shock is grave, then there is a serious risk to depositor loss. Since the efficacy of the Basel III requirements to absorb losses has been doubted,²⁴² a risk of failure, and therefore depositor loss is not negligible.

In the event of bank failure, the current regulatory framework puts immense pressure on the Government, either to allow a bank to fail, bail out it out, or haircut the liabilities. Neither of these options are appealing. Allowing an institution to fail in a small concentrated system has the potential to create a systemic risk.²⁴³ It also results in increasing the likelihood of future pre-emptive bank runs, and creates a contagion risk. Moreover, if the institution is too big to fail, the government may be forced to exercise a taxpayer bailout. Historically an implied government bailout existed, there was an understanding that upon financial instability the Government will step in. There was an implicit guarantee.²⁴⁴ Today's environment is different and governmental intervention is less foreseeable.²⁴⁵ This means that a taxpayer bailout is unlikely. This environment exacerbates the risk of depositor loss, and bank runs. Rather than a bailout, the Government is likely to invoke an OBR, and use their powers to freeze a portion of funds. This requires the Minister to give the funds a haircut. Consequently, the Minister will have to decide a limit, and from that amount up, funds are taken to fund the bail out. In other words, certain depositors could suffer drastically. Those with the most funds will be more sceptical, namely wholesale investors. As a result, this mechanism actually encourages wholesale bank runs. One way to protect depositors is for the Minister to implement a de minimus exemption, whereby smaller deposits are excluded from the haircut. This is subject to ministerial discretion, and therefore is unlikely to create the certainty needed to ensure confidence in the markets and therefore prevent bank runs. As noted by the run on Northern Rock, such an environment aggravates the risk of bank runs, and therefore bank failure.

The Reserve Bank is satisfied that the prudential standards set will ensure minimal loss on all deposits. However, the standard depositor is not an economist, and a rational response to potential bank failure is not to run the risk that minimal funds will be haircut, and instead run the bank. This accelerates bank failure. This is aggravated by the fact that financial instability can occur rapidly, as seen by the failure of Northern Rock. The consequence being that the Government may be forced to implement a poorly drafted scheme to rectify a systemic risk, or alternatively implement a taxpayer bailout.

All three options currently available to the Government upon bank failure are unfavourable. They carry a real risk of depositor loss. The financial safety net in New

²⁴² Wesemann, above n 15, at 36; and Independent Commission on Banking above n 76, at 9.

²⁴³ RBNZ Internal Memo, above n 9, at [15].

²⁴⁴ Geof Mortlock "How safe are our deposits if a bank fails?" (8 April 2016) Stuff <www.stuff.co.nz>.

²⁴⁵ Geof Mortlock "How safe are our deposits if a bank fails?" (8 April 2016) Stuff <www.stuff.co.nz>.

Zealand will be stronger if deposit insurance exists. The OBR paired with deposit insurance will ensure that all retail deposits are recovered, including those that would otherwise be frozen under an OBR. This provides depositors with certainty, decreasing the risk of bank runs. Despite wholesale funding not being insured, the threat of wholesale bank runs will also decrease. This results from the decrease in likelihood that wholesale funding will be subject to a haircut. It is accepted that the moral hazard will be exacerbated, however as outlined below this can be combatted through appropriate regulation and careful design. Erosion of market discipline will occur, but such a decrease is minimal because market discipline is still provided through wholesale funding.²⁴⁶ It is true that the implementation of disclosure regimes, and the publishing of credit ratios do reduce the information asymmetry between banks and investors, theoretically allowing depositors to make informed decisions. However, as aforementioned, depositors are not overly prudent. Therefore, even without deposit insurance little market discipline is supplied by retail customers, such customers are unlikely able to protect themselves. The corollary of this is twofold, first, deposit insurance should be adopted to remove this vulnerability. Second, the decrease in market discipline provided by retail depositors is likely to be insignificant, because the level previously provided was already minuscule.

B A Bench Mark

When considering how to design a deposit insurance scheme, it is appropriate to consider the internationally set principles for effective deposit insurance. These principles have been promulgated by the Basel Committee on Banking Supervision and the International Association of Deposit insurance (the Authorities) and are a useful benchmark for how a deposit insurance scheme should be designed. The Authorities outlined 18 core principles that can fall within ten groups.²⁴⁷ These groups will be discussed.²⁴⁸

1 Setting Objectives

When adopting deposit insurance, it is first essential to outline the public policy objectives. The objectives should be integrated into the design of the scheme. The overarching objective of deposit insurance is to protect depositors and contribute to the stability of the financial system.²⁴⁹ This protection should solely target those who need protecting. Namely, retail depositors and small business depositors, those not well placed to make informed assessments about the risk of bank failure.²⁵⁰ These objectives should be clearly and formally specified in the appropriate legislation. Secondly, the design and the wider financial system should be crafted to mitigate the moral hazard created through insurance.²⁵¹ This risk can be minimised by having risk-weighted premiums, limits on the amount insured and limits on coverage.²⁵²

²⁴⁶ RBNZ Internal Memo, above n 9, at [31].

²⁴⁷ Basel Committee on Banking Supervision and International Association of Deposit Insurances *Core Principles for Effective Deposit Insurance Systems* (Bank for International Settlements, Switzerland, 2009) at 2.

²⁴⁸ Many of the Authorities' principles overlap with points already raised. It is nonetheless beneficial to outline the specified groups.

²⁴⁹ Basel Committee on Banking Supervision, above n 247, at 2.

²⁵⁰ At 9.

²⁵¹ At 2.

²⁵² At 9.

2 *Mandates and Powers*

It is also necessary that the deposit insurer's mandate and powers are clearly outlined. Typically, the role of the insurer will take one of two options. It can be minimal, called a pay box system, where the insurer merely controls the funds and reimbursements. Alternatively, the insurer could have broad powers that extend to risk management and control over insured institutions.²⁵³

3 *Governance*

The insurer should be “operationally independent, transparent, accountable and insulated from undue political and industry influence”.²⁵⁴ Inevitably there will be overlap between the government and the insurer, however it is important that the operation and management over the organisation is stable and has clear processes. There should not be excessive reliance on the government.

4 *Relationships with other safety-net participants and cross-border issues*

As aforementioned financial stability will not be provided solely through deposit insurance. A wide financial safety-net is necessary. It is therefore important that if there are multiple authorities involved in ensuring financial stability that communication between those authorities is clear. The powers and limits of each authority should be certain, there should be close coordination and information sharing on a routine basis. Information sharing should also extend to insured banks. These arrangement should be legally formalised to ensure clarity.²⁵⁵ Similarly, cross-border issues should be addressed. Deposit insurance will likely overlap between jurisdictions. Therefore, a clear understanding between neighbouring jurisdictions relating to respective responsibilities during reimbursement is necessary. This cross-over should be reflected when setting premiums and levies.²⁵⁶

5 *Membership and Coverage*

Membership should be compulsory for all institutions that accept deposits from depositors that fall within the objective outlined in the first principle. This ensures adverse selection does not occur. It stops higher risk banks opting in and lower risk banks opting out.²⁵⁷ It is equally important that institutions are subject to strong prudential regulations and supervision to reduce the exposure to unnecessary risk. This is of particular importance if non-traditional banks are included, such as NBDTs. Typically, these banks operate at higher risk profiles and therefore are more likely to fall into financial difficulty. Secondly, the level of cover available to deposit taking institutions should be ascertainable, and certain.²⁵⁸ Coverage should not be arbitrarily assigned, it should be determined with reference to the policy objectives. It should ensure that the majority of depositors requiring protection are covered. This should be determined with reference to relevant statistical information, such as the size and distribution of deposits in banks.²⁵⁹ Coverage should be monitored and adjusted as

²⁵³ Basel Committee on Banking Supervision, above n 247, at 10.

²⁵⁴ At 10.

²⁵⁵ At 11.

²⁵⁶ At 11.

²⁵⁷ At 12.

²⁵⁸ At 12.

²⁵⁹ At 13.

necessary. If adjustment is necessary, especially if moving from unlimited coverage to limited coverage, transition should be rapid, and well published.²⁶⁰

6 *Funding*

As aforementioned there are three methods of funding, ex post, ex ante, or a hybrid system. The method used should be moulded to the circumstances of the country. Of primary important is that the cost of deposit insurance is borne by those who gain the benefit, the bank and their clients.²⁶¹ It is also vital that the funding procedure is transparent, clear and ensures prompt reimbursement.

7 *Public Awareness*

Effective deposit insurance requires the public to be informed on the scope, limits, and benefits of deposit insurance. Without this the success of the scheme will jeopardised. This is clear from the run on Northern Rock. Public education should promote confidence in the system, reach the entire community and occur through a wide ambit of channels.²⁶²

8 *Selective Legal Issues*

Two principles fall within this heading. First it is important that the deposit insurer and those working for them are provided legal protection for actions and decisions that further the mandate and are made in good faith.²⁶³ This protection should ensure diligence is exercised and deter conflicts of interests. Secondly, repercussions should exist for those at fault during a bank failure. There should be a clear system of accountability ensuring appropriate redress.²⁶⁴

9 *Failure Resolution*

The system for resolving banks should allow early detection and timely intervention. To ensure this it is important that banks are supervised and managed diligently, and that the various authorities involved in the scheme know their respective roles. To ensure that costs are minimised and recovery is maximised, interventions should be made early and the intervention process should follow a well-defined criteria.²⁶⁵ Resolution of banks involves three options, liquidation and reimbursement of claims, purchases and sales, and open-bank financial assistance. Furthermore an appropriate body should exist that can implement flexible mechanisms to preserve critical banking functions and assume liabilities of failed banks.²⁶⁶

10 *Reimbursing Depositors and Recoveries:*

If payments to insured depositors are necessary, the scheme should ensure prompt access to funds. There should be prior systems in place that allow the insurer to have the necessary information about the insured depositors. Depositors should be aware of the reimbursement process, when it can occur and the time limits involved. Upon bank

²⁶⁰ Basel Committee on Banking Supervision, above n 247, at 13–14.

²⁶¹ At 14.

²⁶² At 15.

²⁶³ At 16.

²⁶⁴ At 16.

²⁶⁵ At 17.

²⁶⁶ At 17.

failure, the management and recovery process should be guided by commercial considerations and the insurer should share in the proceeds of recoveries made.²⁶⁷

The Authorities saw these ten categories as vital to effective deposit insurance. The importance of having a wider system of financial regulation and systems in place to ensure stability was seen as paramount. This includes ensuring the existence of sound governance structures, clear disclosure regimes, strong prudential regulation and supervision and an ongoing assessment of the financial sector.²⁶⁸ These factors will be outlined below in relation to New Zealand's circumstances.

C Recommendation

Thus far this essay has outlined the various ways that financial stability can be achieved. What is evident from the failure of both Northern Rock and SCF is that conservative capital and liquidity requirements are necessary to buffer losses, however these alone are insufficient to ensure market stability. There must also be clear systems that monitor institutions, promote sensible management, and ensure depositor confidence. This section will first outline why the alternative mechanisms outlined in section four are inferior to adopting a well-designed deposit insurance scheme. Second, recommendations for deposit insurance in New Zealand will be made.

1 Self-Regulation

As aforementioned, one option to ensure financial stability and depositor protection is by allowing the industry to set market conditions. The rationale is that if the public is sufficiently educated, the industry will be forced to undergo industrial change. One potential consequence is the establishment of a mutual guarantee scheme. A mutual guarantee would likely promote stability if suitable minimal liquidity and capital requirements are also set. These could be set either by the government or by a state owned savings bank (such as Kiwibank). One large flaw in this approach is that in New Zealand the abolition of deposit insurance has not led to a mutual guarantee scheme. Therefore, depositors are still vulnerable. For a mutual guarantee scheme to exist, implementation would have to be legislated. Consequently, there would be a level of governmental involvement. This goes against the premise of such a scheme. A further issue is that industry self-regulation may not provide the depositor confidence necessary to inhibit bank runs. Following the failure of de-regulation that occurred during the GFC, depositors are likely to be pessimistic over whether the level of self-regulation sufficiently protects them. A mutual guarantee scheme effectively gives banks even greater control over deposits. Such an approach also fosters the potential for an institution to become too big to fail and therefore the creation of systemic risk, and forced government intervention. This is particularly worrying in New Zealand's concentrated financial sector with four major banks dominating the industry. For these reasons, a mutual guarantee scheme is not the ideal solution to deposit vulnerability in New Zealand.

²⁶⁷ Basel Committee on Banking Supervision, above n 247, at 18.

²⁶⁸ At 7.

2 *Ring Fencing*

As noted by the Vicker's Report and the implementation of the Banking Reform Act, ring-fencing is a mechanism that decreases market risk through differential legislation on institutions according to the types of activities and risks they engage in. In New Zealand during the GFC, only NBDTs failed, traditional banks did not. This signifies that ring-fencing may be appropriate. Historically applying the same regulation (deposit insurance) to banks and NBDTs resulted in a large disparity in risk profiles. An introduction of a ring fence around the retail banking system may insulate retail deposits insurance for wider risks in the financial system. Implementing deposit insurance solely for traditional banks has a similar effect to a ring fence. It has the same result of insulating banks from shocks that occur throughout the wider financial market. The major difference is that retail banks will still be able to engage in some investment activities; therefore, some market distortion could occur.

3 *Deposit Insurance*

I will now analyse New Zealand's conditions against the bench mark set by the IADI and Basel Committee to outline why deposit insurance is a beneficial addition to New Zealand's financial safety net.

The current regulatory environment leaves depositors inherently vulnerable, and the safety of their deposits subject to the whim of the Government. One of the main objectives of deposit insurance should be to target this depositor vulnerability. It should target unsophisticated depositors that are unable to diversify risk throughout banks, and have no skills to interpret and understand bank disclosures. Such as small businesses and individuals. It is submitted that due to the enactment of the Financial Markets Conduct Act 2013 and the 2014 amendment to the Credit Contract and Consumer Finance Act 2003, deposits in NBDTs do not need protection through a deposit insurance scheme. This legislation increases the level of disclosure required by lenders and the responsibility on the parties to ensure that consumers are well informed. It also introduces new standards expected of financial advisors. For these reasons, and the discrepancy in risk profiles between banks and NBDTs, it recommended that NBDTs are excluded from retail deposit insurance. Future research could investigate whether New Zealand would benefit from multiple insurance schemes, such schemes could include wholesale funding, or NBDTs. The benefit of having alternate schemes is that each scheme and the surrounding regulation can be designed to reflect the industry. Additional objectives of a deposit insurance scheme within New Zealand is to reduce contagion risks, reduce the risk of bank runs, and minimise systemic fiscal risks.

A question of particular importance is the mandate and powers given to the insurer. Whether the system should be a simple pay box system, or whether they should have regulatory authority. As outlined above, the Reserve Bank has a supervisory role over the financial sector. For this reason, a separate deposit taking body could be formed that is a subsidiary of the Reserve Bank.²⁶⁹ A level of overlap will allow insurer access to the information acquired by the Reserve Bank. This will also mean that the body can work alongside the Reserve Bank and monitor institutions to ensure that they operate

²⁶⁹ This would be similar to the design of the Australian deposit insurance scheme, where the insurer is a body of the Australian Prudential Regulatory Authority (APRA).

within sensible risk profiles and can make early interventions. Since the Reserve Bank already has the necessary regulatory power to ensure stability in the banking sector, it is unnecessary for the insurer to have independent regulatory power. The respective responsibilities of each party should be made clear, along with certifying that the two bodies work hand in hand to ensure the stability of the banking and wider financial sector. It is important that the supervisory and resolution powers within the Reserve Bank are kept separate to ensure that a potential conflict of interest does not arise. Having the deposit insurer a subsidiary of the Reserve Bank also results in government independence.

Membership should be compulsory for all traditional banks that accept retail deposits. Funding should be a hybrid system. Premiums should be proportionate to the risk of each institution and the opportunity to set levies to recover the full loss should exist. This decreases the moral hazard, as banks are incentivised to operate within sensible boundaries through being charged lower premiums. These premiums will largely be passed onto customers. This will encourage competition in the market. It is also more equitable than if no deposit insurance existed, because in such a scenario those customers of a failed bank would wear the whole loss, as opposed to it being spread throughout the banking sector. The level of coverage is a difficult question. To avoid bank runs it is important that the level of protection given is perceived as sufficient to protect depositors. Since the Reserve Bank believes that the OBR results in most of the loss being worn by the shareholders and creditors, this may mean that a higher limit can be set without a large increase in costs. Ultimately the depositor payout will be recouped through insolvency proceedings. The appropriate limit within New Zealand should be assessed against relevant statistical data. As aforementioned, a prima facie limit is NZD 100,000.²⁷⁰ There should also be supplementary credit available at the Government's disposal. Having a standby facility that allows the Government to loan money to a failing bank is useful in instances where the deposit fund may not cover the full loss. The Government could then recoup their funds during the insolvency proceedings or from future proceedings. To increase the likelihood that funds are recovered through insolvency proceedings, retail deposits should be made preferential to other unsecured creditors.²⁷¹

The bank run on Northern Rock outlines the importance of depositor education, and ensuring that the scheme provides adequate protection. As outlined an OBR scheme alone may not reduce the risk of bank runs. However, an OBR scheme paired with deposit insurance will. The guarantee of access to funds within 24 hours ensures prompt payment and removes the issues of delay outlined by Northern Rock. Public education should occur throughout multiple avenues to ensure that depositors are informed. The distinction between 'big' and 'small' banks should also be removed from the OBR. Currently an OBR can only be invoked if the bank has retail deposits of more than NZD 1-billion.²⁷² Banks below this deposit taking amount are dealt with through s 117. This mechanism does not allow for rapid payout, and depositors are not readily protected. Therefore, there is a large risk of bank runs, and pressure on the Government to intervene. A simple remedy is to extend the application of the OBR to all traditional banks incorporated within New Zealand.

²⁷⁰ See section II.

²⁷¹ Such as in Australia and the United Kingdom.

²⁷² Reserve Bank of New Zealand "Open Bank Resolution: Frequently Asked Questions" <www.rbnz.govt.nz>.

One final circumstance is the overlap between the Australian and New Zealand banking sector. One potential implication of the absence of deposit insurance is that informed depositors may choose to move their deposits into Australian banks to gain protection. A further implication is that since New Zealand's major banks are subsidiaries of Australian banks. A large shock through the Australian banking sector would likely be felt in New Zealand. Therefore it is important that the two jurisdictions take a coordinated approach and have clear mechanisms in place to deal with trans-Tasman failure.²⁷³ One available approach is through a single point of entry. This would entail injecting capital into the Australian parent bank, which will have beneficial flow down effects of stabilising the New Zealand banking sector.²⁷⁴ For this to be a viable mechanism, it is important that the two jurisdictions have clear respective responsibilities and understandings in place.

Currently New Zealand has good banking practises and sound records. However, so do many other countries with deposit insurance. New Zealand's circumstances do not justify this distinction. This is particularly evident from the comparative analysis with the UK. Despite the UK framework having multiple mechanisms to ensure stability and prevent bank failure, the framework still recognises that not everything can be predicted, and therefore deposit insurance is necessary to provide depositor protection in the event of bank failure. If deposit insurance is implemented New Zealand will no longer be an anomaly, and the wider financial safety net will be complete.

VIII Conclusion

This essay provides a robust understanding of deposit insurance and outlines why adoption is necessary in New Zealand. The current regulatory framework leaves retail depositors vulnerable, with deposit safety subject to ministerial discretion. There is a real risk of bank runs, and depositor loss, and no certainty or confidence in the level of recovery upon bank failure. The Reserve Bank's decision not to adopt deposit insurance is questionable and fails to acknowledge the ability to mitigate the shortcomings of deposit insurance, and the inadequacy of the OBR scheme to promote depositor confidence.

The UK framework was used as a benchmark for a sophisticated financial safety net. The comparative analysis revealed that not only does the UK have more complex measures in place to deal with bank failure and market instability. They also have a defined deposit insurance mechanism. This is sensible because of the inherent fluidity and unpredictability of the financial market. New Zealand's framework does not factor this into account, and as a result the risk of loss is placed on depositors, aggravating the risk of bank runs and a contagion risk.

Regulatory change in the banking sector is necessary to correct these faults. The recommendations suggested will put New Zealand in line with their international counterparts, while also ensuring depositors have minimum standards of protection.

²⁷³ See Reserve Bank *Memorandum of Cooperation on Trans-Tasman Bank Distress Management* (Reserve Bank of New Zealand, Information Release) for sufficient mechanisms.

²⁷⁴ Interview with Geof Mortlock, Financial Advisor (the author, Wellington, 15 September 2016).

This reform is crucial and well overdue. Especially when considering the temperament of the financial markets and the level of financial literacy within New Zealand. Future research should focus on whether multiple deposit insurance schemes are appropriate to ensure the protection of deposits held in NBDTs or wholesale funding.

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