

The Treasury

Reserve Bank Act Review Phase 2 Submission Information Release

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Safeguarding the future of our financial system

BNZ's submissions for:

Consultation document 2A – The role of the Reserve Bank and how it should be governed; and

Consultation document 2B – The Reserve Bank's role in financial policy: tools, powers and approach

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1 Introduction

- 1.1 Bank of New Zealand ('BNZ') has prepared this response to the second round of consultation of Phase 2 of the review of the Reserve Bank of New Zealand Act 1989 (the 'Phase 2 Review').
- 1.2 BNZ welcomes this opportunity to respond to the Phase 2 Review and acknowledges the significant work that has been done to present a wide range of potential legislative (and non-legislative) reforms that could help safeguard New Zealand's financial system.
- 1.3 For ease of reference, a summary of BNZ's key points is set out below, with BNZ's detailed responses set out in section 3.

2 Executive Summary

- 2.1 BNZ supports:
 - a) the in-principle decision to replace the Reserve Bank's existing "soundness and efficiency" financial policy objective with a single high-level objective to "protect and enhance financial stability" subject to further clarity on what "financial stability" means and including financial system efficiency as a lower tier objective;
 - b) an expanded role for the Reserve Bank Board as proposed on the consultation which should address some of the potential improvement opportunities identified in the review;
 - c) the appointment of a monitoring agency of the Reserve Bank to help ensure best practice principles continue to be used by the Reserve Bank - BNZ would prefer this to be an international panel or agency with specific global expertise in prudential regulation;
 - d) expanding the scope of the regulatory perimeter to promote a level playing field including in relation to foreign branches;
 - e) further consultation on the potential for a depositor protection regime including its design and how it is balanced with the requirements of the broader financial safety net system;
 - f) replacing conditions of registration with prudential standards (supported by guidelines);
 - g) increased resourcing for the Reserve Bank to enable more intensive supervision across the sector; and
 - h) further review of the bank crisis management regime outside of this Phase 2 review, to ensure it remains in line with international best practice.

Should Treasury have any questions in relation to this response, please contact:

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3 What financial policy objectives should the Reserve Bank have?

- 3.1 BNZ supports the in-principle decision to replace the Reserve Bank's existing 'soundness and efficiency' financial policy objective with a single high-level objective to 'protect and enhance financial stability' subject to greater clarity on what this objective means. We refer to the NZBA's submission on this point particularly the need to include a definition of financial stability
- 3.2 BNZ supports the addition of lower tier objectives to provide further clarity to the Reserve Bank in its financial policy functions. In our view it is important to expressly state financial system efficiency as a lower tier objective to ensure that financial stability benefits are assessed against economic costs/ regulatory burdens.
- 3.3 BNZ agrees that climate change, and society's response to it, present financial risks to the insurance industry and the economy more generally. BNZ considers that the proposed new financial stability objective is broad enough to legitimise action aimed at mitigating the financial risks of climate-related factors. BNZ is mindful that formalising a climate change objective for the Reserve Bank could lead to overlaps with other government policies and create dual climate change reporting obligations. To mitigate these risks, any climate change objective would need to be assessed alongside the Climate Change Response (Zero Carbon) Amendment Bill to ensure consistency of outcomes and reporting requirements.
- 3.4 BNZ strongly supports creating a new "Deposit Takers Act" that combines material from the NBDT Act with the Reserve Bank Act's banking regulation material. It considers this is necessary to give effect to the in-principle decision to bring the bank and NBDT regulatory regimes together in a single "licensed deposit taker" framework in a meaningful and simple way. Moreover, such a move has the potential to "level the playing field" between banks and NBDT institutions. To the extent possible, regulatory requirements need to be consistent across banks and NBDT institutions. If this is not the case, differences in the regulatory framework faced by these two different types of institutions create the potential for disintermediation. However, BNZ is mindful of the need for this to be done in an efficient and effective way which does not hinder competition or impose undue costs on participants or customers. The need for this to be a well regulated and efficient bank and NBDT sector should be considered when designing the prudential framework for both banks and NBDTs.
- 3.5 Assuming that the overarching policy objectives are well defined in primary legislation, BNZ supports introducing a financial policy remit to provide guidance for certain key policies such as macro -prudential policy. This is because policy remits can evolve and change more easily than primary legislation in response to changing circumstances, making them a more flexible instrument and, importantly, ones that are remote from political influence in times of stress or crisis. However, the flexibility of the financial policy remit must always be bounded by adherence to well-defined legislative policy objectives.

4 How should the Reserve Bank be governed?

- 4.1 BNZ agrees with the in-principle decision to establish a new governance board with statutory responsibility for all Reserve Bank decisions (except those reserved for the MPC). Establishing an independent governing board is particularly important given the significant responsibilities and power that the Reserve Bank has. BNZ considers there are good precedents of this structure with well-functioning regulatory boards in New Zealand e.g. the Financial Markets Authority. However, BNZ is keen to ensure that the benefits of the new structure do not impede the ability for the Reserve Bank and its Governor to make decisions rapidly, particularly in times of stress. During the Global Financial Crisis, BNZ experienced the value of the speed of a single decision maker and is wary of losing this with an overly burdensome board or other governance structure. However, BNZ considers that this risk can be mitigated by the following:
- a) The appointment of independent board members with significant experience and skills in prudential regulation and governance. BNZ considers that the board should be predominantly made up of non-executive members. However, BNZ does not consider that there is merit in having representation from the FMA or Treasury on the board but would support including the CEO as an executive member on the board. It is BNZ's view that including an executive director on the board is appropriate given the complexity of financial policy. BNZ considers that an executive director is likely to assist the board to take difficult decisions.
 - b) Allowing for significant delegation of powers from the board to the CEO including all crisis management decisions. However, BNZ would expect that the Board would need to approve the Reserve Bank's key policy direction. BNZ notes the concerns the Consultation Document outlines with extensive delegations to the CEO but considers that these can be dealt with via CEO notifications and post-event assessments.
- 4.2 BNZ agrees that in addition to an independent board, the Reserve Bank needs an external monitoring agency. However, it is not convinced that the Treasury, as currently structured, would be optimal for this role. BNZ thinks it imperative that the entity monitoring the Reserve Bank should be informed by international best practice with specific skills in monitoring prudential regulators. BNZ considers that a specialised international monitoring agency of prudential regulators would be better placed to perform this task. A review by an international panel could be regularly scheduled with pre-determined terms of reference that would allow specific expertise to be sought, depending on the New Zealand environment at that time, or findings from international reviews e.g. IMF FSAP.
- 4.3 BNZ supports reclassifying the Reserve Bank as an Independent Crown Entity to make it structurally consistent with other public independent institutions.

5 How should the regulatory perimeter be set?

- 5.1 BNZ welcomes the in-principle decision to bring the bank and NBDT regulatory regimes together into a single "licensed deposit taker" framework.

- 5.2 As part of the decision to bring non-bank deposit takers and registered banks into the same regime, BNZ considers it is appropriate to also review the compliance requirements of **all** entities to ensure they are working fairly and ensuring a level playing field across different types of institutions. In this regard BNZ considers that the compliance requirements of banks that operate in New Zealand as branches of overseas-incorporated banks are also reviewed as part of setting the regulatory perimeter.
- 5.3 In principle BNZ supports tailored approaches for institutions of different scales or with specific business models. For example, the Reserve Bank could impose higher threshold requirements based on systemic impact in terms of the size and complexity of the entity. However, BNZ would caution against material differences in compliance requirements. This is imperative if one of the goals is to achieve a level playing field between all entities providing similar services. Therefore, its preference would be for a standard rulebook approach where exceptions could be made on application to the Reserve Bank by entities meeting specific criteria.
- 5.4 In particular, BNZ has concerns that locally incorporated bank regulatory requirements are currently not uniformly applied to foreign branches operating in New Zealand creating regulatory arbitrage rather than creating a level playing field. This setting disadvantages locally incorporated banks that do not have parent branches to share the regulatory burden with. This would not be an issue if, for major bank branches, the APRA and Reserve Bank supervisory regimes were harmonised. On that basis BNZ submits that the regulatory requirements of all foreign branches should be harmonised with locally incorporated banks. BNZ further notes that if financial and governance requirements of foreign branches were harmonised with domestic banks, it may reduce the attractiveness of using foreign branches and create a level playing field.
- 5.5 In addition, given there is a finite saving pool in New Zealand, foreign branch deposit taking activities should subject to limits. This would assist locally incorporated banks from over-reliance on offshore wholesale funding markets to meet their core funding gap shortfalls.
- 5.6 BNZ also proposes that the Reserve Bank reviews branches of non-resident banks that operate outside Basel III framework before they can offer core banking services ie retail banking and/or deposit taking. Compliance with the Reserve Bank banking supervisory regime should be a central component of whether a branch can be established by a non-resident banking institution. For branches that originate from supervisory regimes that are not harmonised with Basel disciplines there should be defined requirements to establish board of directors/ executive management of high -calibre to safeguard investors and depositors. This should include requirement to establishment of board committees that oversee funding, liquidity capital and risk management.
- 5.7 In support of its submission on this point BNZ refers to: OECD: The Conditions For Establishment Of Subsidiaries And Branches In The Provision Of Banking Services By Non-Resident Institutions¹ and the extracts set out in the Appendix.

¹ <https://www.oecd.org/daf/fin/financial-markets/Conditions-for-establishment-in-the-provision-of-banking-services.pdf>

6 Should there be depositor protection in New Zealand?

- 6.1 BNZ agrees with the description of the financial safety net and that all 5 elements are needed for the smooth functioning of the financial system. However, BNZ queries whether the details of the 5 elements of the financial safety net as currently proposed are well balanced. In addition, BNZ supports the in-principle decision to introduce a depositor protection regime provided that its impact on the broader system risk profile is considered as part of the design e.g. capital settings.
- 6.2 In particular, BNZ notes that the current Reserve Bank capital consultation proposes very conservative capital buffers on the basis that this will reduce the chances of banks failing in New Zealand. While the government has made provisional decisions around deposit insurance, these need to be considered alongside the proposal to increase bank capital and cannot be developed as independent policies. For example, if the Reserve Bank does instigate significantly higher capital requirements, then the costs of a deposit insurance should be minimal and funded on an ex-post basis (discussed further below). Alternatively, if depositor protection is introduced in its proposed form, the proposed capital settings should be reconsidered.
- 6.3 BNZ's strong preference is that depositor protection is funded on ex-post basis to reduce the cost to customers in the form of higher borrowing costs and lower returns on deposits. This is model followed in Australia where appropriation is made to cover the scheme with first ranking claim on the assets of the liquidated bank. The ex post basis sends better signals to the market and depositors rather than incentivising bank to pass charges to depositors especially in low interest rate cycles.
- 6.4 If ex ante deposit protection levy is charged, BNZ submits that the levy should be based on differentiated risk premiums tied to the credit worthiness of the underlying bank as determined by the rating agencies. Whilst an argument can be made that a risk-based levy is de stabilising to investors, the reality is that well governed, strongly capitalised banks are more credit worthy than institutions in the opposite spectrum. Deposit insurance should not be perceived as a subsidy for higher risk banks. A risk-based fee instils a level playing field for insured deposit takers. BNZ notes that charging a higher price for insuring deposits at riskier banks will increase the complexity and administrative costs of a deposit insurance scheme. Inevitably implementing a deposit protection scheme will involve considerable administrative expense and BNZ submits that more thought needs to go into how the depositor protection scheme will be structured and funded.
- 6.5 In line with international regimes, BNZ considers that depositor protection should have a combined objective of protecting depositors from loss and contributing to public confidence and financial stability. However, BNZ does agree that it may be difficult to achieve the second limb (to contribute to public confidence and financial stability) via the introduction of depositor protection alone. To achieve this objective, BNZ considers that a publicity campaign would be required as the examples described in the consultation document, along with the survey conducted as part of the consultation, make it clear that

depositor protection may not be widely understood by the general public. BNZ would be happy to participate in this communication exercise.

- 6.6 BNZ considers the proposed per-depositor insurance limit of \$30,000-50,000 is very low. As well as having a limited effect on depositor confidence this low limit is also likely to lead to depositors splitting their accounts to take advantage of the protections, which would lead to higher (total) account costs.
- 6.7 In respect of level playing field foreign resident banks and branches should be compelled to join the Reserve Bank host country depositor protection arrangements as well as home country deposit protection. This will increase the transparency of depositor protection as host country deposit protection schemes will differ from that implemented by Reserve Bank, creating potential de stabilising behaviours among depositors.

7 What prudential regulatory tools and powers should the Reserve Bank have?

- 7.1 BNZ's perspective is that the extensive use of delegated powers by the Reserve Bank has not been problematic. BNZ's experience is that the rules have needed to change overtime to adapt to changing economic conditions and there have been benefits in enabling this swiftly. To the extent that there is a perception that there needs to be a greater check on the use of delegated powers BNZ considers this can be achieved by a new governance board structure and independent monitoring of the Reserve Bank. BNZ does not consider that any further safeguards are required in addition to those identified in the consultation ie:
 - a) increase in the specification of objectives;
 - b) modernise the Reserve Bank Act in areas where the framing of functions and powers would benefit from improved safeguards; and
 - c) provide greater clarity on the intended scope of delegated legislation and administrative instruments.
- 7.2 BNZ agrees that the Consultation Document appropriately identifies the key issues with the current framework for setting prudential rules. BNZ understands that Conditions of Registration ("CoRs") are a unique form of rule-making power and not without issues. BNZ's key concerns with ongoing use of CoRs is that they can be ambiguous and without clear guidance, can create compliance challenges – as discussed in the Consultation Document in relation to the original Outsourcing Policy. However, in BNZ's experience CoRs have not been abused and their flexibility has also been beneficial. That said, BNZ does think that replacing CoRs with prudential standards (supported by guidelines) and regulations for matters which are of particular significance is warranted on the basis that:
 - a) they have a more rigorous drafting process; and
 - b) the market would benefit from greater clarity and consistency in the drafting of these.

- 7.3 BNZ supports the introduction of a legislative requirement for registered banks to report material breaches of rules to the Reserve Bank as soon as practicable and has been working closely with the Reserve Bank as it formulates a new policy along those lines.² In addition, BNZ also supports removing criminal liability for breaches of prudential rules that do not involve a fault element.
- 7.4 BNZ agrees that it is important to establish conduct expectations and incentivise compliance for executives and senior management. BNZ has already stated its in principle support for the introduction for New Zealand of a regime similar to the Australian Banking Executive Accountability Regime (BEAR) in its submission on the Ministry of Business, Innovation and Employment's Options Paper regarding the Conduct of Financial Institutions.
- 7.5 As well as ensuring that senior individuals are held accountable for the entity's efforts to meet the conduct duties, BNZ considers that a BEAR-like regime is likely to be able to drive the desired cultural change within financial services entities, which has been signalled by multiple regulators across Australia and New Zealand recently, including in terms of conduct expectations. BNZ considers that a BEAR-type regime is therefore preferable to a legislative liability-imposing framework (such as under the FMC Act or the Reserve Bank Act).
- 7.6 We also observe that the NAB Self-Assessment on governance, accountability and culture, published in November 2018 (and modelled on the APRA Prudential Inquiry into CBA) viewed the introduction of Australian BEAR as having positively impacted accountability within the organisation. The Report noted that "At the Board and [Executive Leadership Team] level, the focus on assigning and ensuring clarity of accountability, has recently improved with the introduction of BEAR....those ELT members recently appointed to new roles further observed that the Accountability Statements [which are a core aspect of BEAR] provided for greater discipline and rigour in managing handovers, particularly understanding the status of risks and issues...BEAR is improving clarity of accountabilities and is motivating a focus on the practices that support their demonstration at the ELT and Board level" (pp 43-44 of NAB Self-Assessment).

8 How should the Reserve Bank supervise and enforce prudential regulation?

- 8.1 BNZ considers that the Reserve Bank's "relationship led" approach to supervision has worked well to date. It also considers that the current enforcement regime has sufficient deterrents to ensure bank boards are very focused on compliance with the prudential policy framework. That said, it would be imprudent to ignore the FSAP results that the Reserve Bank has received in relation to effective supervision and supervision techniques and tools. BNZ is sympathetic to an argument that the Reserve Bank's approach to supervision should be strengthened and considers this is largely because insufficient

² <https://www.rbnz.govt.nz/regulation-and-supervision/banks/consultations-and-policy-initiatives/active-policy-development/public-disclosure-of-bank-breaches>

- resourcing has curtailed its ability to undertake more intensive supervision. BNZ supports an increase in resources at the Reserve Bank for supervision.
- 8.2 BNZ submits that greater supervision would assist a deeper understanding on bank's business and the complexities and nuances. Supervisors clearly need to be knowledgeable in their understanding of the prudential rules but also the entities business models, entities' business strategies, the inner workings of their risk management and internal control processes. Without this, the asymmetries in information are material and there is a risk that the Reserve Bank can oversimplify risks and responses. BNZ is optimistic that more intrusive supervision would result in greater clarity in interpreting rules and setting benchmarks for the industry. In addition, BNZ would expect that a better resourced supervisory division would assist in greater engagement with the Reserve Bank on requests for approvals, authorisations and non-objections.
- 8.3 A consequence of the Reserve Bank's limited resourcing is that New Zealand banks are increasingly subject to extra-territorial regulation. This is particularly acute in the international markets regulation where the Reserve Bank resourcing may force it to take a "wait and see" approach to respond to recent international requirements for derivatives regulation. The consequence of this approach is that New Zealand banks, unable to rely on any "sufficient equivalency" exemptions, are directly subject to the requirements of international regulators.
- 8.4 BNZ also supports a more intensive approach to verifying supervisory information and thinks this could enhance the existing open and effective communication between the Reserve Bank and supervised entities. This is primarily because BNZ expects this will result in increasing the Reserve Bank's depth of understanding of registered banks. BNZ is open to how the Reserve Bank achieve this. BNZ is subject to APRA on-site inspections that the Reserve Bank participates in and would welcome more on-site inspections either spot-check inspections or regular on-site inspections if these were deemed beneficial to the Reserve Bank.
- 8.5 BNZ has no comment on the enforcement tools for the Reserve Bank. However, it strongly supports the independence of the Reserve Bank to set its own approach and take decisions independent of political interference. With that in mind BNZ considers that the Reserve Bank should be able to deregister a Bank without reliance on Ministerial approval.

9 What features should New Zealand's bank crisis management regime have?

- 9.1 BNZ agrees that New Zealand's crisis management framework needs a detailed and thorough review and supports the staged approach suggested by Consultation 2B. BNZ is conscious that overhauling New Zealand's bank crisis management framework is a significant piece of reform that will require extensive re-evaluation of existing policies particularly BS11. That said BNZ provides its initial thoughts to the specific questions below.

- 9.2 BNZ supports clarifying the Reserve Bank’s role as the sole resolution authority for New Zealand banks and we do not see any other viable alternatives to the Reserve Bank as the resolution authority. It also supports giving the Reserve Bank the power to exercise resolution tools as well as a statutory manager.
- 9.3 BNZ agrees that the current role of the Minister in the resolution framework is not appropriate. Ministerial consent should not be required for all types of directions and it is imperative that the Reserve Bank can respond rapidly in times of stress. In addition, it does seem unbalanced in the current model that the Minister is so involved but only in a reactive way. BNZ expects that it would be more appropriate for Minister to be engaged early and expects that would be inevitably the case ‘behind closed doors’ if a New Zealand bank was distressed but agrees that the Minister should only have powers to direct actions in extreme circumstances e.g. when public funds are at risk or wider economic issues need to be considered.
- 9.4 BNZ supports the introduction of express bail-in powers to the Reserve Bank Act’s suite of resolution options. However, BNZ considers further consultation is required to determine the mechanics of the bail-in structure and details of the unsecured liabilities or other instruments available to bail in.
- 9.5 BNZ does not support the recapitalisation of a failing large bank be funded through industry-wide levies or the establishment of an industry resolution fund in addition to any depositor protection scheme. In this respect, BNZ submits that the design of the depositor protection regime needs to be considered with the new bank crisis framework and the bank capital requirements to ensure all of these policies work effectively together.
- 9.6 The BNZ supports introducing explicit protection for bank directors during resolution both with respect to their continuous disclosure objections but also considered in relation to their Company Act 1993 duties. Without this, it is difficult to see how directors can continue to act when a bank is distressed, and resignation of directors would clearly accelerate a stressed bank’s decline.
- 9.7 BNZ considers that APRA needs to be engaged in the design of New Zealand’s crisis management framework particularly any bail -in regime.

10 How should the Reserve Bank coordinate with other agencies?

- 10.1 BNZ supports proposals to increase coordination across agencies. BNZ operates in a complex regulatory space with a number of regulatory and legislative overlaps. For example, in BNZ’s recent submission on a new conduct regime for financial institutions potential legislative overlaps were identified with:
 - a) the Credit Contracts and Consumer Finance Act 2003 (“CCCFA”),
 - b) the Fair-Trading Act 1986;
 - c) the Financial Markets Conduct Act 2014;

- d) the Consumer Guarantees Act 1993;
- e) the Financial Services Legislation Amendment Act 2019 and the accompanying disclosure regulations for advice to retail clients;
- f) the insurance contract law review;
- g) the proposal to increase the protections available to whistle blowers under the Protected Disclosures Act 2000;
- h) MBIE's Review on protecting businesses and consumers from unfair commercial practices;
- i) the Financial Service Providers (Registration and Dispute Resolution) Act 2008;
- j) the review of Section 36 of the Commerce Act, relating to the misuse of market power;
- k) the Farm Debt Mediation Bill; and
- l) the NZBA Guidelines to help banks meet the needs of older and disabled customers.

10.2 Given this BNZ considers that it is very important that all relevant regulators and government departments are working together for consistency of outcomes and liability settings to ensure there is sufficient certainty for industry participants and that the ultimate customer and societal benefits are delivered.

11 How should the Reserve Bank be funded and resourced?

11.1 BNZ recognises that to achieve the proposals discussed in the Consultation Document, the Reserve Bank will require additional funding. BNZ is supportive of the introduction of an industry levy to fund the Reserve Bank's prudential supervisory function.

APPENDIX

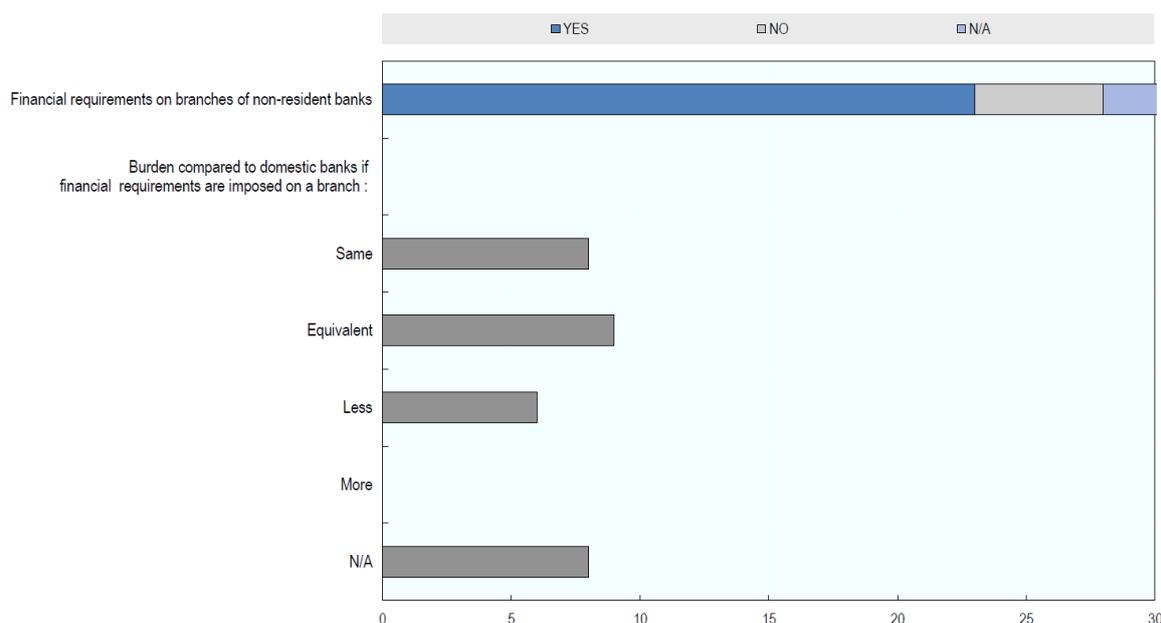
RELEVANT EXTRACTS FROM OECD: THE CONDITIONS FOR ESTABLISHMENT OF SUBSIDIARIES AND BRANCHES IN THE PROVISION OF BANKING SERVICES BY NON-RESIDENT INSTITUTIONS

A. Financial requirements and prudential considerations

Various types of prudential measures may be imposed on banks/credit institutions, including financial requirements such as minimum capital requirements, financial guarantees and asset pledges

The majority of jurisdictions do impose financial requirements on branches of non-resident banks/credit institutions (Figure 15). The requirements include, in addition to the types of measures listed in the paragraph above, liquidity requirements such as the Basel Liquidity Coverage Ratio requirement or alternatively the Minimum Liquid Assets requirement (e.g. Singapore). Branches of non-EU banks/credit institutions based in jurisdictions considered equivalent to the European banking regulation (i.e. Canadian, Japanese, Swiss, and the US) are not subject to the EU capital regulation requirement and directive (CRR/CRD4). Branches of non-EU banks/credit institutions established in countries other than those considered equivalent are subject to the banking regulation applicable to domestic banks (e.g. Italy).

Figure 15. Financial requirements imposed on branches of non-resident banks/credit institutions



Source: OECD Survey on the Conditions for Establishment of Subsidiaries and Branches for the Provision of Banking Services by Non-Resident Institutions (2015).

B. Methodology for the calculation of capital ratios and financial requirements

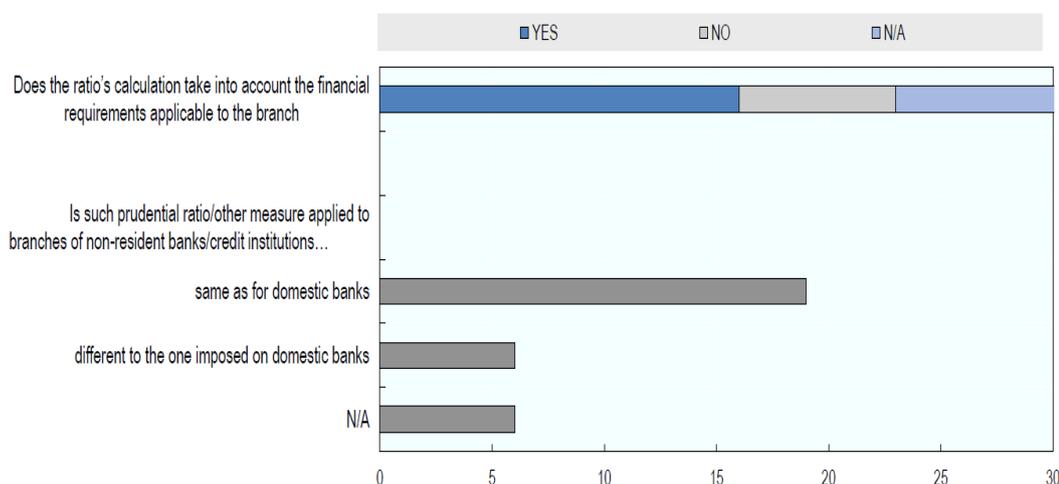
Under the Codes, ratio measures used for prudential or other purposes should be no less favourable when applied to the branches or agencies of non-resident institutions than the ones applied to domestic institutions. Whenever a ratio or other measure is used for prudential or other purposes, full account should be taken of the total amount of any financial requirements that have been met in

the establishment of branches or agencies and of any financial contribution of the same nature that has been provided in excess of such requirements.

In most cases, the types of ratio measures applied to branches of non-resident institutions were considered to be the “same” as for domestic institutions (Figure 16). For a few, the question itself is not applicable either because they do not allow branching by non-resident institutions or because they do not impose capital or financial requirements on branches of non-resident institutions (e.g., Australia, Estonia, New Zealand, Switzerland, UK), even when these measures may be imposed on domestic credit institutions. In Canada, a branch is not required to maintain capital ratios but they must maintain a deposit in Canada with a Canadian financial institution equal to at least 5% of their Canadian liabilities.

Figure 16. Methodology for the calculation of capital ratios and financial requirements of foreign branch vs. domestic banks

Figure 17. Calculation of ratios and financial requirements applicable to the branch



Source: OECD Survey on the Conditions for Establishment of Subsidiaries and Branches for the Provision of Banking Services by Non-Resident Institutions (2015).