
SPEECHES

Financial system regulation in New Zealand

Alan Bollard, Governor, and Tim Ng, Manager, Financial System Policy,
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This paper discusses the Reserve Bank's role in the regulation of the financial system. It begins by outlining the importance of the "infrastructure" supporting financial activity – that is, the framework of applicable statutory law, administered policy, contracts, codes of conduct, corporate governance, and dispute resolution processes. Then, we discuss the Reserve Bank's objectives and our approach to the exercise of our powers. As the Reserve Bank is one of a number of financial regulators in New Zealand, we touch on how our responsibilities fit into the overall regulatory system applying to the financial sector. We make some observations about the special character of the New Zealand financial system, how it is changing, and the implications for financial regulators. Finally, we discuss some current policy work at the Reserve Bank on these issues.

Infrastructure for a sound and efficient financial system

Financial firms accept funds from customers and investors, and transform those funds into financial products carrying a range of risk, return and liquidity characteristics. These products are then offered for sale into the marketplace. Given that financial products are obligations to deliver value in the future, the importance of a sound, robust and transparent framework of rules governing those obligations cannot be overstated. In order for the financial system to perform effectively, the rules must appropriately define the meaning of the obligations, their proper execution, and their enforcement.

At the highest level, rules may be set by statute. In New Zealand, a number of pieces of legislation govern the financial system. The activities of particular kinds of financial institutions may be regulated – for example, by the Reserve Bank of New Zealand Act for banks and by the Life Insurance Act for life insurers. As corporate businesses, financial institutions are also subject to the various statutes defining general business law, such as the Companies Act, the Commerce Act and the Fair Trading Act.

The manner in which financial products may be offered may also be regulated. For example, the Securities Act specifies disclosure and prospectus issuance requirements for securities offered to the public, and the Credit Contracts Act places certain restrictions on advertising content related to consumer loans.

Rules may also be made by government agencies, in cases where they have been empowered by legislation or Ministerial directive. Examples include the rulemaking powers given to the Reserve Bank by the Reserve Bank of New Zealand Act, and to the Ministry of Economic Development by the Securities Act.

Outside the realm of rule-making by Parliament and by government agencies, financial institutions have the ability to enter into contracts with their customers, setting and agreeing to abide by rules defining their rights and obligations with respect to those customers. Financial institutions may also bind their own behaviour through industry-agreed codes of conduct and guidelines for market practices. Finally, as a matter of good corporate governance, individual institutions will typically make internal rules to ensure that the institution's obligations are exhaustively identified and discharged.

All these different means of making rules have a role to play in increasing affected parties' mutual understanding and

acceptance of respective rights and obligations. Such mutual understanding is a crucial component of the actual process of adding and selling value in a financial service.

For any particular kind of financial activity, the particular rule-making device chosen to set parameters around conduct should suit the circumstances, considering the risk and value at stake and the costs and risks of the rule-making device itself. The making of rules should also recognise the limitations of rules. An example is in the area of corporate governance, about which much has been written and said recently (including by the Reserve Bank).

It is certainly true that rules can be made with the aim of improving corporate governance and good business practice. There is, of course, an extensive debate currently about the proper regulatory response to the recent spectacular failures of large, complex firms such as Enron, Worldcom and, closer to home for New Zealand, HIH. In response to the belief that poor corporate governance contributed significantly to these failures, some countries have responded with regulation to corporate governance – for example, the Sarbanes-Oxley Act in the United States.

These debates and initiatives are no doubt worthwhile, but they should not neglect the fundamental importance of ethics at every level of an organisation. Good ethics by their nature are difficult to prescribe in law. Leadership throughout organisations in this area is crucially important, and transparency is probably helpful too.

A third element of sound infrastructure for the financial sector, alongside rules and ethics, is efficient and effective dispute resolution procedures. Such procedures are necessary to cover the inevitable cases where the parties affected by a rule disagree on what constitutes a fair and reasonable interpretation of what was agreed to.

Just as in the case of rule-making devices, in dispute resolution, “horses for courses” applies. There is in New Zealand a well-defined escalation process for financial services complaints, from taking the complaint first to the financial institution, then if necessary to the applicable Ombudsman's Office, then if necessary through the normal judicial process.

The Offices of the Banking Ombudsman and the Insurance and Savings Ombudsman are not statutory bodies, and participation by financial institutions is voluntary. It appears

that most, if not all, significant financial institutions participate. The role of these offices is to assist customers of banks, insurance and savings companies resolve their disputes with their financial institution in an impartial manner, over matters involving monetary sums up to specified limits.

Rules and enforcement processes are particularly important when things go wrong, for whatever reason. In the case of financial institutions, problems may escalate and spread very quickly and constitute, in central banking jargon, systemic events. Systemic events are those in which one institution's distress is not adequately contained within that institution, but spreads to materially weaken other financial institutions. Distress may spread through the exposures financial firms typically have to each other, and through confidence effects affecting the wider financial system. Our interest in the infrastructure supporting the financial system is motivated by the belief that good rules, ethics and dispute resolution contribute importantly to reducing the likelihood that small problems will turn into large ones.

RBNZ's role and objectives in banking supervision

The New Zealand financial system, like those in other countries, is subject to regulation by a number of authorities for a variety of purposes as specified in legislation. As in all countries, the mix of regulatory measures is designed around a balance of systemic, institutional and consumer protection. And as for other systems, sometimes these objectives will be conflicting, with measures intended to protect some parties inadvertently skewing incentives for other parties. To address these sorts of issues, our system recognises the need for cooperation between regulators, and there is regular dialogue among us to this end.

For its part, the Reserve Bank is charged with registering and supervising banks for the purposes of promoting soundness and efficiency in the financial system, and the avoidance of significant damage to the financial system resulting from the failure of a registered bank. In practice, this focus on banks covers the vast bulk of the financial system. The non-bank financial sector is growing quite strongly, but over 90% of total assets in the system continue to be held in banks.

Banks are also important because of their core position in the payments system – performing functions vital to the performance of the wider financial industry and economy. During normal times, the operations of the payment system are probably both out of sight and out of mind for the vast majority of people. But in times of financial distress, disruptions in payments systems may have much more dramatic consequences and effects on the wider economy.

The banking system is itself dominated by five large banks, which together account for around 85% of all assets held in the banking system. These banks are all foreign-owned, with four being owned by Australian parent banks and one by a UK parent bank. This high degree of foreign ownership by large offshore parent banks has particular implications for the design of our regime, which we discuss later.

As noted, the Reserve Bank's regulatory focus is on systemic soundness and efficiency, rather than the financial health of individual banks *per se*. There is no government guarantee that banks will not fail, and there is no deposit insurance provided or mandated by the government. The Reserve Bank does not have depositor protection as one of its objectives. New Zealand is quite unusual in this respect, but there are good reasons for this policy choice, which we explain a little later.

Other types of financial institutions in New Zealand are regulated by other agencies, with varying degrees of emphasis on systemic, institutional and individual protection. For example, the Ministry of Economic Development has primary responsibility for the prudential regulation of non-bank financial institutions such as insurers and fund managers. Issues of competition in the financial sector, and in the rest of the economy, are the domain of the Commerce Commission. The Ministry of Consumer Affairs has a role in ensuring that consumers are well-informed about their rights as they relate to the purchase of goods and services, including financial services.

The Reserve Bank's focus on systemic soundness and efficiency does not mean that we regard ordinary depositors as unimportant. In fact, we feel that depositors, like other creditors and counterparties of banks, have a very important role to play. We require banks to publish an extensive range of information about their business in the form of disclosure

statements, and require some of this information to be packaged such that it is understandable by the ordinary depositor. All deposit-taking banks must publish a Key Information Summary containing information about the bank's creditworthiness, and these Key Information Summaries must be prominently displayed and available on demand in all branches. The purpose of these Key Information Summaries and other disclosures is so that bank depositors and other creditors and counterparties have a large amount of information with which to assess a quality of service that is crucial, but not always highly visible – the creditworthiness of the bank itself. These parties can then make an informed choice about the extent to which they should be exposed to that bank.

An important element of enhancing the effectiveness of market discipline and the value of disclosures is strengthening the incentives on those exposed to financial institutions to monitor their bank's financial health carefully. This is the reason why there is no deposit insurance and no government guarantee of banks in New Zealand – such features would undermine the incentives of depositors, creditors and other counterparties to monitor effectively, to the detriment of soundness and efficiency. In an environment of extensive disclosure and intensive monitoring, any excessive risk-taking by banks will be quickly revealed to the market, and the bank will lose business as a result. Thus will the bank's risk-taking decisions be aligned appropriately to the returns expected and demanded by those who are ultimately exposed to that risk.

In essence, we have made a policy choice in eschewing regulatory measures to protect depositors, in favour of relying on market discipline and encouraging active competition in banking to achieve the same end. In making this choice, we have been aware of the risk that regulatory protection of depositors can inadvertently and inappropriately become *de facto* protection of shareholders, undermining incentives for good risk management and leading to lower-quality financial system performance overall.

The disclosure framework is an important element of our overall strategy for promoting soundness and efficiency. The strategy comprises disciplines on banks to manage their risks appropriately, while encouraging them to innovate and produce better, cheaper financial services. The three

disciplines are market discipline, self-discipline and regulatory discipline. Our regime emphasises self-discipline and market discipline, these being the types of discipline we believe are likely to contribute best to our objectives.

As already mentioned, the foundation of market discipline is the disclosure framework. Maintaining an open and competitive banking industry also contributes importantly to market discipline. The dominance of a few large banks in the system and their ownership by large foreign parent banks means that there are strong incentives for those banking groups to protect their reputations, and to avoid activities to which the market might react adversely once they are disclosed. For these purposes, the relevant “market” is a quite general group of parties, including not only depositors, creditors and counterparties, but also the community of competitor banks, market analysts and commentators that have an interest in scrutinising the financial health and performance of banks. We do note that the record of public scrutiny of bank disclosure statements has sometimes been a little disappointing. While intensely scrutinised by competitor banks, they have not had much attention from the media or analysts. One noteworthy exception is the work of David Tripe at the Centre for Banking Studies, Massey University.

Self-discipline is founded on requirements for bank directors to attest to the quality of their bank’s risk-management systems. It is clearly bank directors’ responsibility to oversee risk management and strategic direction – not the Reserve Bank’s – and the attestation requirements are designed to strengthen and underline these responsibilities. Also, banks are subject to requirements to have at least two independent directors and a non-executive chairman on the board, further bolstering the quality of self-discipline.

Regulatory discipline covers those rules imposed by statutes and government agencies that relate to the financial service business itself. Compared to most overseas jurisdictions, in New Zealand these rules are quite limited. In the case of banking, the Reserve Bank does not do on-site inspections for the purpose of validating banks’ risk-management systems, and in general we avoid imposing detailed, prescriptive rules regarding banks’ risk-management practices.

We do not license the business of banking *per se*. Financial institutions do not have to be registered banks in order to take deposits and make loans. A financial institution can conduct the business of banking without being subject to the Reserve Bank’s prudential requirements for registered banks, so long as it does not use the word “bank” in its name. The main features of regulatory discipline for banks in New Zealand are capital adequacy requirements based on international norms as codified in the Basel Accord – banks must hold capital at least equal to 8% of risk-weighted assets – and restrictions on connected lending and the degree of non-banking business that may be conducted by registered banks.

We avoid prescriptiveness because we believe it may lead to sub-par performance in the financial sector, for a number of reasons. First, the more behaviour is prescribed, constrained and directed by official agencies, the more likely it is that an implicit government guarantee will be created. Second, excessive prescription may distract executives, leading them to neglect effective risk management and instead merely tick boxes to follow regulators’ rules. Finally, in the extreme, excessive prescription may increase the opportunity for cynical gaming of rules, creating a fog of artifice that may expose the firm to large and poorly understood risks – risks that may end up sinking it altogether.

Our reluctance to impose prescriptive rules about permissible financial activities should not be taken to imply that we do not think rules are important. We think they are very important, for the reasons outlined earlier. However, our view is that directors and executives of financial institutions are best-placed to set such rules regarding their own risk management, and that they must take full responsibility for setting appropriate rules in an environment of stringent market discipline and strong measures to encourage self-discipline. Moreover, financial activity is becoming increasingly complex, and increasingly challenging regulators’ technical ability to prescriptively regulate financial innovation without causing unintended distortions, even if regulators had a desire to so regulate, which we do not. Finally, the prescriptive mentality militates against the objective of dynamic efficiency, which requires a sufficiently flexible regulatory environment for innovation to flourish.

Developments in New Zealand financial system and implications

The financial services industry worldwide is increasingly dependent on technology. Advances in information technology are enabling new and increasingly sophisticated financial products to be produced, and risk and return to be unbundled, repackaged and redistributed. Also, IT is enabling financial firms increasingly to operate cross-border and manage their business on a global basis, and to continue to blur the boundaries between bank and non-bank financial institutions. Foreign parent financial institutions already own most of the New Zealand banking, insurance and fund management industries.

There is little doubt that these developments are improving many aspects of the quality of financial services, and reducing their cost. Some of the quality improvements seen by the customer include being able to conduct financial business faster, being able to access financial services in more ways, and being able to build an investment portfolio from an increasing range of sophisticated financial products with more finely grained combinations of risk, return and liquidity.

However, increasing sophistication also presents a number of challenges for regulators charged with promoting soundness in the financial system. Of course, there is the straightforward point that increasing use of financial engineering complicates the assessment of banks' risk positions, by both banks themselves and by regulators. All this means is that everyone involved, bank management and regulators alike, must keep up to date with innovation.

More importantly, efficiency requires that if risks are not eliminated, then that they are properly understood, managed and priced. Where these conditions are not met, risk needs to be regulated, particularly where it may be transferred to unknowing or unwilling parties. One generally unwilling risk-bearer of particular importance is the government. It is a perennial concern of financial regulators to avoid inadvertently creating an implicit government guarantee of financial institutions. The existence of an implicit guarantee leads naturally to excessive risk-taking by financial institutions, keen to enjoy the upside of risky propositions while transferring the downside to the taxpayer.

Also of importance is that operational risk in the financial system may increase as dependence on technology increases, especially in a system with high foreign ownership such as New Zealand's. Financial firms owned by foreign parents may, on perfectly reasonable efficiency grounds, be motivated to consolidate core functions such as payments clearing and other back office functions into the parent's operations at home. In a competitive market in normal times, such efficiencies should be passed on to customers in New Zealand, to their benefit. However, during times of stress, cross-border dependencies may compromise regulators' ability to minimise the systemic consequences of operational disruption or financial distress.

RBNZ policy responses and initiatives

We have emphasised New Zealand's reliance for regulatory purposes upon market forces to achieve good outcomes for customers and the industry alike. This emphasis, however, should not be taken to mean that we are operating a regime of no regulation, or a regime in which the Reserve Bank "looks the other way" in the face of violations of rules we have set. In a limited number of areas – for example, capital adequacy and connected lending – we have been prepared to be prescriptive, where we have felt that the systemic risk to which the financial system would be exposed would otherwise be too great, and the costs of extra prescriptiveness are small in comparison. The attestation and disclosure framework is a fairly extensive set of requirements we have thought very carefully about, we actively enforce it, and we assess it continually against our soundness and efficiency objectives.

How do we know if our regime is right for New Zealand? A related question is, what would we expect to see, or not to see, if the New Zealand financial system were performing well?

In terms of soundness, we would expect to see the financial system continuing to perform its key functions of intermediating credit, providing payment services and circulating liquidity in the face of stress. This is indeed what we do see. No major financial institution in New Zealand has failed since the introduction of the attestation and

disclosure framework – despite a reasonably stringent test in the form of the Asian crisis and a fall in the exchange rate from 70 cents against the US dollar in 1997 to 40 cents in 2001. Currently, the New Zealand banking system is in an extremely healthy state, with non-performing assets at very low levels compared to other developed countries.

In terms of efficiency, there is ample evidence of the beneficial effects of openness and competitiveness in the financial system. Banks, for example, compete actively to offer to customers new products and new ways of obtaining service. The sophistication of New Zealand's retail payments system in particular stands out, with New Zealand banks able to achieve early and successful penetration of innovations such as EFTPOS and internet banking, which continue to grow strongly. Interestingly, after a period of decline, the number of bank branches is growing again (even after deducting the effect of Kiwibank, which had established 280 branches by the end of last year). The latest bank to be registered, Superbank, intends to offer physical banking facilities in supermarkets. Banking activity is increasingly being linked to loyalty programmes. New Zealand banking customers rate very highly internationally in terms of their uptake of new technologies and services. This dynamism in the industry is what one would wish to see from a well-performing financial system that is taking advantage of new technological opportunities and pursuing new business strategies.

This is all well and good. However, as a regulator, no less than as a financial institution, one cannot afford to be complacent. Changing circumstances in the financial system change the nature and magnitude of risks that must be managed, including systemic risks. In the management of systemic risk, a careful balance must be struck between soundness on the one hand, and efficiency on the other. It is an unavoidable fact that not all eventualities can be planned for, and that there exists the possibility of catastrophic risks so large that they will induce financial distress despite any reasonable amount of planning and provisioning.

It is on this class of hopefully very rare, but nevertheless very adverse, events that much of our recent and current policy work is focused. There are two strands to our policy focus on what happens when things go badly wrong. The first is work on initiatives to reduce the probability that things will go badly wrong in the first place. The second is containing

the damage to the financial system in the event that something very bad in fact does happen.

The first strand of work includes an assessment of the quantity and quality of capital for New Zealand banks that would be appropriate given their risk profiles. The Reserve Bank will also need to make some decisions about how New Zealand should implement the new Basel Capital Accord due out at the end of the year. We are implementing our local incorporation policy, under which systemically important banks will be required to be incorporated in New Zealand. Local incorporation will contribute to ensuring that overseas-owned registered banks in New Zealand are governed by directors with a duty to act in the best interests of the New Zealand bank. Currently, only one systemically important bank in New Zealand is not locally incorporated, and we are working with that bank to deal with the issue appropriately.

The local incorporation policy also applies to overseas-owned banks with significant retail deposits in New Zealand whose country of incorporation applies a preference to depositors from that country in the event that the bank fails. Such a situation creates significant uncertainty over the position of New Zealand depositors and creditors of the bank in the failure situation. Australia is one such country, so the issue of depositor preference is quite germane given the extent of ownership of New Zealand banks by Australian parent banks.

The second strand of work is focused on the need rapidly to resume the operations of a failed systemically important bank, to minimise the disruption caused to the rest of the financial system and wider economy in the event of a failure. One major part of this work is to explore the feasibility of recapitalising a failed bank using creditors' funds. A related part is to evaluate the core bank functions necessary for a statutory manager to be able to operate the bank on a stand-alone basis in a distress situation, and how we could ensure that a New Zealand statutory manager will have jurisdictional reach over those functions.

Fortunately, we are not alone in our efforts to improve systemic risk management in the financial system. In the realm of payments systems, much of the work is collaborative with banks. For example, banks are currently working to clarify and update the legal, financial and operational arrangements to apply should a system participant fail to

complete its deferred payment transactions. This clarification will reduce uncertainty about the treatment of payments progressing through the system in the event of disruption. The Reserve Bank is fully supportive of this initiative and is assisting where it can. We are also working with the industry to prepare for the New Zealand dollar to be eligible for settlement through the Continuous Linked Settlement Bank, which will markedly reduce settlement risk in foreign exchange transactions involving the New Zealand dollar.

An overarching issue surrounding much of this work is the implications of increasing integration between financial systems around the world, as alluded to earlier. As already mentioned, New Zealand's financial system is already highly integrated with Australia's. Australian parent banks are increasingly managing their group's business, including importantly its information technology, accounting and risk management functions on a global basis. In normal circumstances, the location of core functionality of a bank is of relatively little concern, provided that there are robust service agreements and the bank in question is fully satisfied that the providers of the functions are capable of performing the functions efficiently and reliably. However, when stress emerges, the legal structure and physical location of different parts of the business may affect the ability of New Zealand authorities to contain the distress. Part of the background to assessing these issues is the respective roles and responsibilities of Australian and New Zealand regulators, especially in cases where the distress event hits both sides of the Tasman. We are now working to clarify the appropriate levels of access to technology and functional control to cope with a stress event.

As the world changes, regulators must be prepared to adapt and respond. Although New Zealand's regime places more emphasis on self-discipline and market discipline relative to regulatory discipline compared to many other jurisdictions, it is probably fair to say that the difference is diminishing. Other regulators are increasingly formalising disclosure requirements and strengthening corporate governance requirements for financial institutions. Likewise, the Reserve Bank always stands ready to adapt the mix of the three disciplines on the banking system to suit evolving circumstances around systemic soundness and efficiency.

In this context it may be appropriate to comment on a recent market development, the decision by Lloyds in the UK to consider a possible sale of the National Bank. A possibility that has been discussed in the media is that an acquirer could be an existing Australian bank. If that were to eventuate, all systemically important banks in New Zealand would be owned solely out of one country. We have kept in touch with the parties and have informed them of our general views on this. Our position is that we would expect there to be no material transfers of National Bank business into branch form, and we would expect further discussions before any movement of technical capacity that reduced the bank's ability to continue to operate on a stand-alone basis under New Zealand statutory management. We would also be looking at the adequacy of current risk-management requirements for systemically important banks in the context of any further aggregation of country risk.

The Reserve Bank is keen to ensure that our regulatory system is invigorated and focused. Thus far, the New Zealand financial system has performed very well. It would be overstating the evidence to attribute that success wholly to our regulatory regime, but neither is there any evidence at all suggesting our regime produces worse outcomes than those in other countries.

The regulatory system needs to be constantly tested. The performance of our regime will come under particularly intensive scrutiny later this year, when New Zealand undergoes a Financial Sector Assessment Programme ("FSAP"). We will gain some important insight from the FSAP into these issues of soundness and efficiency, and into possible regulatory contributions to those objectives. We will, of course, be open to advice from experts, and that advice will be influential in our ongoing assessment of the most appropriate regime for the New Zealand financial system now and in the future.