RESERVE BANK OF NEW ZEALAND
TE PŪTEA MATUA

Consultation Paper:

Public and private reporting by banks of breaches of regulatory requirements, with consideration of materiality

October 2018

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Submission contact details

The Reserve Bank invites submissions on this Consultation Paper by 5pm on 14 December 2018. Please note the disclosure on the publication of submissions below.

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Publication of submissions

All information in submissions will be made public unless you indicate you would like all or part of your submission to remain confidential. Respondents who would like part of their submission to remain confidential should provide both a confidential and public version of their submission. Apart from redactions of the information to be withheld (i.e. blacking out of text) the two versions should be identical. Respondents should ensure that redacted information is not able to be recovered electronically from the document (the redacted version may be published as received).

Respondents who request that all or part of their submission be treated as confidential should provide reasons why this information should be withheld if a request is made for it under the Official Information Act 1982 (OIA). These reasons should refer to section 105 of the Reserve Bank of New Zealand Act 1989, section 54 of the Non-Bank Deposit Takers Act, section 135 of the Insurance (Prudential) Supervision Act 2010 (as applicable); or the grounds for withholding information under the OIA. If an OIA request for redacted information is made the Reserve Bank will make its own assessment of what must be released taking into account the respondent's views.

The Reserve Bank may also publish an anonymised summary of the submissions received in respect of this Consultation Paper*.*

Executive summary

Introduction

1. Regulatory requirements are imposed on registered banks in a number of different ways under the Reserve Bank of New Zealand Act 1989 (the Act). Specifically, public disclosure requirements are set by Orders in Council, credit rating requirements are set by notices issued by the Reserve Bank, and other prudential requirements are set through conditions of registration.

2. A breach of any of these requirements creates an offence under the Act, but the Act does not require a bank to notify the Reserve Bank of breaches. Whether breaches have to be publicly disclosed also depends on how the requirement is set.

3. If a bank has not complied with all of its Conditions of Registration (CoRs) over a given full or half year reporting period, it is required to publish a description of the nature and extent of any breaches, in the disclosure statement for the respective period. If a bank's published disclosure statement (DS) contains information that is false or misleading, or does not contain information that it is required to contain, the Reserve Bank may require the bank to re-publish the DS or include a correction in the following DS. There is no requirement to publicly disclose breaches of credit rating requirements (which are very rare).

4. The current approach dates from the establishment of the disclosure regime in the mid-1990s, and reflects the importance attached to market discipline. With the non-intrusive supervisory approach, most of the work of ensuring that banks complied with regulatory requirements was left to the incentives imposed on them by having to disclose any breach of a CoR. Requiring disclosure of every CoR breach kept the framework simple. Including CoR compliance in the director attestation also tied in to the self-discipline pillar, to give directors strong incentives to ensure that a bank complied with its CoRs at all times.

5. Consideration has been given in recent times to whether it would be appropriate to include a materiality threshold for when breaches of CoRs need to be published (for example, the Regulatory Stocktake in 2014/15 considered this issue). In addition, there have been a number of relatively minor breaches which have been cited as arguments for adopting a materiality threshold.

6. The Reserve Bank has also carried out a thematic review of the effectiveness of the director attestation regime. Feedback from that process suggested that the status quo diverts the scarce time of directors away from thinking about the questions that a board should be focused on, such as the bank's overall strategic direction, and management of key risks.

7. For these reasons, we think there are good grounds for revisiting the introduction of a materiality threshold, and are hence including it as an option in this consultation.

Breach reporting and publication

8. The Regulatory Stocktake concluded that a formal reporting requirement should be imposed on banks using a notice issued under section 93 of the Act. This would require banks to report breaches of CoRs, disclosure Orders in Council (OiCs), and section 80 notices to the Reserve Bank.

9. The Regulatory Stocktake also concluded that the Reserve Bank should maintain a page on its website, linked to the Bank Financial Strength Dashboard (the Dashboard), to provide an up-to-date record of banks' actual breaches. Information on this webpage would be drawn from information reported by banks under their new breach reporting obligation. This is intended to: 1) compensate for the reduction in frequency of DSs from quarterly to half yearly; and 2) make the information more accessible, timely and comparable across banks.

10. The first part of this paper sets out our proposals for the implementation of these matters. The second part of this paper sets out two options on whether this proposal should include a materiality threshold. Specifically:

    - Option 1: to keep the status quo as far as materiality goes, which would mean rolling out the breach reporting and publication mechanism set out here.

    - Option 2: building in a materiality threshold, which would be done by amending the breach publication mechanism.

11. Appendix 1 sets out a draft of a proposed section 93 notice, to be issued to all registered banks. The draft notice includes an attached Annex, which is a template banks would use in complying with the reporting requirement. The wording of the section 93 notice refers to the bank becoming aware that it has breached, may have breached, or is likely to breach a requirement. The proposed new reporting requirement is intended to largely formalise existing supervisory expectations.

12. Appendix 2 shows a flow chart of the proposed process by which banks' regulatory breaches would be published on the Reserve Bank's website (note that the references to "Material" in square brackets are optional extra additions that will only apply if a materiality threshold is adopted). The matters published would be any actual breach of a CoR or of a section 80 notice to maintain a credit rating, but not a breach of a disclosure OiC.

13. The main argument for not including breaches of disclosure OiCs on our website is that the existing process for correcting errors in DSs appears to work satisfactorily, with a graduated range of supervisory responses being available.

14. We propose that the webpage would include all breaches by registered banks that have occurred within the last 5 years, in chronological order with the most recent at the top.

Options with or without a materiality threshold

i. Option 1: Status Quo

15. The proposed breach reporting framework does not include any materiality threshold. While the proposed approach would change the mechanism by which breaches are disclosed and how they are presented, in terms of the overall outcome, it achieves broadly the same results as now (with the small exception of adding section 80 breaches). So in looking at the question of whether or not to add materiality thresholds, we regard this framework as effectively the status quo.

16. This approach has a number of benefits including formalising the Reserve Bank's existing expectation of notifications from banks, supporting market discipline, and including breaches of section 80 notices for the first time. However, the new framework is likely to result in some additional process costs for registered banks. Publishing all bank CoR breaches in one place in a more accessible manner may exacerbate some of the arguable drawbacks of breaches being published without a materiality threshold.

ii. Option 2: materiality threshold

17. This option applies specifically to deciding whether a notified breach of a CoR or of the section 80 credit rating requirements should be published (as breaches of disclosure OiCs will continue to be dealt with in the same way as currently).

18. The intention is that banks would report exactly the same breaches and potential breaches to the Reserve Bank under Option 2 as under Option 1. We do not see any reason to introduce a materiality threshold in respect of breach information that is privately reported to the Reserve Bank. Accordingly, the draft section 93 notice and the reporting mechanism is mostly the same as in Option 1.

19. We also propose that the process <u>after</u> the decision to publish is the same as under Option 1. This means <u>material</u> breaches are published on the website, and the affected bank has five working days to respond to the proposed drafting of the new entry on the website. In particular, this would mean that the affected bank has an opportunity to comment on the conclusion that a breach has occurred, and that it is material.

20. We think it will be important to publish a list of general criteria that we would take into account in assessing materiality. It is important to have such a list to help provide some structure around the decision-making, and also important to publish it to provide transparency around how the decision will be made.

21. This list of general criteria would include matters such as:

    a. The impact of the breach on the bank's ability to carry on business in a prudent manner;

b. Whether the breach was within the bank's control; and

c. How long the breach lasted (if already remedied), or is expected to continue.

22. We do not propose to publish specific materiality thresholds. Given the nature of current standard CoRs for banks, the materiality of a breach will mostly depend on the circumstances at the time. Some types of breach would almost always count as material, although even in such cases there might be strong mitigating circumstances that allow an assessment of non-materiality. At the same time we do not think it would be helpful to be explicit in public about the types of breach that would generally count as <u>not material</u>. This would weaken incentives on banks to comply, and could tie our hands when such a case arose with unexpected features that made it clearly material.

23. Changes would be needed in the two DS items relating to CoR breaches, namely:

- the required description of any CoR breaches that have occurred over the reporting period; and

- directors' statement of whether the bank has complied with all CoRs over the period.

24. We argue that there is a strong case for alignment between both of these disclosure components and the material CoR breaches that would be published on the Reserve Bank website, and propose a number of consequential amendments to disclosure OiCs to ensure this alignment.

25. The benefits of Option 2 are mainly that it would deal with a number of potential problems that have been identified from the current lack of a materiality threshold. For example, it would make it easier to see which breaches are significant, and help ensure that directors' time is not taken up on minor issues. We believe that this would make the market discipline applying to directors more focused and effective. Option 2 would also reduce the frictions and risk involved for banks in explaining to overseas investors how the New Zealand approach to breach publication works.

26. The costs of option 2 are that it might create the risk of the materiality threshold being applied unevenly, and create moral hazard for the Reserve Bank by putting it in a position of assessing for the market whether a breach is immaterial.

Timing and next steps

27. The deadline for submissions on this consultation document is 14 December 2018. We plan to hold at least one workshop for banks during that period, and also reach out to people with an interest in reading information about breaches of requirements.

28. After the consultation has closed, subject to feedback, the first step would be the issuing of section 93 notices to all banks to implement the formalised breach reporting requirements. We would aim to finalise the notice and the online notification form as

soon as feasible after completing analysis of the comments received and any follow-up discussions with banks. This points to an issue date for the s93 notices by end-February 2019.

29. If needed, the section 93 notices could specify a delayed start date for the reporting to begin, to allow system and process changes that banks may need to ensure they meet the formalised reporting requirement, and enable consequential changes to be made to the disclosure OiCs (subject to Cabinet approval). The Reserve Bank will also need to ensure it is ready to receive reports using the new online reporting template by the start date.

30. Subsequent steps will depend on whether Option 1 or Option 2 is chosen in light of the consultation feedback.

Introduction

Current arrangements

1. This consultation is about breaches of three types of regulatory requirements:

   a. Any regulatory requirement imposed on a registered bank ("bank") by means of a condition of registration (CoR), imposed under section 74 of the Reserve Bank of New Zealand Act 1989 ("the Act").

   b. The requirement to publish disclosure statements with specified content and frequency, imposed by Orders in Council (OiCs) made under section 81 of the Act.

   c. A requirement to obtain and maintain a credit rating, imposed by a notice issued to a bank under section 80 of the Act.

2. A breach of any of these requirements creates an offence under the Act, but the Act does not impose a formal obligation on a bank to notify the Reserve Bank of the breach. The nature of the obligations on a bank to publicly disclose a breach varies across the three types of requirement.

3. Currently, if a bank has not complied with all of its CoRs over a given full or half year reporting period, it is required to publish a description of the nature and extent of any breaches, in the disclosure statement for the respective period. The disclosure statement must also include an attestation by the bank's directors (and NZ CEO in the case of an overseas bank branch), which includes the statement whether or not each director believes, after due enquiry, that the bank has complied with all CoRs applying over the period.

4. This does not provide any legal basis for a materiality threshold for disclosure of breaches. CoRs are mostly defined in very specific terms so that it is clear when a bank has breached one. In a few cases, determination of a breach will require more subjective judgement (for example, the requirement to have an internal framework for liquidity risk management that is adequate in the bank's view for managing the bank's liquidity risk at a prudent level). However, even in these cases there is no specific reference to materiality. And once any form of breach has been determined, the bank must include it in its next disclosure statement.

5. Section 83 of the Act gives the Reserve Bank broad discretion in how it deals with a breach of a disclosure requirement. Under section 83, if the Reserve Bank considers that a bank's published disclosure statement contains information that is false or misleading, or does not contain information that it is required to contain, the Reserve Bank may require the bank to re-publish the disclosure statement with the problem corrected, or take other corrective action. The Reserve Bank does use this discretion in practice, applying materiality considerations. In the case of a minor omission that

would have no impact on depositors or potential depositors, the usual remedy is for the bank to ensure that it is corrected in the next disclosure statement.

6. There is no formal private or public reporting requirement for a bank that fails to comply with a section 80 notice. There is no established practice for such reporting, as the nature of the obligation imposed by these notices means that breaches are very rare.

Origins of current approach

7. The origins of this approach lie in the establishment of the disclosure regime in the mid-1990s, and the importance attached to market discipline. With a non-intrusive supervisory approach, most of the work of ensuring that banks complied with regulatory requirements was left to the incentives imposed on them by having to disclose any breach of a CoR.

8. Under the philosophy at that time of avoiding any moral hazard for the Reserve Bank, any involvement of banking supervisors in determining whether a CoR breach was material would have been anathema. At the same time, the Reserve Bank did not want to leave any question of materiality up to banks' judgement. Requiring disclosure of every CoR breach kept the framework simple. Including CoR compliance in the director attestation also tied in to the self-discipline pillar, to give directors strong incentives to ensure that a bank complied with its CoRs at all times.

Stocktake/ Dashboard

9. The Regulatory Stocktake over 2014/15 was intended to identify areas where the Reserve Bank's regulation of banks could be made more efficient and effective, particularly given that the regulatory requirements on banks had evolved significantly with the implementation of Basel II and further developments post-GFC. The Stocktake consultation raised two issues around breaches of requirements:

   a. First, while banks have in practice notified the Reserve Bank if they think they may have breached a regulatory requirement, there is no formal legal obligation on them to do so.

   b. Secondly, banks raised concerns that the requirement to disclose every CoR breach can be disproportionate when a breach is very minor or trivial in nature.

10. Separately, the Stocktake looked at the question of whether the disclosure regime could be made more efficient and effective, and in particular whether the costs to banks of publishing disclosure statements ("DSs") in the first and third quarters of their financial years (the "off-quarters") was justified by the additional benefits off-quarter DSs provide on top of the full and half-year DSs.

11. The outcome from this question was the discontinuation of off-quarter DSs, and the development of the new quarterly Dashboard, which provides more comparable and timely information in a more easily accessible side-by-side format for users, with a

more streamlined delivery mechanism for banks. However, the Dashboard itself is not particularly suitable for displaying information on CoR breaches at present, so this does mean that information on breaches is now only disclosed every six months.

12. On the materiality concern, the Reserve Bank decided against introducing a threshold. This was based on the view that to maintain a consistent threshold over time, the Reserve Bank would need to carry out the materiality assessment itself (banks largely agreed that it should be the Reserve Bank rather than themselves carrying out such assessments). But our view was that that would take up supervisor time that could be used more effectively in other ways. We were also concerned about any watering down of the market discipline incentivising banks to comply with all CoRs.

13. However, the Reserve Bank committed to review the way that CoRs are framed, to find areas where we can reduce the scope for minor or trivial breaches of CoRs to arise. The following are some examples.

LVR second mortgage condition

14. When the limits on housing lending with high loan-to-value ratios (LVRs) were first introduced, they included a CoR that a bank must not take a second mortgage charge over a house to provide additional lending, if that took the total borrowing secured on the house over the high-LVR limit. Making just one such loan was an automatic CoR breach. This strict prohibition was later removed, and instead an additional example was added to the guidance in the policy that gives examples of avoidance behaviour. This makes it clear that if the Reserve Bank judges that a bank is systematically providing high-LVR second mortgage top-up housing loans, the bank will be in breach of the spirit of the policy, and the Reserve Bank may take other supervisory action against it.

New outsourcing policy

15. In developing the new outsourcing requirements for large banks (Outsourcing Policy, BS11, September 2017), the Reserve Bank has attempted to ensure that policy requirements are expressed in flexible ways, so that no single minor event should cause the bank to breach the CoR for the policy, which is expressed simply in terms of the bank meeting the requirements of BS11.

Minimum number of independent directors

16. A New Zealand-incorporated registered bank must have a minimum of 50% of its board of directors counting as independent (as defined in the policy). This is imposed by a specific CoR. There have been cases where an independent director has left a board suddenly for reasons entirely outside the bank's or the individual's control (death or incapacity). We have acknowledged this as a problem, and aim to find a more flexible way to impose this requirement, so that such events do not create an automatic breach of a CoR.

Capital ratio calculation errors

17. "IRB banks" (banks that are accredited to use the internal models approach for calculating regulatory capital ratios) are currently subject to a CoR requiring them to meet all requirements in the capital adequacy policy document BS2B. (This is in addition to the key requirements in CoRs that a bank must maintain its capital ratios above the specified minimum levels.) The effect of this particular CoR is that if an IRB bank makes any error in calculating its capital ratios, no matter how small, it breaches the CoR.

18. Given the complexity of the capital ratio calculations, we view this as unreasonably burdensome in many cases. We have work in progress to reorganise the capital adequacy material, so that only the minimum capital ratios themselves, and certain minimum process requirements in BS2B around the operation of internal models, would be imposed by CoRs.

19. Once we have completed that work, under the proposed s93 notice (see below), a bank would need to report a minor error in a capital ratio calculation to the Reserve Bank only as a potential disclosure error, not as a CoR breach. The bank would correct the error as necessary, following the existing arrangements for revisions to disclosure statements and to the Dashboard. (This outcome would be the same, regardless of whether or not we introduce the materiality threshold proposed below.)

Q1: How far would this particular change go towards addressing any concerns about the need to disclose non-material CoR breaches?

<u>Further materiality concerns raised by industry</u>

20. Since publishing the conclusion of the Stocktake in December 2015, the Reserve Bank has carried out a thematic review (2017) of the effectiveness of the director attestation regime. The regime provides a key underpinning to ensuring that registered banks comply with regulatory requirements and operate sound risk management frameworks. This thematic review included interviews with many directors of registered banks.

21. The need for banks to disclose all CoR breaches however trivial, and directors' involvement in that process, was considered by a number of directors to undermine the effectiveness of the attestation regime. Directors have to be sure of their ground before they sign the attestation that their bank has met all of its CoRs over the period. When a bank has breached a CoR in an immaterial way, directors nevertheless have to be involved in agreeing on the form of words to describe the breach that they are comfortable signing off.

22. Views were that this undermines the power of the regime by devaluing the significance of a breach for directors. It also diverts the scarce time of directors away from thinking about the questions that a board should be focused on, such as the bank's overall strategic direction, and management of key risks, including emerging new risks.

23. For these reasons, we think there are good grounds for revisiting the introduction of a materiality threshold, and are hence including it as an option in this consultation.

Breach reporting

Stocktake and Dashboard consultations

24. The consultation on the Stocktake, in light of feedback received, reached the conclusion that a formal reporting requirement should be imposed on every registered bank under section 93 of the Act, requiring the bank to notify the Reserve Bank promptly of any breach or potential breach of a requirement under a CoR, a disclosure OiC, or a section 80 notice.

25. The follow-up consultation on the Dashboard (September 2016) proposed that the Reserve Bank should maintain a page on its website, linked to the Dashboard, to provide an up-to-date record of banks' actual breaches of CoRs. The information to be published would be drawn from the new required reporting of breaches to the Reserve Bank. The reason for this was both to restore the loss of timeliness caused by reducing the frequency of DSs from quarterly to six-monthly, and also in the spirit of the Dashboard, to make the information more accessible, timely and comparable across banks. There would be a link from the Dashboard to the breaches webpage. The final decision paper on the implementation of the Dashboard (September 2017) left this proposal for follow-up work, as it was not core to getting the Dashboard live.

26. Accordingly, this section of the paper sets out our proposals for the detailed implementation of these two conclusions (formal reporting of breaches to Reserve Bank, and publication on Reserve Bank website). The model presented here does not include any materiality threshold. The next section of the paper presents two options on materiality:

    - Option 1: to keep the status quo as far as materiality goes, which would mean rolling out the breach reporting mechanism set out here.

    - Option 2: building in a materiality threshold, which would be done by amending the breach publication mechanism.

Nature of breach reporting and section 93 notice

27. Appendix 1 sets out a draft of a proposed section 93 notice, to be issued to all registered banks. The draft notice includes an attached Annex, which is a template banks would use in complying with the reporting requirement. (Note that the column in the template headed in italics "View on materiality" would only be included under Option 2, as discussed below.)

28. The wording of the section 93 notice refers to the bank becoming aware that it has breached, may have breached, or is likely to breach a requirement. We believe that all three situations are of interest for the bank's supervisor at the Reserve Bank. A

potential breach typically needs to be discussed with the supervisor to determine whether an actual breach has occurred, and even if not, there may be an issue that needs addressing. Learning about a likely future breach in good time may also be valuable for the supervisor, particularly if the breach is of a key requirement like a minimum capital ratio.

29. Generally, the proposed new reporting requirement is intended largely to formalise existing supervisory expectations. We note that there are various legislative precedents for regulated entities being required to report breaches to their regulator, and in many cases these cover potential as well as actual breaches. A particularly relevant example is s412 of the Financial Markets Conduct Act 2013, and our choice of words “is likely to” matches the wording of s412. However, we would be interested to learn whether formalising the “likely to breach” category may require banks to set up additional processes for deciding what counts as “likely” and ensuring they meet this aspect of the requirement.

Q2: Will reporting instances where your bank is “likely to breach” a requirement present particular challenges? Is there a form of words you would prefer for this obligation?

Process for publishing on website

30. Appendix 2 shows a flow chart of the proposed process by which banks’ regulatory breaches would be published on the Reserve Bank’s website. (Note that the references to “Material” in square brackets are optional extra additions that only apply if there is a materiality threshold, see Option 2 below.) A bank’s submission of a report under the s93 obligation corresponds to the first two blue boxes after “Start”. The process also includes the case where it is the Reserve Bank that identifies a potential breach.

31. Thereafter, the process steps reflect our intention to publish only actual breaches of requirements on our website. Publication would include any actual breach of a CoR or of a section 80 notice to maintain a credit rating, but not a breach of a disclosure requirement.

32. The reason for adding in a section 80 breach is that it is a specific (and important) requirement akin to a CoR. It would be very unusual for a bank to fail to comply (either wilfully or inadvertently) with a section 80 notice, but if this should occur there seems no good reason not to require disclosure similarly as for a CoR breach.

33. We can see two arguments against including disclosure breaches on the website disclosure. First, we do not see significant problems with the existing process for correcting errors in DSs. Secondly, we believe that in the context of the Dashboard, it is errors in numbers on the Dashboard that will be relevant and of interest for readers, and the Dashboard has its own mechanism for banks to correct such errors.

34. Accordingly, we propose to continue the current approach to addressing any errors in banks' published DSs. A graduated range of supervisory responses is available, including the bank re-publishing a DS accompanied by a formal warning from the Reserve Bank. This might arise for example if the bank omitted "material matters" from a DS, which are defined in the OiCs as matters which, if disclosed, would materially affect the decision of a person to subscribe for debt securities issued by the registered bank or any member of its banking group.

35. The next stage in the process is the Reserve Bank's determination of whether a breach of a CoR or section 80 notice requirement has occurred. This would proceed largely as at present, with the supervisor seeking further information from the bank, and holding follow-up discussions as need be, to allow the determination to be reached.

36. If the Reserve Bank concludes that there has been a breach, the final stage is the process of publication on the dedicated website page. The attached Appendix 3 is a draft version of the content we propose to include on that page. We propose that the Reserve Bank would prepare the content of any new addition to the webpage, using as far as possible the text provided by the bank via the reporting template, and would then give the bank in question five working days to give any feedback on that draft content.

37. We propose that the webpage would include all breaches by registered banks that have occurred within the last 5 years, in chronological order with the most recent at the top. We see no point in this information being kept on our website indefinitely, and the 5 year cut-off aligns with the existing requirement for banks to retain their published DSs on their websites for at least 5 years.

Q3: Do you have any comments on the content of the proposed new webpage and the process for updating it?

Options with or without a materiality threshold

Option 1 – Status Quo

38. The proposed breach reporting framework set out in the previous section does not apply any materiality threshold. While the proposed approach would change the mechanism by which breaches are disclosed and how they are presented, in terms of the overall outcome, it achieves broadly the same results as now (with the small exception of adding section 80 breaches). So in looking at the question of whether or not to add materiality thresholds, we regard this framework as effectively the status quo.

39. The following discussion looks at the costs and benefits of this approach by comparison to current arrangements.

Benefits / advantages

40. The proposed section 93 notice formalises an existing expectation on banks, which banks mostly abide by in any case, as there have not generally been serious issues: however, it provides useful extra back-up for the case where a bank was facing major difficulties and might be inclined to hide the problems, or delay notification. Failure to comply with a section 93 notice, or providing information that is false or misleading in a material particular, is an offence under the Act.

41. The proposal for the Reserve Bank to publish breaches on its website refreshes the existing principle that market discipline has an important role to play in ensuring that banks meet minimum prudential requirements. This parallels the new Dashboard approach for disclosure of financial information.

42. We see the inclusion of any breaches of section 80 credit rating notices as an additional new benefit. The requirement to report to the Reserve Bank will provide additional assurance that the bank's supervisor will hear of the problem promptly, and the new publication requirement will strengthen incentives on registered banks to ensure that they maintain credit ratings at all times. (Market incentives to do so are already very strong for stand-alone banks, but this will be particularly relevant for subsidiaries of overseas banks, who must maintain their own separate credit rating.)

Costs / disadvantages

43. The new framework is likely to result in some additional process costs for registered banks. The more formalised approach, and the Reserve Bank's publication role, would require some additional Reserve Bank staff time.

Q4: Please could you provide estimates of the costs to your bank, compared to the current arrangements, arising from:

- **any additional process costs you would incur per breach, in the case of breaches that you think you would have discussed with the Reserve Bank under current arrangements;**

- **additional cases (if any) of potential or likely future breaches you would expect to report to the Reserve Bank in future, that you would not report at present.**

44. Publishing all bank CoR breaches in one place in a more accessible manner may exacerbate some of the arguable drawbacks of breaches being published without a materiality threshold. This could for example highlight to overseas investors that New Zealand registered banks regularly breach conditions of their registration.

45. However, these costs will be reduced to the extent that we make further progress (as planned) on improving the design of CoRs as discussed above. This will ensure that

there are fewer genuinely trivial CoR breaches going through the proposed new process.

Option 2 – materiality threshold

46. This section sets out the alternative option from the status quo, under which a materiality test is applied before a bank is required to publicly disclose that it has breached a regulatory requirement. This proposal applies specifically to breaches of CoRs and the section 80 credit rating requirement – the other case, namely breaches of disclosure requirements, is discussed briefly later in the paper (see paragraphs 82-84).

47. Implementing a materiality threshold would require changes in the two channels through which CoR breaches are (or will be) disclosed, namely the proposed new breach publication framework discussed above, and the existing DS obligations. For section 80 breaches, only the breach publication framework would need adapting, since there is no explicit requirement to report them in DSs at present.

Breach reporting framework – similar to Option 1

48. The first stage in the breach reporting framework is that the Reserve Bank or a registered bank identifies that the bank may have, or is likely to, breach one of the three classes of requirement. The intention is that banks would report exactly the same breaches and potential breaches to the Reserve Bank under Option 2 as under Option 1: we do not see any reason to introduce a materiality threshold at this stage of the process. Accordingly, the draft section 93 notice and the reporting mechanism is mostly the same as in Option 1.

49. However, we propose to add one item to the breach notification template (see the Annex to the attached section 93 notice). This would be the opinion of the banks' directors (or their nominated agents) on whether the breach is material. This is shown in the column headed "View on materiality". We believe it is important to include this so that the Board still remains aware of the number of breaches of Reserve Bank requirements that are occurring in total, and considers which of them are material. The final decision on materiality would rest with the Reserve Bank (see below). The directors' view on whether a breach is material would not be disclosed, but would be one among a number of factors the Reserve Bank takes into account.

50. Our understanding is that it is the public disclosure of breaches, rather than internal consideration of them and judgement on their materiality, that imposes the real burden on bank Boards. Whereas public disclosure creates significant directors' liability for errors or omissions, an opinion on materiality given by directors in good faith privately to the Reserve Bank should pose very limited legal risk for the directors.

Q5: Do you agree that the proposed requirement to give a view on materiality to the Reserve Bank would impose significantly less burden on directors than the current need to handle publication of all non-material breaches?

Variation of the breach publication framework

51. The key stage at which materiality is determined would be the same stage as the one for determining whether a breach has occurred. So instead of reaching a decision on whether a breach has occurred, the decision would be whether a material breach has occurred. The only change in the process map (Appendix 2) would be the inclusion of the references to "material" shown in square brackets.

52. We propose that every notification be provided in templated form, and be added to the Prudential Supervision Department's internal Compliance Issues Register. (This is already current practice when a supervisor becomes aware of a potential breach, and would also continue under Option 1.) This arrangement would:

    - help to ensure that the process is traceable, and can be reviewed over time for consistency of outcomes;
    - help internal supervisory decisions, for example spotting if a given bank suffers a rash of non-material breaches which might act as red flags for a supervisory response, even if not public disclosure; and
    - ensure that the banks themselves are providing the basic text that will be published on the website if the breach is material. (The information in the template, presented in the same form as in the template, is what will be published on the website if the breach is material (subject to any changes we wish to make to that text).)

53. We also propose that the process after the decision has been taken is the same as under Option 1. This means material breaches are published on the website, and the affected bank has five working days to respond to the proposed drafting of the new entry on the website. In particular, this would mean that the affected bank has an opportunity to comment on the conclusion that a breach has occurred, and that it is material (in the absence of formal rights of review or appeal, this will help ensure that natural justice considerations are satisfied). As noted, the proposed drafting of the new entry on the website will be drawn directly from the template notification of an actual or potential breach provided by the bank (subject to any revisions we wish to make).

54. A key challenge for the Reserve Bank in acting as the "gatekeeper" for decisions on materiality will be to establish and maintain a fair and consistent approach. We see a number of dimensions of consistency –

    a. consistency across time, so that the same issue gets the same decision whenever it occurs;

    b. consistency across different types of breach that are not measured in the same way (as far as can be feasibly achieved); and

c. consistency across banks: we think seriousness of a breach should be assessed solely in relation to its importance to a bank, rather than to the financial system. So for example, a breach of a minimum capital ratio would most likely be disclosable, regardless of the size of the bank.

55. We think it will be important to publish a list of general criteria that we would take into account in deciding materiality. It is important to have such a list to help provide some structure around the decision-making, and also important to publish it to reduce concerns about arbitrariness.

56. Our initial thinking on this list is the following –

a. The impact of the breach on the bank's ability to carry on business in a prudent manner.

b. Whether the breach was within the bank's control.

c. The value to users of disclosure information or the general public of knowing about the breach.

d. How long the breach lasted (if already remedied), or is expected to continue.

e. Whether the bank has promptly reported the breach.

f. The nature of remedial action taken to address the breach.

g. The opinion of the banks' directors on whether the breach is material.

Q6: Do you have suggestions for additions or amendments to this list?

57. We do not propose to publish specific materiality thresholds. Given the nature of current standard CoRs for banks, the materiality of a breach will mostly depend on the circumstances at the time. Some types of breach would almost always count as material, although even in such cases there might be strong mitigating circumstances that allow a decision of non-materiality. At the same time we do not think it would be helpful to be explicit in public about the types of breach that would generally count as not material. This would weaken incentives on banks to comply, and could tie our hands when such a case arose with unexpected features that made it clearly material.

58. As noted above, we plan to remove the problem of very minor calculation errors in capital ratios causing CoR breaches by changing the nature of the conditions. This will remove the need to set out specific percentages for materiality thresholds on such errors.

Changes to disclosure statement requirements (OiCs)

59. Changes would be needed in the two components of disclosure relating to CoR breaches, namely:

- the required description of any CoR breaches that have occurred over the reporting period; and
- directors' statement of whether the bank has complied with all CoRs over the period.

60. We think there is a strong case for congruence between both of these disclosure components and the material CoR breaches that would be published on the Reserve Bank website under the proposal above. Any discrepancy would be confusing for users of the information, and if there was a lower materiality threshold for DSs, or no threshold at all as now, that would remove essentially all of the benefits of having a materiality threshold in the new centralised publication mechanism.

61. We propose that the list of breaches to be disclosed should be linked directly to what has been disclosed on the website. The current wording of the required item to be disclosed is[1]:

> "If the registered bank has not complied with all conditions of registration over the full year accounting period, a description of the nature and extent of each case of non-compliance."

62. We propose the revised wording should be:

> "If the registered bank has not complied with all conditions of registration over the full year accounting period, a description of the nature and extent of each case of non-compliance which the Reserve Bank, on or before the signing date, has determined to be a material breach and has published on the Reserve Bank website."

63. This wording would mean that the timing question, that is, whether a given breach occurred during the reporting period, would have to be decided as it is now: this is usually fairly clear but can involve some element of judgement. The additional text means that no breach would have to be disclosed before it has been confirmed as material by the Reserve Bank and published on the website. But as long as that process has been completed by the signing date of the DS, the DS would have to include a description of the breach. (Corresponding wording would apply for the half-year accounting period.)

64. The case could arise where a CoR breach occurring in a full-year period (or even in an earlier period) has not been confirmed as material until after the signing date for the DS for that period. We propose that a bank should be required to disclose that breach in the DS for the subsequent period. If that is agreed, we will prepare additional new OiC text to put it into effect.

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[1] See Schedule 2, subclause 12(4) in Registered Bank Disclosure Statements (New Zealand Incorporated Registered Banks) Order 2014 (as amended), and Schedule 2, subclause 14(4) in Registered Bank Disclosure Statements (Overseas Incorporated Registered Banks) Order 2014 (as amended). Corresponding requirements for the half year DS are in Schedule 3 of both Orders.

Q7: Do you agree with the proposed timing for inclusion in the DS? Do you have any other comments on the revised wording?

65. We think that directors should be able to attest that their bank has complied with all of its conditions of registration, if the only CoR breaches that have occurred are those that have been through the materiality threshold test and judged not material. We think that many of the advantages of a materiality threshold would be lost otherwise. We suggest that the current disclosure item required by the Orders in Council could be suitably amended by simply inserting the word “materially”, as follows[2]:

> “A statement by the directors as to whether or not each director believes, after due enquiry, that, over the full year accounting period—
>
> a. the registered bank has <u>materially</u> complied with all conditions of registration that applied during that period;” [*etc*]

66. Corresponding amendments would be made for both full-year and half-year periods, and for locally-incorporated banks and overseas bank branches.

Q8: Do you think this is a workable amendment to the director attestation?

67. Note that updating the disclosure Orders in Council takes a minimum of three months for minor changes, so any changes agreed as a result of this consultation will require at least that much additional time to be fully implemented. Changes to the OiCs are also dependent on the Minister of Finance and Cabinet accepting the Reserve Bank’s recommendations. The linkages between the OiC updates and the breach reporting arrangements are discussed further under “Timing and next steps”.

Benefits / advantages of Option 2 compared to Option 1

68. The benefits of Option 2 are mainly that it would deal with a number of potential problems that have been identified from the current lack of a materiality threshold.

69. A materiality threshold would ensure that readers of disclosure information are able to find out about breaches of prudential requirements by banks that are of actual significance, rather than being presented with mostly trivial infractions that have no bearing on whether the bank is sound and well-run. Particularly with the move to the web-based publication of breaches alongside the Dashboard, we are aiming to broaden the range of depositors who take an interest in their bank, and a more filtered approach will help less financially expert readers see information that is actually relevant.

70. For banks, this will mean that the market discipline imposed by the need to disclose breaches will focus on the issues that really matter. The purpose of financial regulation is to better align the private incentives on bank management with the public good, given the failure of the market to deliver that alignment. Having to disclose trivial

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[2] The text comes from Schedule 2, subclause 17(2) of the Order in Council for NZ-incorporated banks.

breaches perversely worsens the distortion of incentives. Hence, bringing in a materiality threshold for disclosure will allow banks to allocate their risk-management efforts more efficiently to where the most important risks arise.

71. Banks' directors treat any disclosure of a breach as a serious matter, which reportedly takes up a material amount of their time, questioning management on the nature of the breach and deciding on the best public presentation of the information. At the same time, this tends to divert directors' attention towards the process of disclosure, rather than on the actual nature of the breach. Directors' time is a scarce resource, and a materiality threshold would allow more of it to be spent on questions like the bank's strategic direction and emerging threats to its business model. It would also help directors not to lose sight of any breach that is actually material, among a string of minor infractions.

72. With some prudential requirements, disclosure also distorts the way that banks comply. For example, the intent of the corporate governance policy was that at least half a bank's directors should be independent. Banks now commonly have one extra independent director above the minimum to avoid breaching the corresponding CoR for reasons entirely outside their control.

73. The Reserve Bank remains committed to market discipline as an important part of its three pillars approach to prudential supervision. For the above reasons, we see a materiality threshold not as a retreat from market discipline, but as a way to focus it and make it more effective.

74. New Zealand is an outlier internationally in its approach to banks disclosing breaches of prudential requirements. Overseas prudential regulators for the most part only require publication of a breach of a prudential requirement when it has been determined as a result of enforcement action taken against a bank, and even then, publication is decided on as part of the enforcement process, and is only required in the most serious cases.

75. Internationally, the only matters on which a breach of a minimum prudential requirement is automatically disclosed relate to the Basel Committee's "Pillar 3" disclosure requirements. If a bank did not meet its minimum capital ratios or the Basel Liquidity Coverage Ratio, this would be obvious from the numbers in its Pillar 3 disclosure. There are also a number of overseas banking supervisors that publish the results of individual bank stress tests that determine whether a bank would still have sufficient capital in a severe economic downturn.

76. Overseas market-conduct regulators tend to have a more disclosure-based approach to breaches, but still only following regulatory enforcement action.

77. Aligning with overseas common practice is not an objective in itself. However, the larger New Zealand banks are heavily reliant on overseas investors for funding. Overseas investors may be familiar with disclosure of conduct breaches by banks, but would tend to view a breach of a prudential requirement as a serious matter.

Introducing a materiality threshold would reduce the frictions and risk involved for banks in explaining to overseas investors how the New Zealand approach works.

78. The benefits of Option 2 would be reduced to the extent that we make further progress on improving the design of CoRs. In the limit, if we could frame CoRs so that any breach was always genuinely material, there would be no benefits from Option 2.

Costs / disadvantages of Option 2 compared to Option 1

79. Option 2 would remove the current certainty that all breaches are disclosed. A materiality threshold might cause concerns that disclosure thresholds are applied unevenly across banks. Some current readers of disclosure information might actively want to continue receiving information on all breaches, if they prefer to make their own assessment of the implications and seriousness of a given breach.

80. The idiosyncratic nature of breach disclosure in New Zealand reflects our idiosyncratic approach to prudential supervision generally. Although the New Zealand model has evolved considerably since the original market discipline-based approach was set up in 1995, it remains thinly-resourced and non-intrusive by current international standards. With a limited role for supervisor verification in our approach, losing the ex ante market discipline provided by banks' management knowing that <u>all</u> CoR breaches will be published could arguably change incentives in a material way. (However, that would be offset, at least to some extent, by the formalising of reporting of all breaches to the Reserve Bank.)

81. The new webpage proposal might help deal with the problem of trivial breaches, by allowing readers to understand better the nature of CoR breaches, and the distinction between trivial and significant ones. For the larger banks, this might make it easier for them to demonstrate to international investors that breaches are a normal feature of the New Zealand approach.

Q9: What are your views on the balance of benefits and costs of introducing a materiality threshold?

<u>*Process for handling errors in disclosure statements*</u>

82. The current flexible approach to handling errors in DSs has been referred to above. We believe that this approach works satisfactorily in practice.

83. One option that we could consider would be to give explicit guidance on tolerance thresholds for important numbers. For example, we could specify that an error of less than 10 basis points in the CET1 capital ratio can wait to be corrected in the next DS, with corresponding steps up the correction ladder for higher ranges of error.

84. However, we believe the other initiatives proposed in this paper should be given higher priority, so we do not intend to explore this option further at this stage.

Q10: Do you think this would be a helpful proposal to develop further in due course? Do you agree that it should be given lower priority than the other proposals in this paper?

Timing and next steps

85. The consultation runs until 14 December 2018. We plan to hold at least one workshop for banks during that period, and also reach out to people with an interest in reading information about breaches of requirements.

86. After the consultation has closed, subject to feedback, the first step would be the issuing of section 93 notices to all banks to implement the formalised breach reporting requirements. We would aim to finalise the notice and the online notification form as soon as feasible after completing analysis of the comments received and any follow-up discussions with banks. This points to an issue date for the s93 notices by end-February 2019.

87. If needed, the section 93 notices could specify a delayed start date for the reporting to begin, to allow system and process changes that banks may need to ensure they meet the formalised reporting requirement. The Reserve Bank will also need to ensure it is ready to receive reports using the new online reporting template by the start date.

88. We do not propose this new reporting obligation to include any “back-filling”, that is, any reporting of breaches that have occurred since the publication of DSs moved from quarterly to six-monthly (end-March 2018) and the start date of the new reporting. Since end-March 2018, the timing gap between the occurrence of a CoR breach and its disclosure has widened by 3 months. The new proposals will restore the previous timeliness (and more) for the future, and the actual harm to market discipline that could be fixed by back-filling appears minimal.

Q11: Do you think your bank will need additional preparation time between the finalisation of the reporting notice and its start date, and if so, how long?

89. Subsequent steps will depend on whether Option 1 or Option 2 is chosen in light of the consultation feedback.

90. Under Option 1, no changes would be needed to the disclosure Orders in Council. Accordingly, we propose that the new Reserve Bank web page presenting all registered bank CoR and s80 breaches would go live on the same date that the reporting obligation starts. For simplicity, we propose that the new webpage would contain all actual determined breaches which first come to the Reserve Bank’s attention, via the reporting mechanism or by other means, on a date on or after the start of the new mechanism. The web page includes a field for the date or date range of when the breach occurred. Explanatory text on the webpage would explain the nature of when its coverage starts.

91. Under Option 2, the disclosure OiCs will need to be updated as discussed above, so that DSs include details of CoR breaches and the directors' attestation in relation only to <u>material</u> breaches. Full and half year DSs published for periods ending on or after the effective date of the OiC changes will only report material breaches. Given the process requirements needed to make OiC changes, we assume for illustrative purposes that the earliest date by which OiC changes can take effect will be 30 June 2019.

92. If we assume that the section 93 reporting process and the breach reporting web page go live on 1 April 2019, this means there are two options for handling the first year of implementation:

    a. If the OiC changes take effect on 30 June 2019, any breaches that have occurred between 1 July 2018 and 31 March 2019 (and may have already been published in a half-year DS) will need to be retro-actively assessed by the Reserve Bank to determine if they need to be disclosed by a bank in its DS for end-June 2019 or later.

    b. Otherwise, the effective date of the OiC changes could be delayed until 31 March 2020. The breach webpage would publish only material breaches starting from 1 April 2019, and DSs from end-March 2020 would refer only to those breaches. This would mean that from April to December 2019, a bank's DSs would include all CoR breaches, but the webpage would report only breaches found to be material under the new process in place.

Q12: Which of options (a) or (b) do you prefer, and why?

Appendix 1 – Draft section 93 notice and online breach notification form

[Date to add]

[CEO name to add]
Chief Executive Officer
[Bank name to add]
[Bank address to add]

Dear [CEO name to add]

New breach reporting requirements

As you will be aware, the requirement for registered banks to prepare off-quarter disclosure statements was removed from 31 March 2018. A consequence of this change is that any breaches of conditions of registration by a registered bank are now only published in disclosure statements on a six monthly basis. To compensate for this change, and to formalise existing arrangements around the private reporting of breaches to the Reserve Bank, we are issuing all registered banks with a notice under section 93 of the Reserve Bank of New Zealand Act 1989 requiring them to provide information on any breaches of prudential requirements, and certain related matters.

This letter therefore gives you notice under section 93 of the Reserve Bank of New Zealand Act 1989 of the requirement to provide information on these matters.

Notice under Section 93 Reserve Bank of New Zealand Act 1989

If [bank name to add] becomes aware of information that leads it to form a belief (or reasonably ought to have led it to form a belief) that it has breached, may have breached, or is likely to breach a specified requirement at any time from [1 April 2019] onwards, [bank name to add] must provide the Reserve Bank with a completed version of the template contained in the Annex to this letter as soon as practicable.

For these purposes, “specified requirement” means a requirement set out in any of the following instruments made under the Reserve Bank of New Zealand Act 1989:

- A condition of registration imposed under Section 74;
- A notice issued under section 80; or
- An Order in Council made under section 81.

Under the Reserve Bank of New Zealand Act information collected pursuant to this notice is confidential to the Reserve Bank and may only be disclosed outside the Reserve Bank in the circumstances listed in section 105 of the Act. Section 105(2)(d) of the Act permits the Reserve Bank to disclose this information for the purposes of, or in connection with, the exercise of powers under the Act. The Reserve Bank may publish confirmed breaches of prudential requirements on its website under section 105(2)(d).

If you have any further questions regarding this request, please contact [name and contact details to add].

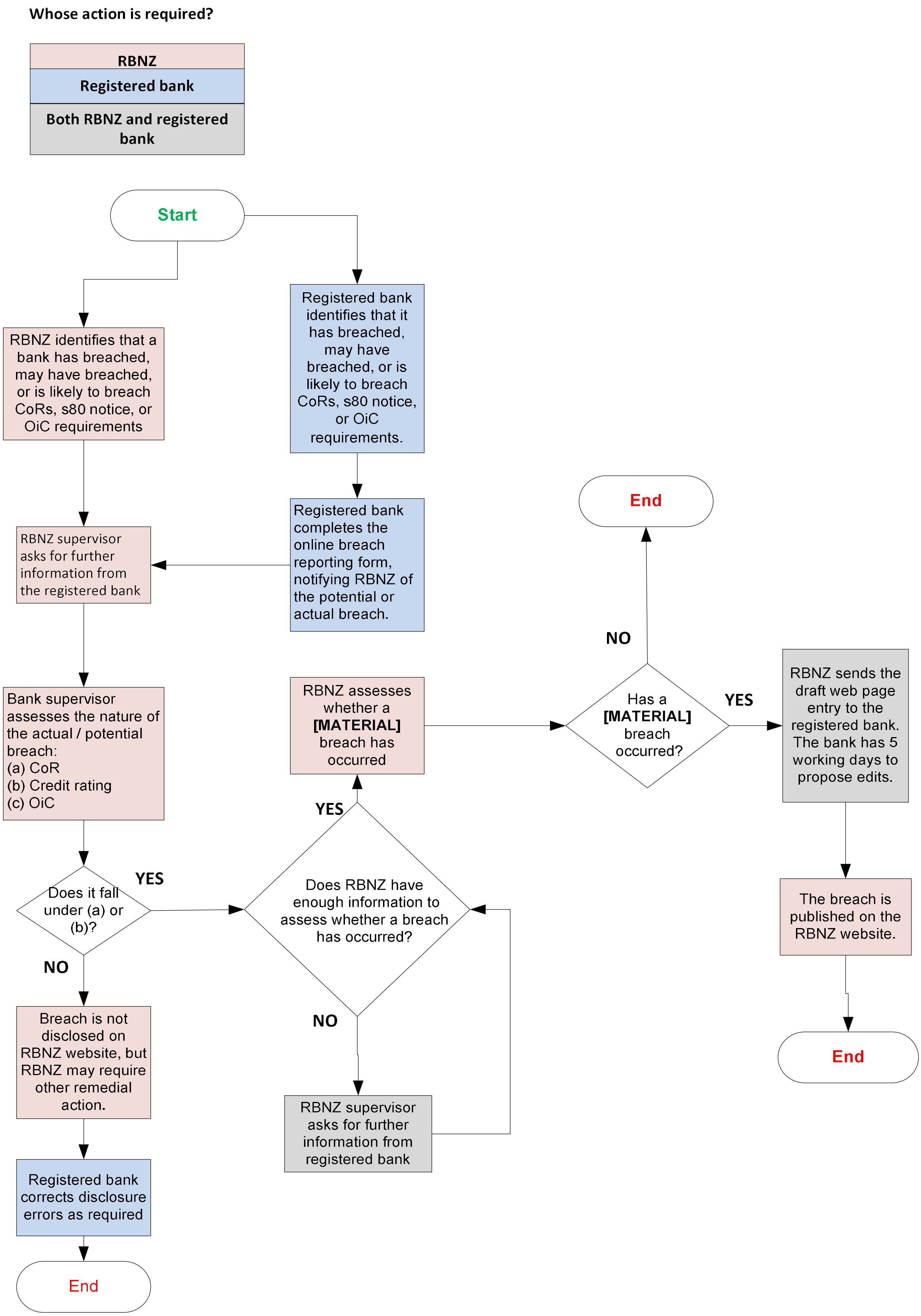
Yours sincerely

[name to add]
Senior Manager Supervision

Annex to Section 93 Notice – Template for notifying the Reserve Bank

Bank	**Contact details**	**Nature of breach**	**Category of breach**	**Date of actual or potential breach**	**Date the bank became aware of the breach**	**Bank directors when the breach occurred**	***[View on materiality – for Option 2 only]***	**Remediation plan**
	Name, position and contact details of the person completing the form	*CoR, credit rating, or OiC breach?* *Nature and impact of the breach.* *Note: where possible, please include information on the scale of the breach, e.g. dollar amount involved, number of customers affected.* *How was the breach identified?*	- Capital - Liquidity - Loan to Value restrictions - Governance - Credit ratings - Outsourcing - Connected exposures - Open bank resolution - Other	*Date or date range of when the breach occurred / may have occurred / will likely occur*	*Date the bank became aware of the breach*	*Directors of the registered bank during the period that the breach of prudential requirement/s occurred*	*[Whether or not, in the opinion of the directors, the breach was material.]*	*Remediation actions already undertaken by the registered bank and / or proposed actions to rectify the breach.* *Note: The bank may wish to leave this section blank if the bank has not yet formed a remediation plan.*

Appendix 2: External process map for breach reporting



Appendix 3 – Draft Reserve Bank webpage

Breaches of registered banks' prudential obligations

Descriptive text may explain / include links to:

- *What are registered banks' prudential obligations?*
- *What is a breach of a registered bank's condition of registration?*
- *[Under Option 2, include discussion of the materiality threshold]*
- *What is a breach of a bank's requirement to maintain a current credit rating?*
- *Prudential dashboard*
- *Online breach notification form*

Bank	**Nature of breach**	**Category of breach**	**Date the breach occurred**	**Date the bank became aware of the breach**	**Date the breach was confirmed by RBNZ**	**Bank directors when the breach occurred**	**Additional information (if any)**
	CoR breach or credit rating breach? *What is the nature and impact of the breach?* *How was the breach identified?*	- Capital - Liquidity - Loan to Value restrictions - Governance - Credit ratings - Outsourcing - Connected exposures - Open bank resolution - Other	*Date or date range of when the breach occurred*	*Date the bank became aware of the breach*	*Date that RBNZ confirmed that the bank has breached its prudential requirement/s*	*Directors of the registered bank during the period that the breach of prudential requirement/s occurred*	*Any public action taken by RBNZ in response to the bank's breach [to be filled out by RBNZ]*

Appendix 4 – Consolidated list of consultation questions

Q1: How far would this particular change go towards addressing any concerns about the need to disclose non-material CoR breaches?

Q2: Will reporting instances where your bank is “likely to breach” a requirement present particular challenges? Is there a form of words you would prefer for this obligation?

Q3: Do you have any comments on the content of the proposed new webpage and the process for updating it?

Q4: Please could you provide estimates of the costs to your bank, compared to the current arrangements, arising from:

- any additional process costs you would incur per breach, in the case of breaches that you think you would have discussed with the Reserve Bank under current arrangements;

- additional cases (if any) of potential or likely future breaches you would expect to report to the Reserve Bank in future, that you would not report at present.

Q5: Do you agree that the proposed requirement to give a view on materiality to the Reserve Bank would impose significantly less burden on directors than the current need to handle publication of all non-material breaches?

Q6: Do you have suggestions for additions or amendments to this list?

Q7: Do you agree with the proposed timing for inclusion in the DS? Do you have any other comments on the revised wording?

Q8: Do you think this is a workable amendment to the director attestation?

Q9: What are your views on the balance of benefits and costs of introducing a materiality threshold?

Q10: Do you think this would be a helpful proposal to develop further in due course? Do you agree that it should be given lower priority than the other proposals in this paper?

Q11: Do you think your bank will need additional preparation time between the finalisation of the reporting notice and its start date, and if so, how long?

Q12: Which of options (a) or (b) do you prefer, and why?