RESERVE BANK OF NEW ZEALAND
TE PŪTEA MATUA

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

Summary of submissions and policy decisions

September 2019

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

1. On 23 October 2018, the Reserve Bank published a consultation paper "Public and private reporting by banks of breaches of regulatory requirements, with consideration of materiality" with submissions due by 14 December 2018. The main matters consulted on were a formal requirement for banks to notify the Reserve Bank of any breaches of their conditions of registration, publication of collated breach information on the Reserve Bank's website, and consideration of an option to apply a materiality threshold to publication of breaches.

2. The intent of the proposals is to enhance the market discipline effect of prompt breach reporting and publication and, in considering the option of a materiality threshold on publication of breaches, to reduce the focus on relatively minor breaches that may divert directors' attention away from more important areas such as the bank's overall strategic direction and management of key risks.

3. We received three submissions, from the New Zealand Bankers Association ('NZBA'), Bank of Baroda (NZ) Ltd, and the Banking Ombudsman. All submissions have been published, with the consent of the submitters, on the Reserve Bank's website.

4. This document summarises the submissions, and sets out the Reserve Bank's final decisions, in light of the feedback received, on how the proposed reporting and publication of breaches should operate.

Outline of the proposal consulted on

5. The basic framework proposed in the consultation paper was that banks would be subject to a formal notice issued under section 93 of the Reserve Bank of New Zealand Act 1989 ('the Act'), requiring them to report any case where they have breached, may have breached, or may be likely to breach, a regulatory requirement. The Reserve Bank would then filter this material to display only actual breaches on a new webpage, and under Option 2 (of two options), only material actual breaches would be published on this webpage.

6. Banks would be provided with a reporting template which would be used to populate cells on the webpage with specific information about reported breaches. However, the Reserve Bank would retain ultimate control over what was published, so could depart from the information that banks reported (in the unlikely event that was considered necessary). Breaches would be left on the website for 5 years, in order to align with the period banks must keep disclosure statements (DS) on their websites.

Key areas of feedback

Materiality threshold for disclosure

7. All respondents were in favour of putting in place a materiality threshold for public disclosure (option 2 in the consultation paper).

8. **Response**: The Reserve Bank intends to proceed with option 2.

Nature of formal reporting obligation to Reserve Bank

9. The NZBA raised concerns about using a formal section 93 notice to establish a requirement to report all breaches to the Reserve Bank, rather than just those breaches that are material. Their key point is that failure to comply with a section 93 notice carries

a criminal penalty for the registered bank, so requiring reporting of immaterial breaches would defeat one of the main purposes of the changes, namely to free up directors' time from considering trivial compliance breaches (actual and potential). The burden would simply shift from considering the content of DSs, to the content of section 93 reports to the Reserve Bank.

10. The NZBA also warned that this approach could lead to delays in notifying supervisors (compared to what happens under the current informal understanding), as banks would be careful to make sure they have all the information needed, and that it is correct, before reporting.

11. The NZBA also suggested that principles of self-discipline suggest that it should be the responsibility of directors to assess materiality, and noted that this would align with directors' duties in other contexts (for example, NZX does not pre-approve market disclosures).

12. **Response**: The Reserve Bank acknowledges the concerns around routine reporting of all breaches under section 93 reports with no materiality threshold. The proposed approach will be modified such that:

    - The section 93 obligation will only require a bank to report promptly to the Reserve Bank when it has breached, may have breached, or is likely to breach, a requirement in a material manner; and

    - The reporting bank will be responsible for assessing whether an actual or potential breach is material for these purposes.

13. This approach also has the incidental benefit of aligning the scope of the section 93 notice with banks' reporting obligations under section 412 of the Financial Markets Conduct Act 2013 (FMC Act). However, it leaves open the question of how non-material breaches should be treated.

14. The NZBA proposal was to rely on existing arrangements for this, under which we expect a bank to be in touch with its supervisor promptly when any question of a breach or potential breach arises. The NZBA argued that this is in the spirit of the Relationship Charter,[1] which will help to support this approach. They also suggested that we could bolster this approach by additional guidance on our expectations around supervisory relationships, with a warning that in any case where a bank lost our trust, we would issue that bank with a section 93 notice to require immediate reporting of all breaches.

15. **Response**: The Reserve Bank considers that additional requirements are appropriate given the materiality threshold in the section 93 notice referred to above, and therefore has decided that banks will be subject to a separate obligation in the section 93 notice requiring them to report within a set period after the end of each half-year instances during the half-year where the bank has become aware of, and has confirmed that there has been, a breach of a requirement, This reporting obligation may also cover:

    - Instances of a breach identified in earlier periods that was not fully remediated at the start of the half-year period;

[1] https://www.rbnz.govt.nz/news/2018/12/reserve-bank-aims-for-best-regulatory-relationships

- Instances where the bank has identified that it may have breached, or is likely to breach, a requirement during the half-year, and where at the reporting deadline it has not yet been determined whether or not a breach has occurred; and

- Instances where the bank previously reported that it may have breached, or was likely to breach, a requirement in an earlier half-year report, alongside the final determination of whether or not there was a breach.

16. The purpose of this requirement is to enable supervisors to perform an *ex post* check on whether all material breaches have been reported promptly under the section 93 notice, and to get an overview of the nature of all non-material breaches during the period, and whether there are any that were not notified informally to the supervisor, but which may warrant supervisory follow-up.

17. Following feedback from banks, the deadlines for providing these reports will align with those for publishing DSs, namely 2 months for the half-year, and 3 months for full-year reporting.

Scope of the breaches to be covered by the new framework

18. The consultation paper proposed that the section 93 notice would cover three types of compliance failure: (1) a breach of a Condition of Registration (CoR); (2) a failure to comply with a section 80 notice requiring banks to have a credit rating; and (3) non-compliance with an Order in Council (OiC) disclosure statement requirement. However, the website would list material, actual breaches of only the first two, and not OiC errors. The rationale for this is that the disclosure regime already has its own flexible mechanism for publicising any error that a bank makes in a disclosure statement: the degree of publicity can already be tailored to the seriousness of the error in that context.

19. The NZBA took this rationale further and argued that the section 93 notice should also only cover CoR and section 80 breaches, as the current approach for informally reporting disclosure errors works well.

20. **Response**: Directors already have to attest to the accuracy of DSs when they are published, so the benefit of covering OiC breaches in the section 93 notice is to cover any breaches that are identified after the disclosure statement is published. Also, the burden on banks of including OiC breaches in the section 93 notice is substantially reduced if the notice just requires reporting of material breaches. On balance the Reserve Bank considers that the section 93 notice should require the reporting of material OiC breaches when they are identified, and that the half yearly reports of all breaches (including non-material breaches) should also cover breaches of OiC requirements. However, breaches of OiC requirements would not be published on the Reserve Bank website, as they will continue to be dealt with through the existing process.

High-level definition of materiality threshold

21. The CP did not specify any high-level principle for what counts as material, and the NZBA asked for more clarity on how materiality should be determined. They suggested that the high-level test should be based on what the disclosure is for, namely to enable market discipline. They point to the interest of depositors and investors being in the credit risk of a bank, and the FMA's principle that the market requires "clear, concise and effective communication".

22. **Response**: The Reserve Bank considers that in addition to the test above there could be some other types of breach that are not material for investors interested only in a bank's creditworthiness, but are material for the Reserve Bank as regulator. Therefore a second limb will be added to the test in order to cover this, and any breach counting as material under either limb of the test should be captured by the section 93 report and published on the website. The materiality threshold to be used will be set out and clarified in guidance.

Lower-level guidance on the materiality threshold

23. In the consultation paper there was a non-comprehensive list of criteria for assessing materiality, as an illustration of how the Reserve Bank expected to apply the materiality threshold. NZBA suggested that three of these criteria were relevant only for the regulatory consequences for a bank following a breach, rather than materiality of the breach as such. We accept this point. At the same time the NZBA also provided a number of other possible criteria.

24. **Response**: We will incorporate this feedback in the guidance document, which will provide more detailed examples around the materiality threshold to clarify the high level principles.

Ownership of the wording for the website

25. The proposed framework meant that the Reserve Bank would finalise the wording of the description of a breach on its website, although it would "as far as possible" use the text provided by a bank on the section 93 reporting template, and we would give the bank the opportunity to comment on the proposed text (with a 5 working day turn-around).

26. NZBA had concerns that this would undermine ownership of, and accountability for the breach, and hence undermine the principle of self-discipline. This would also be inconsistent with directors being accountable for the description of breaches in DSs, and in fact, as website publication of a breach would come before its inclusion in a DS, this would amount to the Reserve Bank dictating how directors should describe a breach in the DS.

27. NZBA proposed instead that a bank would provide the Reserve Bank with text for the website description of a breach no more than 10 working days after they had sent us the notification of the breach in line with the section 93 notice.

28. **Response**: The DS is signed off by the directors and responsibility for the wording remains firmly with them. It is important that banks retain this responsibility as much as possible. The website itself can also make it clear that the text that is being disclosed has been provided by, and is the responsibility of, the bank that has breached. In the rare case that a departure is made from the text provided, the Reserve Bank will provide reasons for the departure and a longer period of time to respond than the 5 days that banks will usually have to check the accuracy of what the Reserve Bank proposes to publish. In these cases the website will make it clear that the text being used is not that provided by the reporting bank.

Other matters

Changes to disclosure statements

29. The CP included draft wording changes in two parts of the OiCs. NZBA have proposed one minor wording change in the revised directors' attestation. This is to replace

"materially complied with all CoRs" with "materially complied with each CoR" (or words to that effect).

30. **Response**: The wording suggestion is accepted.

31. The consultation paper gave two options for how long after the launch of the website page the OiC changes should go live. NZBA preferred the option of earlier change, Bank of Baroda the later option.

32. **Response**: On balance the Reserve Bank considers the earlier date appropriate for the OiC changes. This means that when the OiC changes go live, it is possible that some banks may have already disclosed a breach in a half-year DS, which occurred before the start date of the web page disclosure of material breaches. Any such breach will need to be separately assessed to see whether it counts as material, or whether it can be dropped from the full-year DS.

Keep disclosures on website for 5 years

33. We proposed that the website should only include breaches that have occurred in the last five years, in line with the current requirement for banks to keep their DSs available on their website for at least 5 years. The NZBA response agreed with this, while Bank of Baroda thought only one year's breaches should be disclosed, in line with what is in the current DS.

34. **Response**: This balance of views supports keeping the disclosures on the website 5 years. In addition, the Reserve Bank confirms that the webpage will cover only new breaches reported after the go-live date. The webpage will make it clear what time period it covers.

Definition of "when the bank becomes aware"

35. The draft section 93 notice requires a breach report "if [the bank in question] becomes aware of [relevant] information …". NZBA have noted that this could be interpreted in a number of ways. What they suggest is that a bank is "aware" once "senior managers" (as defined in the Financial Markets Conduct Act 2013 (FMCA)) have actual knowledge of the facts which give rise to the need for disclosure.

36. **Response:** This suggestion appears reasonable and workable to the Reserve Bank. This interpretation will be incorporated into the guidance document that supports the section 93 notice, noting that both directors and senior managers will be included in the definition of an organisation 'becoming aware'.

Detailed content of the breach reporting (as per Annex to the s93 notice)

37. The CP included a proposed template to be attached to the section 93 notice, setting out the information that a bank is required to provide on each breach. NZBA proposed an additional column to specify whether the notification covers an actual, "may have occurred", or "will likely occur" type of breach.

38. **Response**: This suggestion is accepted. Also, given the changes from the original proposals in the CP, two versions of the reporting template will be provided for (one for the prompt reporting of a material breach, and one for the six-monthly reporting of all breaches during the period). There will be some minor differences between the templates to reflect the different coverage or each.

Detailed content of the website

39. The CP proposed that the webpage should list the names of the directors of the bank when the breach occurred. NZBA argued against this on the basis that this information is available elsewhere, and also that directors may change over the period when a breach occurs.

40. **Response**: The Reserve Bank acknowledges that the possible complexities in this requirement outweigh any benefits, and has decided that it is not needed on the webpage or in the information provided on the section 93 reports.

Next Steps

41. The Reserve Bank would like to thank all submitters for their constructive input into the development of this reporting policy. A draft of the section 93 notice will be sent to all banks for any last comments. Final section 93 notices will then be issued to all banks in time to come into effect for the current target date of 31 December 2019. Draft revisions to the OiCs will be sent to all banks for consultation in 2019, to align with the intended date the new OiCs come into effect of 31 March 2020.