

The Regulatory Stocktake: An Update

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“Everything should be made as simple as possible, but not simpler” – Albert Einstein

Introduction

Thank you for the opportunity to meet with you this afternoon.

It is exactly 364 days since the launch of the Reserve Bank’s Regulatory Stocktake project. We said at the time that the work was likely to take about a year. We have beaten that target – if by only one day!

It has been a busy 12 months for us and for our stakeholders, including industry, who have contributed enormously to the progress we have made. I would like to place on record my thanks to all the individuals who have helped shape our thinking and provided important and varied perspectives.

As you will know, the stocktake is a review of the prudential framework for banks and Non-bank Deposit Takers (NBDTs), and our policy development processes.

To set the context, I will first say a few words about why we prudentially regulate banks and NBDTs and how this regulation operates, before discussing in more detail the origin and purpose of the stocktake, and the contents of the public consultation document we are about to publish.

Part 1: The role and nature of our prudential regulatory regimes

The primary objective of our prudential framework is to promote the maintenance of a sound and efficient financial system (or in the case of insurance, a sound and efficient insurance sector). It achieves this objective by helping to address major externalities and information asymmetries that could affect the soundness and efficiency of the financial system as a whole.

We have spoken elsewhere about the scope for these kinds of externalities to arise (for example, the likelihood that banks and NBDTs have incentives to increase leverage and risk in the expectation of higher returns, without necessarily bearing all of the costs if things go sour). The potential scale of these externalities is well known and was illustrated by the Global Financial Crisis (GFC).

Information asymmetries (where one party to a transaction has better information than the other) can also easily arise due to the nature, scale or complexity of the business being carried on by banks and NBDTs. We address information asymmetries mainly through credit rating and disclosure requirements.

Our regulatory approach is based upon the three pillars of 1) market discipline, 2) self-discipline and 3) regulatory discipline. In practice, this framework means that we:

- Place primary responsibility for risk management and for compliance with regulatory standards on directors and management;
- Place significant weight on effective public disclosure; and

- Generally adopt conservative prudential standards.

As a result of this, we also adopt a less intrusive supervisory approach than many of our counterparts around the world. We're focused on governance, strategic direction and risk management, with no on-site inspections in the ordinary course of supervision.

Part 2: Origins and purpose of the regulatory stocktake

Over the last 10 years, there have been significant changes to the prudential requirements that banks must comply with. These changes include the adoption of Basel II and III capital requirements, new liquidity and governance requirements for banks, the Open Bank Resolution (OBR) policy, and new macro-prudential tools like loan-to-value ratio (LVR) restrictions. At the same time, NBDTs have been made subject to prudential regulation for the first time.

Some of these changes have been driven by international reforms, in particular following the GFC. We agree with the underlying rationale for these reforms, and have in most cases adopted them, although customising them for New Zealand's circumstances where appropriate.

Other changes have been driven more by domestic factors. One example of this is the adoption of LVR restrictions in light of the financial stability risk posed by house price inflation over recent years. Another example is the prudential regulation of NBDTs, which was implemented in part as a result of 45 finance companies going into liquidation, receivership or moratorium between 2006 and 2011.

Such a diverse set of changes can create the risk of inefficiencies and inconsistencies developing in our overall regulatory framework. It is also good practice to review regulatory regimes from time to time, to ensure they remain effective and fit-for-purpose. For these reasons, we announced in July last year that we would be carrying out the stocktake.

However, we also indicated at the time that we considered that the key foundations of the prudential framework (e.g. adequate capital and liquidity, effective governance, and risk management) were appropriate, and that fundamental changes in these areas were not being considered.

Part 3: Progress of the regulatory stocktake to date

The primary objective of the stocktake is to help ensure the efficiency, clarity, and consistency of prudential requirements applying to banks and NBDTs. In particular, we want to ensure that the prudential regime does not unnecessarily undermine dynamic, allocative and productive efficiency in the market, and the scope for innovation. In practice, this means ensuring that it does not impose unnecessary costs or restrictions on banks and NBDTs, while still achieving its core financial stability objectives.

The secondary objective of the stocktake is to consider whether there are areas where we can further improve the quality and effectiveness of the current policy development process across our prudential and macro-prudential functions. A particular focus of this objective is considering the transparency of our policy development processes and our engagement with stakeholders.

Within the scope of the stocktake are the conditions of registration, Orders in Council, and guidance material that make up the Banking Supervision Handbook, and the specific prudential requirements applying to NBDTs (such as those relating to capital, liquidity, and risk management).

But the stocktake is not designed to review the core foundations of our regimes, whether legislative (the content of the Reserve Bank of New Zealand Act 1989), or fundamental policy settings (such as the specific calibration of bank capital and liquidity requirements).

As part of the stocktake, we have carried out a detailed analysis of the prudential requirements applying to banks and NBDTs. We have consulted broadly with industry, including holding four separate industry workshops with banking industry representatives, and consulting with relevant NBDT industry bodies. We have also held four separate meetings with a panel of independent banking and regulatory experts, to test our thinking as it has progressed. I would like to take this opportunity to thank participants at the industry workshops and the members of the expert panel for the very valuable contributions they have made.

Part 4: Public consultation on the stocktake

Today we are publishing a consultation document relating to potential changes to the banking regime arising out of the stocktake, and a separate 'Industry Update' on our responses to the NBDT related issues that have been raised as part of the stocktake.

The consultation document is divided into six separate sections.

Section 1: Disclosure and data reporting requirements

The first of these sections discusses a number of possible changes to banks' public disclosure and statistical reporting requirements.

Between 2009 and 2011, we carried out a review of the disclosure statement regime for banks. This review resulted in a variety of changes, including removing the requirement to prepare key information summaries and supplemental disclosure statements. At the time, cost estimates from the banks indicated that these changes would result in direct cost savings of between \$99,000-\$140,000 per year for larger banks, and \$21,500 per year for smaller banks.

Since that time, a number of other issues with the disclosure statement regime have been raised with us. The most important of these issues is the value and cost-effectiveness of some or all banks preparing off-quarter disclosure statements. For those not familiar with the term, "off-quarter disclosure statements" are those that are produced for the three month periods after the end of the full and half-year.

Whether the requirement to prepare off-quarter disclosure statements should be retained is an issue that we have considered again as part of the stocktake. Because the disclosure regime plays a key role in supporting the market and self-discipline pillars of our regulatory approach, we want to move carefully in this area, and ensure that any changes to the

requirement to prepare off-quarter disclosure statements do not open up gaps in the prudential framework.

In saying that, we are also well aware of the concerns banks have raised about the financial and opportunity costs created by having to prepare off-quarter disclosure statements, and the importance of assessing whether the benefits of this requirement still outweigh the costs. With this in mind, the consultation document will propose four options relating to the requirement to prepare off-quarter disclosure statements. These options are:

- Retaining the status quo;
- Removing the requirement for branches, and locally incorporated banks with retail deposits under \$200 million, to prepare off-quarter disclosure statements, and scaling back the contents of other banks' off-quarter disclosure statements to just capital and asset quality disclosure;
- Removing the requirement for all banks to prepare off-quarter disclosure statements, and replacing it with some form of continuous disclosure that would complement the ongoing requirement to prepare full and half-year disclosure statements; and
- Removing the requirement to prepare off-quarter disclosure statements altogether.

We have discussed these options in detail with interested parties (such as the Financial Markets Authority), but have not yet formed a view on which of these options would be preferable. More information on costs and benefits would be valuable. Obviously, we would like to hear from industry about the actual costs and benefits of each option, and we encourage submitters to be as specific as possible about the qualitative and quantitative costs and benefits. We would also welcome input from stakeholders generally about other matters, such as their perspectives on the market and self-discipline benefits.

In addition, we are proposing a number of technical changes to the contents of disclosure statements, which in totality should deliver benefits at a somewhat lower cost (for example, removing or scaling back some public disclosure relating to concentrated credit exposures). We would also welcome views on whether other changes to the contents of disclosure statements would help to improve their usefulness.

While I'm on the subject, I note that we have recently decided to remove the current requirement for banks to publish, as part of their full-year disclosure statements, solo legal entity financial statements alongside their group financial statements. Our prudential supervisors will still need to get hold of some of the data from these reports, but we will do that in future via private reporting. We think this will mean a net saving for banks, and are working to have this change in place by the end of this September.

Section 2: Handbook restructure

The second section of the consultation document discusses proposals to restructure the Banking Supervision Handbook. The Handbook has grown 'organically' over time, in the sense that new documents have been added to it and numbered in chronological order, rather than being fitted into a more coherent structure. We believe that the structure and presentation of the Handbook can be significantly improved.

We expect that this will be of significant benefit to users of the Handbook, by making the different parts of the prudential framework significantly clearer and easier to navigate.

Some of the more specific changes we are proposing as part of this work are:

- Clarifying the boundary between binding requirements and guidance in various parts of the Handbook;
- Breaking up some of the more complex parts of the Handbook (for example, the current BS2A and BS2B documents dealing with capital requirements) into smaller more manageable modules; and
- Creating a single document that provides all of the material needed by applicants for registration.

Completing this work will be a major exercise, so the discussion document does not include fully drafted proposals for a new Handbook. Rather, it sets out the main parameters of the work, and also a proposed project timetable broken up into four stages.

Section 3: Capital

The third part of the consultation document discusses a variety of initiatives that are underway or planned in future relating to capital. This includes removing from the Handbook certain capital-related matters that may no longer be relevant and have never been used (for example, the Foundation Internal Ratings Based (IRB) approach, which was originally intended as a half-way measure between full IRB accreditation and being on the standardised approach, and the Qualifying Revolving Retail Exposure class).

While it is not formally part of the stocktake, we also note that, as announced in the May 2015 *Financial Stability Report*, we will shortly be conducting a review of bank and NBDT capital requirements. This will take into account any changes recommended by the Basel Committee as part of its current work on reviewing the standardised and IRB approaches to bank capital requirements.

Section 4: Policy-making approach

The fourth part of the consultation document deals with our policy-making approach, which is an area that I know many of you have an interest in.

The Reserve Bank's approach to policy seeks to follow best practice approaches by working through the key stages of problem definition, option analysis, and consultation. We prepare regulatory impact statements for proposals that will result in legislation, and separately analyse the regulatory impacts of other policy proposals. We also aim to periodically review key policies to ensure that they remain effective and fit for purpose. Many of you will have seen our *Financial Stability Report*, which provides an update of developments in prudential regulation.

The stocktake has highlighted stakeholders' interest in greater transparency regarding the Bank's policy-making processes, as well as enhanced engagement with industry regarding new policies or policy changes.

In light of this, we are proposing to publish a new document that describes our approach to policy making. The document will note, amongst other things, how we approach problem definition and option analysis. To quote directly from the draft attached to the consultation document:

“Not every potential market failure warrants a regulatory solution. Regulatory costs can be significant and there is always a risk of regulatory failure...The Reserve Bank's analysis of policy options is undertaken against the status quo and/or the absence of regulation. Regulatory action is only proposed if a regulatory solution is likely to improve on the market outcome.”

The document will also highlight our aim of consulting “over a 4-8 week period, depending on the significance of the proposal”, and in the occasional cases where this is not possible, seeking to be clear about the reasons for this. Over the last 12 months, we have met this target: all the eight policy consultations we initiated were for at least four weeks; the mean period was seven weeks; and one was for ten weeks.

To improve communication with stakeholders more broadly, we also propose to:

- Revise the content of our website to make it more user-friendly (this will build to some extent on the changes to the structure and presentation of the Banking Supervision Handbook);
- Provide a more dynamic *Consultations and Policy Initiatives* section on our website, by updating it at least quarterly to include current initiatives that the Reserve Bank is working on relating to bank regulation and supervision;
- Develop an *Industry Update* newsletter for banks (based on the current *Insurance Industry Update*) to keep them informed about our work;

In addition, we know that banks and NBDTs are subject to a number of different regulatory regimes, and that the compliance cost burden is often driven by the total amount of regulation an entity is subject to, rather than a single regulatory regime.

Many of you will know that the Reserve Bank is a member of the Council of Financial Regulators (along with Treasury, MBIE and the FMA), which meets on a quarterly basis to share information and discuss emerging issues. Last year, the Council established a new subcommittee called the Banking Forum (which IRD and the Ministry of Justice are also associate members of).

The Banking Forum is intended to help ensure that government agencies can oversee all of the regulatory initiatives affecting the banking sector at any one time. The exchange of information at the forum will increasingly help agencies to sequence regulatory reforms and

consultations, so that pressures from bunching are avoided. The Forum has also been considering ways of better engaging with industry.

Section 5: Differentiated regulatory approach

The fifth part of the consultation document analyses the ways that we differentiate the regulatory requirements that apply across different classes of bank. We believe that a differentiated approach has value in delivering the objectives of prudential supervision in a more effective and efficient way than applying a 'one size fits all' approach. Our analysis of this issue has also raised a number of areas for separate consideration. For example:

- Whether to push ahead with previous proposals to extend a form of one-week liquidity mismatch ratio to branches. (This would form part of planned work to consider whether it would be appropriate to modify our liquidity policy in light of the new Basel III requirements); and
- Whether to reduce disclosure requirements applying to branches, both in line with the options for changes to the disclosure regime discussed above, and in some areas of more specific detail.

Section 6: Miscellaneous issues

During the stocktake, our analysis has also raised a number of more minor or technical matters that could usefully be addressed as part of the project. These matters are fairly diverse, and are addressed in the sixth part of the consultation document. We consider that overall they can be expected to improve how efficiently the regime operates and achieves its objectives.

They include refining the existing suitability assessment process for the directors and senior managers of banks. In particular, we are giving consideration to adopting a tighter, more focused definition of 'senior manager' for these purposes, as well as ways of ensuring that the suitability of directors and senior officers is assessed on an ongoing basis.

We are also looking at ways of formalising the reporting of breaches of conditions of registration privately to the Reserve Bank, and ensuring that the reporting of breaches in public disclosure statements operates in an efficient manner.

Separate industry update for NBDTs

Finally, in respect of NBDTs we are publishing a shorter *Industry Update* document, which responds to the various NBDT related issues that have been raised as part of the stocktake. Perhaps the most significant of these issues are:

- The calibration of NBDT capital requirements, which, as I noted earlier, will be part of a separate review that will also cover bank capital requirements; and

- The threshold for qualifying for exemption from the requirement to have a credit rating, which we have recently decided to increase, subject to some entities having to maintain a higher minimum capital ratio to qualify for the exemption.

Part 5: Next steps

We seek and value comprehensive stakeholder input on all of the matters covered by the consultation document, and encourage you to provide free and frank feedback on these issues. We also encourage you to quantify the costs and benefits of the status quo, and the options and proposals in the consultation document, as much as possible. This will help with our analysis and will be important in justifying any changes to some of the more important matters covered in the consultation document (such as the requirement for banks to prepare off-quarter disclosure statements).

The closing date for submission on the consultation document is 16 September. To help banks refine their submissions, next month we propose to have a further banking industry workshop to discuss the contents of the consultation document in more detail. Our final conclusions on the matters covered in the consultation document are then likely to be announced before the end of this year.

I would like to conclude by stressing that the Reserve Bank is committed to ensuring that we have a world-class prudential regulation framework in New Zealand. We see the regulatory stocktake as an important project in helping to ensure that we continue to achieve that outcome.

Thank you once again for the opportunity to talk to you today.