New Zealand's evolving approach to prudential supervision

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Thank you for the opportunity to speak to you this evening.

Today I would like to talk to you about our underlying approach to prudential supervision – our supervisory framework. It has two key parts: our philosophy (the principles underpinning our framework), and our supervisory practices (the tools we use to achieve the outcomes we seek).

We want our framework to be well grounded empirically and in first principles. We seek to adapt it as the financial system and expert thinking evolve. In light of this, we have recently undertaken a periodic 'health check' to ensure our overall framework remains fit for purpose in our changing world.

Many of you will be aware that the International Monetary Fund (IMF) is currently visiting to assess New Zealand's financial system and regulatory settings (a Financial System Assessment Programme or FSAP), an exercise that was last done thirteen years ago. External reviews do concentrate the mind, and the FSAP has been a factor in our critical re-examination of our framework. The IMF will communicate their findings and recommendations to us and the public late this year or early next year. But based on the internal re-examination we have just done, we think the overall New Zealand regulatory framework remains generally suitable, and indeed there seems to be no groundswell for change from industry or public stakeholders. New Zealand's financial system came through the global financial crisis in good shape. That said, we have identified a number of areas where we can consider tilting the approach.

Today I will outline the supervisory philosophy, which has been broadly confirmed by our recent health check. I will then outline some ways we may shift our supervisory practices to ensure that practical implementation aligns with our philosophy.

Our supervisory philosophy

In essence, our supervisory philosophy is to implement cost-effective regulations to mitigate market failures and thereby promote a sound and efficient financial sector for New Zealand.

The starting point for this is the Reserve Bank's statutory objective to maintain a sound and efficient financial system (or, in the case of insurers, the insurance sector). This objective covers a range of sectors, including banks, insurers, finance companies, credit unions, building societies and the payments system.

A sound and efficient financial system can be largely achieved by keeping financial regulation to a minimum so that everyone can get on with their business unimpeded. But where material market failures exist, financial institutions will face incentives to act in ways that differ from the public interest, and regulation might be needed. [1]

The two main market failures we are focussed on are externalities and asymmetric information.

[1] For a detailed discussion of the evolution of prudential supervision in New Zealand, see *the evolution of prudential supervision in New Zealand*: http://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2012/rbb2012-75-01-05

Externalities are costs to wider society that financial institutions have little incentive to take account of when they make commercial decisions. One externality that particularly concerns us is the cost to society when a financial institution fails, or nearly fails, in a disorderly way.

When a financial institution fails, there are inevitably major costs for the institution itself. The shareholders lose their investments, employees lose their jobs, and the board and management may suffer a reputational and financial hit. But there are also major external costs on the wider economy. For example, the failure of a major bank could result in the public losing temporary, or even permanent, access to funds that they rely on to do basic transactions. This can cause widespread disruption in the economy. Interconnectedness can also mean that the failure of one large financial institution – which would already be disruptive enough on its own – can quickly put stress on others. We saw this overseas in the 2008 financial crisis, where stress among a number of overseas banks led to a worldwide credit crunch.

The costs of financial crises are significant – we estimate a potential cost of between 10 and 20 percent of GDP from a serious financial crisis. [2]

In turn, the large social costs of failure can put pressure on governments to bail out or support failing financial institutions. The potential for government support can create an implicit government guarantee on financial institutions' liabilities. Without pre-emptive regulation, an implicit guarantee could even arise in countries like New Zealand, where there is no explicit guarantee. Implicit guarantees can create moral hazard and, perversely, encourage financial institutions to take on even more risk than would be in the public interest. This all provides a strong motivation for financial regulation.

The other market failure we focus on is asymmetric information – where one party to a transaction has better information than the other, and can use that to their advantage (not necessarily consciously). Market participants – and especially individual firms and households – do not have anywhere near as much information about the strength of a bank or insurer as its managers do. Asymmetric information can prevent customers from making informed decisions and undermine the incentives on financial institutions to run their business soundly.

Addressing the market failures

Our philosophy in addressing these market failures is to take regulatory actions that help realign the interests of financial institutions, their customers and wider society. We do this through three pillars – self, market and regulatory discipline.

The self-discipline pillar is aimed at supporting firms' internal risk management and governance systems. It is very hard for customers to evaluate the quality of a financial institution's governance and internal controls, but with regulatory intervention to support self-discipline, customers can have confidence that minimum standards are being met.

[2] Reserve Bank of New Zealand (2012) 'Regulatory impact assessment of Basel III capital requirements in New Zealand', available online at: http://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/banks/policy/4932427.pdf?la=en.

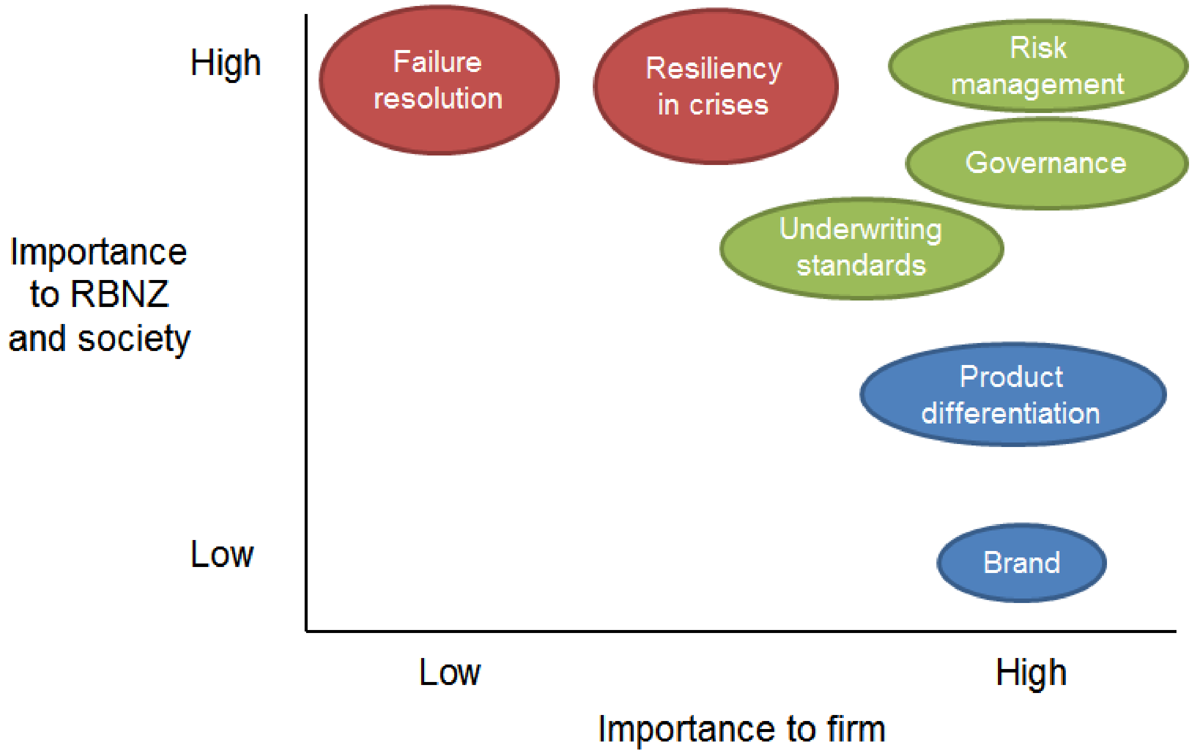
An aim of the market discipline pillar is to reduce the information asymmetry between firms and market participants so that they can effectively monitor and influence financial institutions.[3]

The third pillar – regulatory discipline – involves setting rules and requirements.

Where possible, we prefer to use the less prescriptive pillars of self and market discipline. These work by enhancing the natural incentives on firms to run their business soundly. But sometimes it is very hard to align the incentives on firms with those of society, and we need to use the more prescriptive pillar of regulatory discipline. Here are some examples of our current supervisory practices.

Figure 1 shows some of the interests of the Reserve Bank and financial institutions. Those furthest to the right are the ones that firms themselves have the strongest interest in taking care of. Those furthest to the top of the diagram are those that the Reserve Bank, as the regulator and supervisor acting to address market failures on behalf of wider society, has a strong interest in.

Figure 1: Selected interests of the RBNZ, society and financial institutions



[3] *The importance of market discipline to the Reserve Bank's prudential regime:* http://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2016/rbb2016-79-02

Some things - like a firm's brand in the market and product differentiation (in blue) – are of real interest to the firm itself, but are of more limited interest to the Reserve Bank. We keep our regulation of these areas to a minimum. Some things – like risk management and underwriting standards (in green) – are of strong interest to both the Reserve Bank and firms. Here we tend to use market and self-discipline. Examples of some of our supervisory practices in this area are:

- Disclosure of credit risks;
- Mandatory credit ratings;
- Governance requirements; and
- Publicly disclosed attestations by the board that key risks are being managed.

In some areas the incentives are poorly aligned. Failure resolution is a good example: firms understandably have limited incentive to prepare for, and spend shareholders' money on, an orderly failure. Moral hazard associated with implicit government guarantees mean that resiliency in crises (capital, liquidity, reinsurance and solvency) is another area with poorly aligned incentives. In these areas we rely more heavily on regulatory discipline, where we create and enforce prescriptive rules to mitigate the incentive misalignment. For example, to make the failure of a bank more manageable we have developed the open bank resolution (OBR) and outsourcing policies.[4] Likewise, to boost firms' resiliency in crises we have minimum capital and liquidity requirements for banks and non-bank deposit takers (NBDTs), and minimum solvency requirements for insurers.

Regardless of the sector or the market failure our regulation targets, or the pillar we use to address it, we aim to make our regulation proportional to the severity of the market failure and the misalignment of incentives. This means that our regulatory actions tend to be stronger in areas like failure resolution and resiliency in crises. Similarly, although our philosophical approach is the same across our four regulated sectors, the intensity of our regulatory actions will be scaled according to the risk each sector poses to financial stability. For example, the assets of the non-bank deposit taker (NBDT) sector are around one percent of the size of the assets of the banking sector, so our regulation for NBDTs is lighter than for banks.

Strong and effective 'three pillars'

To keep each of the three pillars strong and effective, we apply certain overarching principles.

Self-discipline

In the self-discipline pillar, we take care to ensure our regulations enhance existing incentives and do not absolve boards and senior managers of responsibility to manage the firm's risks. Reflecting its importance, self-discipline has been at the heart of the Reserve Bank's supervisory philosophy ever since we were first tasked with prudential supervision 30 years ago. Director attestations are a key part of our framework that aligns with this principle. Requiring directors to attest that their institution has satisfactory risk management processes boosts the incentives for directors to run their business soundly and works with the grain of their governance structure.

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[4] For more information on Open Bank Resolution see here: http://www.rbnz.govt.nz/regulation-and-supervision/banks/open-bank-resolution

For the same reason, we avoid detailed on-site inspections of financial institutions. If institutions' directors knew that the Reserve Bank would act as another line of defence, they have less incentive to ensure robust internal controls.

The absence of detailed on-site checking is a defining feature of New Zealand's regime compared with those in other comparable nations. As well as diluting self-discipline, an on-site programme carries significant costs for both industry and the taxpayer. We remain comfortable being an outlier in this regard.

Market discipline

In the market discipline pillar, we aim to ensure that market participants have the information, incentives and mechanisms to exercise effective market discipline.

The Reserve Bank was a leader internationally in developing disclosure requirements for banks in the 1990s. A cornerstone of our disclosure regime has long been that we want information about an institution's financial health in the public arena so people can make their own informed assessment. A further argument has been that, by minimising information that is only available to the prudential supervisor, then if an institution failed, it helps government to resist inevitable pressures to rescue a firm in distress, to some extent at least[5].

But it is not enough for market participants to have information alone. For market discipline to be effective, market participants must have incentives to use and respond to this information. Therefore, in supporting market discipline, we **do not** guarantee that no financial institution will fail, and we **do not** have explicit customer protection. While the New Zealand financial system is sound, history tells us that banks, NBDTs and insurers can, and do, fail. Consequently, depositors and policyholders – both wholesale and retail - may suffer losses. Our mandate is soundness and efficiency of the financial system as a whole. The growth and demise of individual institutions in accordance with the competence of their management and demand for their services are a natural part of a competitive and efficient economy.

Since no financial institution is guaranteed by the government, there is more market pressure on institutions to compete on safety than there would be in a system with guarantees. There is solid international evidence showing that, on balance, the absence of guarantees improves the overall stability of the financial system.[6]

Regulatory-discipline

The regulatory discipline pillar in our regulatory philosophy has grown in importance over the last 15 years. A range of developments has underscored the need for direct regulatory discipline, including the global financial crisis, the NBDT failures in New Zealand over 2006-2009, and the failure of AMI Insurance in 2011. As the regulatory discipline pillar has grown, we have developed some principles in how we develop rules.

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[5] See, for example http://www.rbnz.govt.nz/research-and-publications/speeches/1996/speech1996-06-05

[6] See, for example: http://documents.worldbank.org/curated/en/875521468177845210/How-does-deposit-insurance-affect-bank-risk-evidence-from-the-recent-crisis

First, we aim to be pragmatic and realistic about what kinds of regulations can be useful in a small country like New Zealand. In considering any potential new rule, we need to have a convincing case that:

- there is a market failure, AND
- it materially impacts on the achievement of our objectives, AND
- the benefits of the regulatory intervention outweigh the costs.

We do this through the normal policy development process, with engagement with stakeholders and the development of Regulatory Impact Assessments.

Secondly, we take international standards as an important benchmark for our policy development, but do not adopt them if they are going to be inappropriate for New Zealand. For example, following consultation processes, we decided against implementing detailed rules around large exposures and remuneration. In general, we favour simple, quantitative rules that are can be effectively supervised and enforced. Where rules need to be qualitative, they will ideally be outcome-focussed rather than prescriptive and detailed.

A final area where our philosophy and practice have developed since the global financial crisis is our engagement with regulated entities. The frequency of meetings and the quality of the engagement have increased substantially. This has proven useful in three ways. First, it assists the two-way flow of information for our policy development process. Second, it informs our day-to-day supervision. Finally, it puts us in a better position to manage crises as it gives us contacts throughout the industry.

In summary, our recent internal ‘health check’ of the framework has helped us to confirm that the philosophy remains broadly fit-for-purpose for New Zealand. That is, our philosophy will continue to be to address the two key market failures – externalities and asymmetric information – using the three pillars of self, market and regulatory discipline.

Domestic and international experience over the last decade has also played an important part in our reflections. For example, a key reference point for our liquidity framework for banks is the learnings from the global financial crisis and the New Zealand banking system’s (then) dependence on short-term wholesale funding. The Canterbury earthquakes were an important factor in shaping our thinking about insurance. On the one hand, the vulnerability to concentration risk and the moral hazard inherent in catastrophe risk were exposed; on the other hand, private insurers were able to leverage the offshore reinsurance sector.

Areas where our supervisory practices may shift

The health check has highlighted areas where it may be worth shifting our supervisory practices to align them with our philosophy. I will cover four main areas.

First, given its importance in the framework, we intend to review the attestation regime for banks. We want to confirm that the attestations provided by bank directors in their public disclosures are reliable and accurate. We intend to undertake a thematic review of the attestation process: how effective and comprehensive these systems are. We will work collaboratively with banks and their boards, recognising that it is in all parties’ interests that the regime works efficiently and robustly.

Secondly, we want to investigate creating greater consistency in the practices we employ across sectors. In particular, as part of the review of the Insurance Prudential Supervision

Act (2010) we will consider bringing some of the practices we have found effective in banking regulation across to insurance. We will look at the merits of an attestation regime for insurers as a way of bolstering self-discipline. We will also examine whether a stronger role for disclosure for insurers will be a cost-effective way of bolstering market discipline.

We want to explore areas where the legislation or our approach may have unintentionally imposed unnecessary costs on insurers.

Next, we will consider shifting our supervisory effort towards areas where the incentives on financial institutions differ most starkly from society's interests. These areas mostly relate to failure prevention and resolution. In the case of banks they include OBR, outsourcing, liquidity and capital; and in the case of insurers they include solvency and reinsurance. Conversely, we may decide to do less intensive supervision of areas where incentives are better aligned.

Lastly, we are currently evaluating how to strengthen disclosure in the banking sector. The 1990s framework minimised the information that the supervisor received privately. Such an approach reduces moral hazard: if a supervisor is "fixed" with information not available to the market, it may be more difficult for the authorities not to compensate those who lose money in a failure. It is also desirable to make as much information as possible available to the market, provided it is accessible and tractable.

But moral hazard is just one dimension and we now see a range of trade-offs. As previously noted, we have increased our engagement with boards and management of supervised entities, and widened the amount of private data we receive from banks. This has been a conscious move. A trade-off exists between speed and accuracy – the private information we receive tends to be provided quickly, but without the checks and validations that go with formal disclosure.

Having said that, we will investigate whether more of the quantitative data we currently receive privately could be publicly disclosed, via the 'dashboard' project. We are developing the dashboard as an accessible, electronic repository which would allow data to be compared across banks in a consistent and timely way. We may look at including, for example, large exposures, bank liquidity and LVR information in the dashboard. If the information can be presented accessibly and consistently across banks, is accurate and not commercially sensitive, we will be looking to include it.

Conclusion

The FSAP has provided a specific impetus for us to review our supervisory practices. It is valuable to do so periodically.

We believe that the founding principles of the regime for banks remain broadly appropriate – stressing the importance of self-discipline and attestations, and of market discipline combined with a non-zero failure attitude. This has helped deliver a low-intensity regime and a strong, robust banking system.

In our review, we have thought explicitly about areas where incentives are less well-aligned and where it is therefore harder for self-discipline to carry the load. These include preparations for failure and balance sheet resilience. You can expect our supervisory efforts to tilt even more in this direction.

And the IPSA review gives us an opportunity to reflect on how this framework can be better applied to the insurance sector. This will not be a quick journey – we will seek industry and other stakeholder input through a consultation programme over the next one to two years.

Meanwhile, we look forward to the IMF's input to our thinking, including their views on which international standards we should perhaps be paying more attention to, in the context of our overall philosophy and New Zealand's place in the world.