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Outcomes of the 2016 New Zealand Financial Sector Assessment Programme

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This article reviews the outcomes of the IMF's 2016 Financial Sector Assessment Programme (FSAP) for New Zealand. An FSAP is a comprehensive review of a country's financial system against international standards, with a particular focus on the quality of financial sector regulation. The 2016 FSAP took place over two missions in August and November respectively. The Reserve Bank and other New Zealand agencies spent a considerable amount of time and resource preparing for and supporting the missions.

The results of the IMF's assessment were released in early May 2017. There were well over 100 recommendations, most of them directed at the Reserve Bank given its broad range of financial system responsibilities. The Reserve Bank is considering all the relevant findings and recommendations, and the extent to which implementation would further support the Reserve Bank's statutory purpose of promoting and maintaining a sound and efficient financial system. Several specific FSAP recommendations dovetail with on-going policy and supervisory initiatives such as the bank director attestation review, the review of bank capital requirements, the review of the statutory framework for the insurance sector and consultation on a debt-to-income instrument for the macro-prudential toolkit.

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1 Introduction

In early May 2017 the International Monetary Fund (IMF) released the findings and recommendations from its 2016 review of the New Zealand financial system, known as the *Financial Sector Assessment Programme* (FSAP).[2] An FSAP is a key part of the IMF's surveillance of individual member countries. FSAPs analyse the resilience of the financial sector, the quality of financial sector regulation, and the capacity of authorities to manage and resolve financial crises.

The Reserve Bank and other New Zealand authorities strongly support the FSAP as a means of promoting and improving both the quality of financial sector regulation and the outcomes that this regulation seeks to achieve.

The last New Zealand FSAP was in 2003-04, so the 2016 exercise was a timely opportunity for New Zealand to be assessed against evolving international standards, particularly in light of significant changes in

2 The IMF's reports and media releases from New Zealand authorities can be found on the Reserve Bank's website. This webpage also contains a link to a 2016 *Bulletin* article which provides additional background material.

New Zealand's regulatory landscape. The 2016 FSAP involved an assessment of the Reserve Bank's broad range of financial system-related functions, as well as the market conduct role of the Financial Markets Authority (FMA).

This article explains how the Reserve Bank and other New Zealand agencies prepared for the FSAP, as well as some of the key features of the FSAP process (section 2). Section 3 provides a high-level overview of the results, focussing on the 'key recommendations' outlined in the IMF's main summary report. The remaining sections discuss the results that relate to the Reserve Bank's role as prudential regulator and supervisor, and identify areas of continuing work in responding to the recommendations.

2 Background

In March 2014 the Reserve Bank, on behalf of other members of New Zealand's Council of Financial Regulators (CoFR) – an inter-agency body comprising the Reserve Bank, FMA, Ministry of Business, Innovation and Employment (MBIE), and the Treasury – approached the IMF to request an FSAP. Agreement was subsequently reached with the IMF that one would take place during 2016.

CoFR agreed that the Reserve Bank would act as lead coordinator of the FSAP process. An inter-agency governance structure was established comprising a Steering Group providing oversight, supported by a Secretariat of working-level officials from the four CoFR agencies. The Steering Group provided regular updates to CoFR and periodic progress reports for the Minister of Finance, and the Minister of Commerce and Consumer Affairs.

Preparations and planning

By early 2016, it was agreed that the New Zealand FSAP would take place across two 'missions' in August and November, with the assessment conducted by sectoral experts (some of whom were IMF staff and others external consultants hired by the IMF).

New Zealand authorities produced a number of background papers, self-assessments and responses to questionnaires, all designed to support the discussion and analysis across the two missions. This preparatory work included discussions with the IMF's stress testing expert on the scope and design of the approach to assessing the resilience of the New Zealand banking system.

The bulk of the preparatory work was undertaken by the Reserve Bank and the FMA, supported where necessary by MBIE and the Treasury, and involved a significant amount of staff resource from both organisations. In addition, the Reserve Bank provided administrative resource to facilitate the planning and scheduling of the meetings across the August and November missions.

August mission

The August mission involved the following:

- A detailed (graded) assessment against the international standards for banking supervision.

- A detailed (graded) assessment against the international standards for insurance supervision.

- A non-graded assessment of New Zealand's crisis management and resolution framework for banks, insurers and non-bank deposit-takers.

- A non-graded assessment of the regulation and oversight of financial market infrastructures (FMIs).

The August mission began with some of the FSAP team visiting Sydney and Melbourne to meet with Australian authorities and the parents of the four large Australian banks that operate in New Zealand. This visit underscored the importance of the trans-Tasman relationship for financial system outcomes in New Zealand.

There were more than 130 meetings across the banking, insurance, crisis management and FMI assessments during August, as well as discussions around the bank stress-testing exercise. This total also included meetings with private sector stakeholders: regulated entities, audit firms and industry groups.

November mission

The main focus of the November mission was on the role of the FMA in regulating New Zealand's capital markets. Specifically, a non-graded assessment of the FMA's role as market conduct regulator with a particular emphasis on managed investment schemes (more commonly known elsewhere as collective investment schemes).

The November mission also covered the following areas:

- A non-graded assessment of the Reserve Bank's macro-prudential policy framework.

- The completion of a stress testing exercise directed at the large banks that had begun earlier in the year.

- A series of meetings on the topic of correspondent banking relationships (CBRs), and the interface between New Zealand's Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) regime and money remittances.

Draft findings and recommendations

Across the two missions the IMF produced two *Detailed Assessment Reports* (DARs), and five *Technical Notes*. The DARs reflect the graded assessments of the banking and insurance sectors, while the *Technical Notes* are tied to the other non-graded components of the FSAP. Across all seven reports there were around 120 specific recommendations. The findings and conclusions of the two missions would form the basis of the main report that would be published in May under the title, *Financial System Stability Assessment* (FSSA).

Upon receipt of the draft findings and recommendations, New Zealand authorities were able to comment on all of the draft reports. In parallel the IMF undertook its own internal peer review process.

Publication

The review process was completed in April. In early May the FSSA was discussed at the IMF's Executive Board, alongside New Zealand's annual Article IV report.[3] New Zealand's representative at the IMF also made a concluding statement prepared in conjunction with New Zealand agencies. IMF Board directors broadly concurred with the findings and recommendations of the FSAP main report.

Following the board meeting the IMF released the FSSA and an accompanying press statement on 8 May. The seven individual reports were released two days later.

New Zealand agencies coordinated the release of press statements on 9 May.[4]

3 Overview of findings and recommendations

The FSSA provides a high-level summary of the findings and recommendations across both the August and November missions.

The FSSA notes that the main macro-financial risks confronting the New Zealand financial system stem from imbalances in the housing market, concentrated banking exposures to the dairy sector and a high reliance by New Zealand banks on wholesale funding. These are the same set of risks that the Reserve Bank has identified in recent *Financial Stability Reports*.[5]

That said the FSSA notes that the New Zealand banking system appears reasonably well placed to withstand large, but plausible shocks – as judged by a battery of stress tests directed at the large banks. The New Zealand banking system also benefits from a relative absence of the sort of contagion channels evident in other jurisdictions (in the form of significant inter-bank exposures, or exposures to other non-bank financial institutions).

Stress tests have their limits as a litmus test of financial sector resilience. The IMF has proposed a large number of recommendations designed to improve, in its view, the quality of financial sector regulation. This includes recommendations to improve both prudential regulation and supervision (the remit of the Reserve Bank), and market conduct (the remit of the FMA and MBIE), together with the framework for crisis management and resolution.

Table 1 lists the key recommendations from the FSSA. Given the broad range of financial sector functions that the Reserve Bank has been delegated, most of the key recommendations and the majority of the overall recommendations are tied to prudential regulation and supervision.

At a high level, the IMF believes that the Reserve Bank should rebalance its 'three-pillar' approach to regulation and supervision towards a greater emphasis on 'regulatory discipline'.[6] That is to say, the focus

3 Article IV missions are part of the more regular monitoring and surveillance activities of the IMF. Article IV missions typically focus on the exchange rate, monetary and fiscal policies, as well as various structural reforms. Financial sector regulatory frameworks can also form part of these annual discussions.

4 The press statement from the Minister of Finance can be found on the Beehive website and the FMA's on its website.

5 The latest *FSR* is available on the Reserve Bank website.

6 The Reserve Bank's 'three-pillars' are self, market and regulatory discipline. See the 2016 speech by Fiennes for an overview of the Reserve Bank's three pillar approach to prudential supervision. For a discussion of how these three pillars have evolved over time see this *Bulletin* article.

Table 1
Key recommendations

Financial stability and financial sector resilience	**Timing[1]**	**Agency**
Increase RBNZ resources for the supervision and regulation of banks, insurance companies, and FMIs	ST	RBNZ
Strengthen cooperation and collaboration arrangements with Australian authorities	ST	All
Clarify responsibilities of the Treasury and RBNZ on financial sector issues to reinforce the role of RBNZ as prudential regulator and supervisor	ST	RBNZ Treasury
Issue enforceable standards on key risks, governance, risk management, and controls to make RBNZ's supervisory expectations more transparent and support supervisory preventive action	ST	RBNZ
Review and extend the enforcement regime to promote preventive action and enhance sanctions powers, including by eliminating ministerial consent for directions, and making compliance with RBNZ policy documents evidence of prudent practice	MT	RBNZ
Initiate on-site programmes to test the foundation of the three pillar approach and directors' attestations, and increase supervisory engagement with institutions in order to require appropriate action	ST	RBNZ
Refine FMA supervision by a) direct monitoring of aspects of asset management relevant to financial stability; b) ensuring quality of Financial Markets Supervisors; and c) enhancing insurance intermediary and conduct regulation and supervision	I	FMA MBIE
Expand the FMA's regulatory perimeter to include licensing and supervision of custodians and appropriate oversight of wholesale asset managers	ST	FMA MBIE
Adopt and implement proposed FMI legislation on regulation, oversight, and enforcement powers	I	RBNZ FMA
Adopt the PFMI through detailed requirements in secondary legislation; change the frequency of FMI self assessments in the proposed regime from three to two years; and enhance compliance of the designated FMIs with PFMI requirements	ST	RBNZ FMA
Ensure that designated non-financial businesses and professions are subject to AML/CFT requirements, particularly company service providers, lawyers, and accountants	MT	MoJ DIA
Expand data collection and modelling efforts to develop structural models for credit risk in commercial real estate (CRE) and corporate portfolios	MT	RBNZ

1 C = continuous; I (immediate) = within one year; ST (short-term) = 1–3 years; MT (medium-term) = 3–5 years

(continued overleaf)

Table 1
Key recommendations (continued)

Macro-prudential framework	**Timing**	**Agency**
Strengthen arrangements for macro-prudential policy by increasing communication efforts; by increasing the transparency of the process to adjust the framework; and by maintaining an accountability framework that does not jeopardise the integrity and independence of the macro-prudential decision-making process	C	RBNZ Treasury
Introduce DTI measures in the macro-prudential toolkit	I	RBNZ Treasury
Implement DTI measures if the changes to the LVR do not reduce the risks in the housing sector	I	RBNZ
Increase capital buffer requirements to reflect the concentration of the financial sector in four banks	I	RBNZ
Crisis readiness, management, and resolution	**Timing**	**Agency**
Strengthen domestic crisis management arrangements by reaching ex ante agreement on roles, responsibilities, and processes; pre-positioning, mobilisation, logistics, and communications plans; and testing through simulation exercises	MT	RBNZ Treasury
Reconsider the merits of deposit insurance, or in the absence of policy support, introduce a limited depositor preference to provide legal certainty for the *de minimis* exemption in OBR	MT	RBNZ Treasury
Revise the RBNZ Act to provide greater clarity and certainty in resolution, by inserting objectives in resolution including protection of depositors and the public interest and requiring accountability reporting against these objectives; by clarifying that the RBNZ is the sole resolution authority, and inserting an express requirement for ministerial consent for resolutions with fiscal or systemic implications only	MT	RBNZ Treasury

[1] C = continuous; I (immediate) = within one year; ST (short-term) = 1–3 years; MT (medium-term) = 3–5 years

on the nature and scope of the requirements (rules, standards) placed upon regulated entities that are designed to ensure the overall health of the financial system, together with the way these requirements are implemented and enforced. By adopting a somewhat more intrusive approach, the IMF is of the view that this will further support the other two pillars of self- and market discipline.

Cross-cutting issues

There are a number of general recommendations that cut across different parts of the FSAP.

Resources

The IMF is of the view that the current level of supervisory resources across all sectors is insufficient, even if no significant change to regulatory frameworks is envisaged. This applies mainly to the Reserve Bank as prudential regulator, although more resource for the FMA in respect of its market conduct role for the insurance sector is also recommended.

For the Reserve Bank, the current level of resourcing has evolved in response to a relatively low-intensity approach to prudential supervision (compared to other jurisdictions) tied to the emphasis that is placed on self and market discipline within the three-pillar framework.

Clarify responsibilities and define accountability to support independence

The IMF recommends a number of steps to strengthen institutional arrangements, define responsibilities, and to clarify the objectives necessary to support the operational independence of New Zealand's financial regulators. These recommendations cover prudential regulation and supervision, crisis management, and macro-prudential policy.

The IMF notes that the Reserve Bank, as a financial regulator, must have a suitable distance between itself and the executive branch of government. Independence is a necessary pre-condition for optimal policy and supervisory outcomes, albeit this needs to be supported by a robust framework that holds the Reserve Bank accountable to both government and the public.

Cooperation with Australian authorities

The IMF recommends strengthening collaboration and cooperation with the Australian authorities in order to recognise the important interdependencies between the two financial systems. The IMF recognise that there are already well-developed working relationships between the New Zealand authorities and their Australian counterparts. This is reflected in on-going supervisory contact between the Reserve Bank and its counterpart in Australia, as well as through forums such as the Trans-Tasman Banking Council (TTBC) which is a body comprising various New Zealand and Australian agencies.

Reserve Bank response

The Reserve Bank has already begun the process of reviewing all the relevant findings and recommendations. The initial focus is on the extent to which greater alignment with international orthodoxy – as envisaged in most of the recommendations – might further contribute to the Reserve Bank's statutory objectives tied to the promotion of a sound and efficient financial system.

The Reserve Bank continues to believe that its three-pillar framework, and an emphasis on self- and market discipline, has served New Zealand well. That said, there are a number of recommendations that, if adopted, may support financial system outcomes and the statutory purpose of the Reserve Bank.

In this regard the Reserve Bank will consider how it can more actively cooperate and coordinate with the Australian Prudential Regulation Authority (APRA) in the on-going regulation and supervision of the large Australian-owned banks.

The Reserve Bank will work with the Treasury to consider those recommendations tied to the 'institutional boundary' question in order to preserve and enhance a suitable degree of operational autonomy.

More generally, the Reserve Bank will be closely examining those recommendations that taken together may enhance the three-pillar approach to regulation and supervision. Elements of this model could include more independent verification or validation of information provided by regulated institutions, and a greater use of thematic reviews.

Other elements of this enhanced BAU model could include more clearly articulated (and enforceable) policy requirements, a re-emphasis on conservative and simple regulatory settings, and a more systematic and consistent approach to disclosure in the insurance sector. The review of the bank attestation regime currently in progress is likely to provide some insights into the value of the attestation process, how it could be enhanced and possibly how it could be applied to other sectors the Reserve Bank supervises.

The Reserve Bank will provide quarterly reporting, along with other agencies, to the Minister on progress in implementing FSAP findings and recommendations via CoFR.

4 Banking supervision assessment

The assessment of the regulatory and supervision framework for New Zealand's registered banks was undertaken against international standards developed by the Basel Committee on Banking Supervision (BCBS). There are 29 core principles (the 'Basel core principles' (BCPs)) divided into two broad categories: *supervisory powers, responsibilities and functions* (BCPs 1-13), and; *prudential regulations and requirements* (BCPs 14-29).[7] This assessment is graded on a five point scale: compliant, largely compliant, materially non-compliant, not compliant and not applicable. Each BCP has a number of 'essential criteria' against which the overall grade is judged.

The BCP assessment was undertaken during the first mission. There were two banking sector experts as part of the IMF's mission team, and most of the meetings involved the Reserve Bank. In addition, the banking assessors met a number of other government agencies, banks, industry bodies and other stakeholders.

The banking assessors acknowledged the significant enhancements to the regime since the last FSAP in 2003, and the capable and professional staff of the Reserve Bank. Nevertheless the current supervisory approach results in a low level of formal compliance against the requirements of the BCPs, while policy and supervisory resources are seen as insufficient, even for the current framework. This lack of formal compliance is centred on those BCPs that require specific policies (BCPs 14-29), and a reasonably high level of prescription for such policies. In addition, the assessors noted the lack of on-site inspections and a lack of independent validation or verification of the information provided by banks to the Reserve Bank.

The main recommendations are as follows:

- Continue to enhance the 'regulatory pillar'.
- The need to conduct or arrange on-site inspections and develop processes to ensure there is 'strong first hand verification of prudential returns'.
- Issue more regulatory guidelines to support self-discipline and in particular to help with verifying or validating director attestations.
- Shift the focus of enforcement from formal breaches to preventative actions (i.e. actions undertaken prior to formal breaches of

7 The latest (2012) version of the core principles is available on the BIS website.

Table 2
BCP assessment - summary of results

Core principle	Compliant	Largely compliant	Materially non-compliant	Non-compliant	Not applicable
✓ FSAP assessment					
BCP 1: Responsibilities, objectives & powers		✓			
BCP 2: Independence, accountability, resourcing & legal protection for supervisors			✓		
BCP 3: Cooperation & collaboration		✓			
BCP 4: Permissible activities		✓			
BCP 5: Licensing criteria	✓				
BCP 6: Transfer of significant ownership	✓				
BCP 7: Major acquisitions	✓				
BCP 8: Supervisory approach			✓		
BCP 9: Supervisory techniques & tools			✓		
BCP 10: Supervisory reporting			✓		
BCP 11: Corrective & sanctioning powers		✓			
BCP 12: Consolidated supervision		✓			
BCP 13: Home-host relationships		✓			
BCP 14: Corporate governance			✓		
BCP 15: Risk management			✓		
BCP 16: Capital adequacy	✓				

(continued overleaf)

Table 2
BCP assessment - summary of results (continued)

Core principle	Compliant	Largely compliant	Materially non-compliant	Non-compliant	Not applicable
BCP 17: Credit risk			✓		
BCP 18: Problem assets, provisions & reserves			✓		
BCP 19: Concentration risk & large exposures			✓		
BCP 20: Transactions with related parties			✓		
BCP 21: Country transfer risk	✓				
BCP 22: Market risks		✓			
BCP 23: Interest rate risk in banking book			✓		
BCP 24: Liquidity risk	✓				
BCP 25: Operational risk			✓		
BCP 26: Internal control & audit			✓		
BCP 27: Financial reporting & external audit		✓			
BCP 28: Disclosure & transparency	✓				
BCP 29: Abuse of financial services	✓				
Totals	8	8	13		

regulatory requirements, based on a judgement that a bank is not carrying on its business in a prudent manner).

- Delineate more clearly the roles and responsibilities of the Reserve Bank and the Treasury so as to maintain the operational independence of the Reserve Bank.
- Take a more proactive approach to trans-Tasman collaboration.

The formal grades received are summarised below in table 2. Overall, the Reserve Bank was judged 'materially non-compliant' for 13 of the 29 BCPs.

These grades, accompanying analysis, and the full set of recommendations can be found in the banking assessment DAR. The DAR also contains the Reserve Bank's formal response to the assessment (pages 219-221).[8]

Reserve Bank response

The FSAP assessment against the BCPs was a timely opportunity to have the Reserve Bank's three-pillar approach to prudential supervision benchmarked against international standards, particularly in light of regulatory changes in the banking sector since the last FSAP. These changes have included new liquidity standards in 2010, the adoption of the Basel II and III capital standards in 2007 and 2013 respectively, and the introduction of the Open Bank Resolution (OBR) policy – designed to minimise the damage to the financial system resulting from the failure of a large bank. In addition, the Reserve Bank has increased the intensity of its supervisory approach since the global financial crisis (GFC), in terms of degree of engagement with banks and improvements in supervisory analysis and data.

The Reserve Bank recognises that, despite a rebalancing towards more regulation post-GFC, New Zealand's banking regime remains unusual given the emphasis that is placed on self and market discipline, and its relatively low-intensity supervisory approach. In this regard, the results of the formal grading assessment against the BCPs came as no surprise – and indeed aligned very closely with the Reserve Bank's own self-assessment conducted prior to the August mission.

As noted in section 3, the Reserve Bank will be paying particular attention to those recommendations that support the functioning of its three-pillar framework, and in particular the way in which responsibility is placed on senior management and board directors of banks to ensure that they appropriately oversee and manage risks facing their institutions.

As an example, the Reserve Bank has initiated a thematic review of the bank attestation framework, partly in response to the IMF's findings in this area.[9] The review is intended to assess the effectiveness of the New Zealand-incorporated registered banks' arrangements for quarterly disclosure statement attestations, and the processes that bank directors use to fulfil their obligations under sections 81 to 82 of the Reserve Bank of New Zealand Act 1989. The review includes a survey of bank directors, and interviews of directors, senior management and external/internal auditors.

It should be noted that the Reserve Bank is aiming for a regime that is 'fit for New Zealand'. It is not likely that any changes that may stem from the FSAP will result in full compliance with the BCPs.

8 This 'response from authorities' section is also reproduced in the IMF's main summary report.

9 For more information see the Reserve Bank's April Banking Industry newsletter.

5 Insurance supervision assessment

The assessment of the regulatory framework for the insurance sector was undertaken against the standards developed by the International Association of Insurance Supervisors (IAIS). There are 26 core principles (the 'insurance core principles (ICPs)).[10] Two of the ICPs come under the broad responsibilities of the FMA: those on *intermediaries* (ICP 18) and *conduct of business* (ICP 19). The remaining 24 ICPs are prudential in nature and therefore the responsibility of the Reserve Bank. There is a five point grading scale: observed, largely observed, partly observed, not observed and not applicable. Attached to each principle are a number of standards.

As for the banking assessment, two insurance experts were assigned to the IMF mission. The assessors met with the Reserve Bank for the most part and the FMA, as well as other government agencies, insurers and industry bodies.

The insurance assessors acknowledged that the implementation of the Insurance (Prudential Supervision) Act (IPSA) in 2010, and the subsequent licensing process, was a major achievement. Given the relative newness of the prudential regime, the overall observance with the ICPs detailed below in table 3 reflects the fact that a number of supervisory practices are still being bedded in. Formal observance has also been influenced by the Reserve Bank's more general approach to prudential regulation (such as the absence of 'on-site' inspections).

10 The latest (2015) version of core principles can be found on the IAIS website.

The main recommendations are:

- Increase the Reserve Bank's powers for setting standards and administrative sanctions.
- Enhance requirements tied to governance, while increasing the supervisory focus on assessing the effectiveness of governance arrangements (and other regulatory requirements).
- Review the stance on policyholder protection (e.g., extend statutory fund protection to non-life policyholders and make policyholder preference explicit in insolvency).
- Clarify day-to-day cooperation with the Treasury on supervisory matters to reduce the risk of encroachments on Reserve Bank operational independence.
- Enhance collaboration and cooperation with Australian authorities.
- Greater focus on the regulation of insurance intermediaries and market conduct by the FMA.
- More resources for both the Reserve Bank and FMA for insurance-related activities.

Table 3 summarises the grades across the 26 ICPs. There are 13 'partly observed' grades which are broadly comparable to the 'materially non-compliant' grades in the banking assessment context.

As with the banking assessment, the insurance DAR contains a formal response from the Reserve Bank (and FMA) to the IMF's findings and recommendations.

Table 3
ICP assessment - summary of results

Core principle	Observed	Largely observed	Partly observed	Not observed	Not applicable
✓ = FSAP assessment;					
ICP 1: Objectives, powers and responsibilities of the supervisor		✓			
ICP 2: Supervisor		✓			
ICP 3: Information exchange and confidentiality requirements	✓				
ICP 4: Licensing		✓			
ICP 5: Suitability of persons		✓			
ICP 6: Changes in control and portfolio transfers			✓		
ICP 7: Corporate governance			✓		
ICP 8: Risk management and internal controls			✓		
ICP 9: Supervisory review and reporting			✓		
ICP 10: Preventive and corrective measures		✓			
ICP 11: Enforcement		✓			
ICP 12: Winding-up and exit from the market		✓			
ICP 13: Reinsurance and other forms of risk transfer			✓		
ICP 14: Valuation		✓			
ICP 15: Investment			✓		
ICP 16: Enterprise risk management for solvency purposes			✓		

(continued overleaf)

Table 3
ICP assessment - summary of results (continued)

Core principle	Observed	Largely observed	Partly observed	Not observed	Not applicable
ICP 17: Capital adequacy		✓			
ICP 18: Intermediaries			✓		
ICP 19: Conduct of business			✓		
ICP 20: Public disclosure			✓		
ICP 21: Countering fraud in insurance	✓				
ICP 22: Anti-Money laundering and combating the financing of terrorism	✓				
ICP 23: Group-wide supervisor			✓		
ICP 24: Macro-prudential surveillance and insurance supervision			✓		
ICP 25: Supervisory cooperation and coordination		✓			
ICP 26: Cross-border cooperation and coordination on crisis management			✓		
Totals	**3**	**10**	**13**		

Reserve Bank response

There have been significant changes in the landscape of insurance regulation since the last FSAP associated with the introduction of IPSA and the establishment of the FMA as New Zealand's market conduct regulator.

Despite this the IMF notes a number of areas where the prudential regime falls short of full observance. The Reserve Bank is considering those recommendations that will help improve the three-pillar approach as applied to the insurance sector. Examples include those findings on enhanced disclosure from insurers, and the expansion of powers to develop standards for corporate governance, risk management and internal controls.

More generally, a number of the IMF's recommendations are helping to inform the current review of the statutory framework for prudential regulation and supervision – the 'IPSA review'. In March the Reserve Bank released an issues paper for public consultation. During May several stakeholder forums were held to discuss the issues paper. Consultation closed on 30 June.

6 Macro-prudential policy

In 2013 the Reserve Bank introduced a new prudential framework associated with macro-prudential policy, based on existing statutory powers. Shortly thereafter loan-to-value restrictions were implemented on residential mortgage lending in response to rising imbalances in the housing market.[11]

To assess this new policy area, the IMF's macro-prudential policy expert met with the Reserve Bank to discuss the legal mandate for macro-prudential policy; the interaction between macro-prudential and monetary policy; the interaction between macro and micro-prudential policy, and; the way the Reserve Bank undertakes the monitoring of systemic risk.

The macro-prudential assessment also included meetings with the Treasury and a number of banks.

Overall, the IMF has concluded that New Zealand has a strong institutional framework, based on a clear mandate and powers, independent decision-making and external oversight. Macro-prudential policy is a new policy area globally, as well as in New Zealand. As such there are no formal international standards. However, the IMF is of the view that New Zealand's framework meets their two key criteria for an effective approach to addressing macro-financial risks.

Firstly, the framework provides a strong basis for a *willingness to act,* and therefore a counterbalance to any bias towards inaction. This derives from the role of the Reserve Bank as the single prudential regulator, with a clear mandate for financial stability, operationally clarified by a Memorandum of Understanding (MoU) with the Minister of Finance.

Secondly, the framework also provides the prerequisites necessary for the *ability to act*. The Reserve Bank has access to the necessary information to assess macro-financial risks and vulnerabilities, and a specific toolkit to address these risks.

However, the IMF has recommended improvements in the framework. Firstly, the arrangements for amending the MoU should be more transparent. As it stands, any change to the Reserve Bank's macro-prudential toolkit must be agreed with the Minister of Finance under the terms of the MoU. The IMF suggests that the procedures for considering new tools and other adjustments should be more transparent, particularly where there are disagreements between the parties to the MoU. This is currently a 'live issue' as the Reserve Bank is consulting on adding a debt-to-income (DTI) limit instrument to the macro- prudential toolkit.

Moreover, the IMF sees particular merit in including a DTI instrument in the MoU. The IMF further recommends that the Reserve Bank implement a DTI tool if housing imbalances persist.

11 See the Memorandum of Understanding (MoU) signed between the Minister of Finance and the Governor of the Reserve Bank for a discussion of the objectives, instruments and accountability arrangements attached to macro-prudential policy.

Other macro-prudential recommendations include more capital for New Zealand's domestic systemically important banks (DSIBs), and a review of current prudential liquidity requirements.

Reserve Bank response

The Reserve Bank welcomes the IMF's overall finding that our macro-prudential framework has a strong foundation, one that gives the Reserve Bank an appropriate degree of operational autonomy.

The IMF's observations on the framework will be addressed in the five-year review of the MoU that will be undertaken in 2018.

The Reserve Bank's current consultation on adding a DTI instrument to the toolkit will inform the on-going discussion with the Minister of Finance on this topic.

The issue of higher minimum capital levels for New Zealand's systemically important banks will be canvassed as part of a broader review of the Reserve Bank's capital requirements for locally incorporated banks. An initial consultation document was released in early May. The review is divided into three parts: dealing with the definition of regulatory capital, the measurement of risk-weighted exposures, and the minimum capital ratios.

The Reserve Bank also intends to review its prudential liquidity policy against the new international standards developed as part of Basel III, and consider the case for harmonisation.

7 Crisis management and resolution

The assessment of New Zealand's crisis management and resolution framework focussed mainly on registered banks, with somewhat less consideration of arrangements for insurers and non-bank deposit-takers.

The crisis management expert met with the Reserve Bank, as well as several other government agencies, banks and insurers.

The IMF has found that the Reserve Bank's standing liquidity facilities are 'well designed' and they are very receptive to OBR as a resolution option.

However, they believe a number of practical issues need to be addressed with OBR, including around the legal framework and the powers required to implement an actual resolution after entry into statutory management. The IMF recommends embedding some of the key elements of OBR in legislation to enhance this mechanism as a credible option. Tied to this, the IMF supports the idea of an 'enhanced *de minimis'* as a form of limited depositor preference.[12] An enhanced *de minimis* – that is, a pre-announced fixed amount – is seen as an alternative to the continued absence of a formal deposit insurance scheme.

12 Under OBR the *de minimis* is a dollar amount that is protected from the allocation of losses and remains fully available to the account holders when the bank reopens the next business day following the appointment of a statutory manager. For depositors with a balance greater than the *de minimis* amount, a portion of the additional funds will be 'frozen' in order to be available to bear losses. For those depositors any remaining unfrozen portion (together with the *de minimis* amount) will be available and guaranteed by the government when the bank re-opens the next day. Under the current policy, there is no fixed *de minimis* allowance. A decision on whether to apply one, and the appropriate level, will be taken on the day having regard to the specific circumstances of the failure. More information about Open Bank Resolution is available on the Reserve Bank website.

In addition, the IMF believes that greater clarity is required on the decision-making process for dealing with a crisis and the exercise of resolution powers.

The main recommendations can be grouped together under two broad headings:

Institutional arrangements, coordination and preparedness

- Strengthen domestic crisis management arrangements, through changes to preposition logistics, communications plans, and procedural guidelines.

- Confirm the Reserve Bank as the lead resolution authority for all Reserve Bank regulated institutions.

Resolution regime

- Insert clear resolution objectives for the Reserve Bank (maintenance of financial stability, protection of depositors and the public interest, and maximising recoveries from the failed institution).

- Reconsider the merits of deposit insurance or in its absence introduce an enhanced *de minimis* exemption within OBR.

Reserve Bank response

The Reserve Bank has long argued against the introduction of a formal depositor protection scheme in New Zealand. This has been based on various grounds, including that such a policy would undermine the role that bank customers and other market participants play in helping to influence the behaviour of banks (market discipline).

However, there may be merit in a more limited form of protection tied to the OBR framework – in the form of an enhanced *de minimis*. The Reserve Bank will be working with Treasury to provide advice to the Minister of Finance on the costs and benefits of a pre-announced *de mimimis* policy.

8 Financial market infrastructures

Financial market infrastructures (FMIs), such as payment and settlement systems, are the channels through which financial institutions, governments, businesses and individuals transmit money and financial instruments.

The IMF's FMI expert met with both the Reserve Bank and FMA to discuss various aspects of both the current approach to the regulation and oversight of FMIs and, more importantly, to discuss a set of proposals designed to improve the FMI regime.[13] The context for these proposals was a review the Reserve Bank undertook of its existing powers for the oversight of payment and settlement systems in 2013. This review concluded that the current regulatory framework left significant systemic risks unaddressed and that it did not provide for sufficient regulatory oversight of a sector that is critical to the New Zealand financial system.[14]

13 The FMA jointly oversees designated settlement systems with the Reserve Bank.

14 For a summary of the subsequent consultation and submissions on the oversight of designated FMIs (December, 2015) click here, and for crisis management powers for systemically important FMIs (August, 2016) click here.

As in other parts of the FSAP, the FMI assessor met several other government agencies and various industry participants.

One of the key recommendations from the IMF's assessment in this area is an endorsement of the proposed legislation. In the IMF's view, the proposed reforms will bring New Zealand broadly in line with international standards as defined by the Bank for International Settlements' Committee on Payments and Market Infrastructures (CPMI) and their *Principles for Financial Market Infrastructures* (PFMIs).[15]

Other recommendations stemming from the assessment include:

- Formalising supervisory practices alongside an increase in Reserve Bank and FMA staff numbers.
- Greater transparency of FMA's role and policies with respect to FMIs.
- Fine tuning crisis management arrangements to address specific features of FMI resolution.
- Developing a crisis management framework taking into account a system-wide perspective.

Reserve Bank response

The Reserve Bank notes that the IMF has endorsed the current legislative proposals.

In April, Cabinet agreed to the adoption of the new legislative framework.[16] The first part of the framework is an information gathering power that applies to all FMIs. This power will support monitoring of the entire sector, and help ensure the prompt identification of systemic risks. The second part of the framework is a set of regulatory powers that will apply to all designated FMIs (i.e. FMIs that are identified as systemically important, or that opt-in to designation to access the legal protections currently available to designated settlement systems under Part 5C of the Reserve Bank of New Zealand Act 1989).

These regulatory powers include the ability to set regulatory standards for designated FMIs, powers to oversee their rules, investigative and enforcement powers, and crisis management powers. The focus on designated FMIs is designed to ensure that regulatory interventions under the framework are proportionate to the risks raised by different FMIs, and to minimise compliance costs and barriers to entry.

Legislation establishing the new framework will be drafted over the coming months, and an exposure draft will be released for public consultation prior to this legislation being introduced into Parliament.

The Reserve Bank will consider the specific approach it will take to FMI supervision, and accompanying staff levels and skill requirements, once the legislation has been passed. Alignment with the supervisory approach taken to other sectors the Reserve Bank supervises will be considered in the context of the broader review of the Reserve Bank's three-pillar framework.

15 More information on CPMI is available on the BIS website.

16 The Cabinet paper can be found on the Reserve Bank website.

9 Stress tests

A stress testing exercise for the banking sector was undertaken over the course of 2016 as part of the FSAP's assessment of the resilience of the New Zealand financial system.

Drawing on the key risks and vulnerabilities facing the New Zealand financial system, this exercise was tied to four macro-financial risks that could impact the solvency and liquidity of the banking sector.

These risks were:

- a collapse in the housing market,
- depressed dairy prices,
- a deterioration in global economic conditions, and
- a tightening in financial market conditions.

The resilience of the New Zealand banking sector in this context was assessed in a number of ways. Separate solvency and liquidity tests were conducted, and the results subject to various sensitivity tests to assess the impact of various risk parameter calibrations.

In the case of solvency, both the IMF and the Reserve Bank ran parallel tests using their respective models.

In addition, two approaches were used to better understand the linkages between financial institutions: a 'network analysis' drawing on bilateral exposures to help ascertain how credit and funding risks would propagate across the financial system, and: a 'contagion analysis' based on market data on the parent banks to evaluate the scope for contagion implied by equity price co-movement.

Reverse stress tests conducted by the 'big four' banks also yielded additional insights into what it would take to seriously undermine these banks.

Overall, the battery of results suggests that the New Zealand banking system is well placed to withstand large, but plausible shocks. In addition, the network analysis suggests there is likely to be a limited impact from contagion owing to transactional exposures to other banks and non-bank financial institutions.

The stress test *Technical Note* includes a number of recommendations focussing on improving the Reserve Bank's stress testing capabilities – in particular, around the credit assessment of commercial real estate and other corporate exposures.

Reserve Bank response

Stress tests are an increasingly important part of the way the Reserve Bank assesses the resilience of the banking sector. Over recent years the Reserve Bank's capability in this area has improved. The Reserve Bank will continue to build its capability and will consider the IMF's recommendations.

Regarding the specific results, the Reserve Bank takes some comfort in the fact that New Zealand's banking system appears well-placed to absorb a significant shock – confirming the results of various stress testing exercises the Reserve Bank has itself conducted in recent years.

However, as a measure of financial sector resilience, stress tests do have their limitations, and so the results do not suggest any room for complacency on the part of the Reserve Bank given the risks facing the New Zealand financial sector.

10 Conclusion

The 2016 FSAP provided an important and extensive review of New Zealand's financial system, benchmarking it against international standards. It has proved a timely opportunity for the Reserve Bank to reflect on its current regulatory and supervisory model and the extent to which, together, the 'three-pillars' of self, market and regulatory discipline might better contribute to a sound and efficient financial system.

The Reserve Bank is actively considering the various FSAP recommendations. Where necessary, the Reserve Bank will work with other agencies in areas of common interest or joint responsibility. The Reserve Bank will report quarterly to CoFR and the Minister of Finance on progress in the consideration and implementation of the FSAP findings.

Many of the specific FSAP recommendations dovetail with on-going policy and supervisory initiatives. Examples include the bank director attestation review, the review of registered bank capital requirements, legislative reform for the FMI regime, the review of IPSA, and the five-year anniversary and review of the macro-prudential policy framework in 2018.

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