RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Regulation and the Financial System

A speech delivered to Law and Economics Association of New Zealand in Wellington

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Introduction

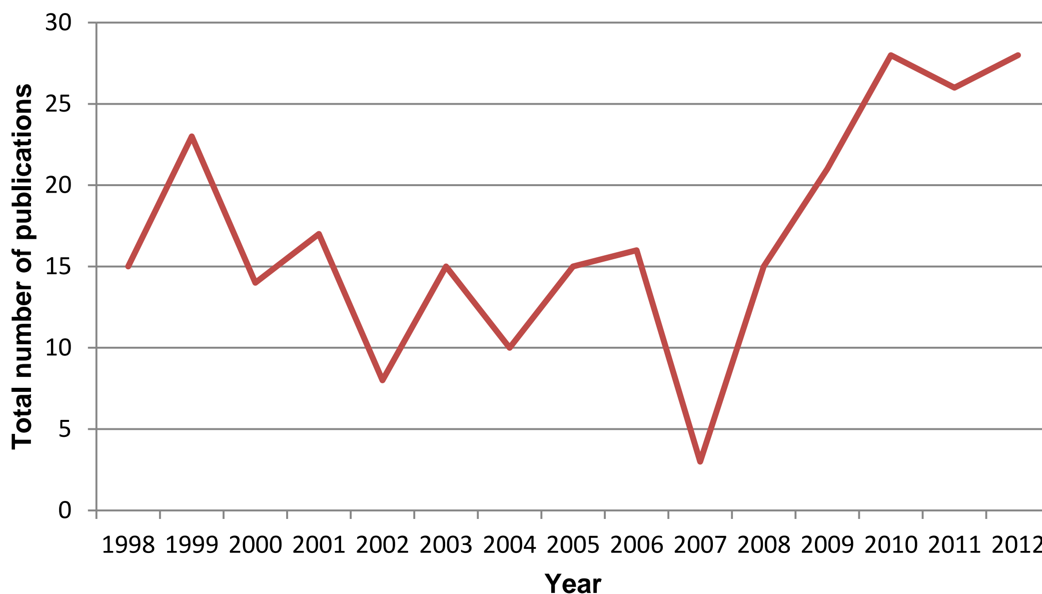
Today I would like to step back and discuss our overall framework for regulating the New Zealand financial system. In doing so I will focus on three aspects:

- first, why we regulate financial intermediaries;
- secondly, our general philosophical approach to this task, which is rooted in the legislation under which we operate; and
- finally, some reflections on the likely direction of financial regulation.

This is all within an international context of rapid and extensive regulatory change. The global financial crisis (GFC) has led banking regulators around the world to revisit their whole approach. Here in New Zealand, the finance company failures and the repercussions from the Canterbury earthquakes have underlined the importance of sound regulation that can help prevent failures.

The Basel Committee has been developing new standards at an unprecedented rate. The chart below shows how their publications per annum have increased dramatically, particularly around key topics such as capital and risk management. I will discuss how this has affected New Zealand, what the major areas of debate are currently and how we think about the various international initiatives in the context of our own country.

Basel Committee on Banking Supervision publications per year



Source: Basel Committee on Banking Supervision publications at http://www.bis.org/bcbs/publications.htm

Why regulate?

So first of all, why do we have prudential regulation?

There are two main reasons: the existence of *externalities*; and the existence of *information asymmetries*.

The presence of externalities (social costs that are not considered in an individual's or firm's utility maximising decision) is a compelling reason for regulatory intervention. The interests of banks, bankers and their shareholders can differ widely from those of society at large. Bankers face incentives to increase leverage and risks in the expectation of achieving higher returns, without bearing all the costs if things turn out badly. In doing so, they tend to under-price tail risks and often seek to build competitive advantage through complex financial products and customised services. Financial institutions, banks especially, are interconnected, meaning the failure of one can spill over to others and damage the financial system, public confidence and the wider economy. We saw this at the height of the GFC: banks in many countries became unwilling to transact with each other or to lend to their customers, and the result was a credit crunch, with immediate and damaging impact on the economy and the welfare of citizens. Banks sit at the heart of the payment system so a bank failure can quickly spread and affect people and businesses who are not direct customers of the failed bank.

People's lives can also be seriously affected by the failure of an insurance company. The availability and reliability of insurance are important in giving people confidence in their everyday commercial activities. Take away that confidence and you will find that people feel less secure and become more tentative in their dealings with one another. Lenders would be less willing to lend against property security.

These externalities are large and are the main reason why, over the years, prudential regulation has been introduced, developed and embedded in New Zealand and across the world. The costs of financial crises are significant – we estimate[1] a potential cost of between 10 and 20 percent of GDP from a serious financial crisis.

Intervention is also necessary because of information asymmetries – 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 - don't have anywhere near as much information about the quality of a bank's assets or an insurer's claims book as its managers do. Institutions such as rating agencies evolve to help manage such asymmetries, and financial institutions which are in the business for the long-haul attempt to develop a reputation for sound management and trustworthiness.

But securities law and prudential regulation help to buttress and underpin these behaviours. With hindsight, we can see that the ability of finance companies to attract retail depositors to – in effect – finance high risk speculative property developments was a significant contributor to the over-exuberance and subsequent painful bust in the property development sector over 2006-2009.

As I shall explain later, our emphasis on disclosure is, in part, aimed at reducing these information asymmetries.

Legislative framework

Promoting financial stability and avoiding the large potential costs from failures of financial intermediaries is deeply embedded in our legislative framework. Sections 68 and 157A of

[1] 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/finstab/banking/4932427.pdf.

the Reserve Bank of New Zealand Act 1989 have a system-wide focus and require us to supervise banks and monitor non-bank deposit takers (NBDTs) in order to maintain the soundness and efficiency of the financial system[2].

The legislation does not require us to prevent any failure - no regulatory regime could achieve this - nor directly to protect consumers of financial services, such as depositors. That said, our regulation and supervision provide significant comfort and a reduced likelihood of failure – a theme I shall develop further.

Similarly, the insurance legislation – Insurance Prudential Supervision Act 2010 (IPSA) – requires us to promote the maintenance of a sound and efficient insurance sector and promote confidence in the insurance sector. Again, there is no reference to consumer (policyholder) protection. Our goals in overseeing payment and settlement systems (often referred to as the "plumbing" of the financial system) are similar[3].

All these pieces of legislation make reference to the Reserve Bank promoting soundness and efficiency. The international consensus is that the primary purpose of prudential regulation is to promote soundness. The Basel Core Principles (the international standard for banking supervisors) describe themselves as "minimum standards for sound prudential regulation and supervision". Through this lens, the efficiency objective could be viewed as a constraint, to deter regulators from imposing excessive compliance costs or generating unwarranted economic distortions.

In practice, we take full account of the efficiency objective when we consider the costs of new proposals. We calibrate our models to ensure that the quantitative requirements we impose match our risk appetite in a particular industry. Further, we endeavour to capture both the direct and indirect costs in our regulatory impact assessments. Direct costs arise from any additional resourcing required by the Reserve Bank and the costs to the entities of compliance. Indirect costs may arise from resulting misallocation of resources, loss of availability of services (if firms choose to leave the market as a result of regulation) and costs from attempts to circumvent regulation. We publish regulatory impact assessments alongside every major new initiative that cover in detail these expected costs of regulation.

Features of our regime in practice

If a Martian with a deep understanding of financial concepts and of the world's major languages were to visit this world now, how would it assess New Zealand's financial system and our style of regulation against that of other countries and a hypothetical ideal?

Our Martian would notice that we are one of the developed countries whose financial system remains fundamentally in good shape. Our banking sector maintains high (and increased in recent years) levels of capital and has adequate liquidity buffers. The core payment systems generally operate smoothly and people have confidence in the core financial institutions. The insurance sector has been subject to enormous unprecedented stresses following the Canterbury earthquakes but, the AMI restructuring apart, is positioning itself well for future shocks.

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[2] The precise wording in s68 is "promoting the maintenance of a sound and efficient financial system; or avoiding significant damage to the financial system that could result from the failure of a registered bank." S157A is the same but refers to "NBDT" rather than "registered bank".

[3] Section 156K is identical to the wording in s68 except that it refers to "a participant in a settlement system" instead of a "bank".

New Zealand banks' credit ratings are all investment grade or above and our big four banks are in the AA range.

There are a number of reasons why our financial system has fared relatively well through the GFC – it is part luck, part sensible conservatism on the part of the bankers, part the absence of severe asset price adjustment, but also in part a result of the regulatory framework. Given the extensive Australian ownership of our banking system, the role of the Australian Prudential Regulatory Authority (APRA) has been important. The features of our framework that I would highlight are:

- A strong emphasis on the responsibilities of the board and management of financial institutions ("self-discipline");
- Disclosure and market discipline;
- A conservative approach to prudential standards;
- A focus on understanding key risks and key business drivers, rather than a deep detailed dive into firms' businesses; and
- Minimising 'moral hazard', including emphasising that this is not a zero failure regime.

This emphasis on self and market discipline with conservative minimum standards works well for us in New Zealand. We have a relatively vanilla financial system, with very limited exposure to complex derivative products for example, to which sound governance and firm supervision are well-suited.

We comply, and wish to be seen as complying, with international standards, sometimes tailored to New Zealand conditions. The relevant standards are the Core Principles (for banks)[4], IAIS (for insurers)[5] and CPSS (for payment systems)[6].

Since the GFC, the Basel standard setters have pushed through a series of reforms, known as Basel III, aimed at boosting the resilience of banks. We implemented the core Basel III framework very quickly in New Zealand, putting it in place on 1 January 2013. Crucially, we had always required high quality capital and our regulatory settings for calculating capital ratios were always conservative.

Three pillar approach

Our supervisory approach rests on three pillars: self-discipline, market discipline and regulatory discipline.

Self-discipline is closely linked with sound governance. We have a strong tradition of director attestations, coupled with heavy penalties for non-compliance. For example, bank directors who fail to comply with disclosure obligations face fines of up to $200,000 or 18 months in prison.

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[4] See Basel Committee on Banking Supervision (2012) 'Core principles for effective banking supervision' available online at http://www.bis.org/publ/bcbs230.htm.
[5] See International Association of Insurance Supervisors (2012) 'Insurance core principles, standards, guidance and assessment methodology' available online at http://www.iaisweb.org/Insurance-Core-Principles-material-adopted-in-2011-795.
[6] See Committee on Payment and Settlement Systems (2012) 'Principles for financial market infrastructures' available online at http://www.bis.org/publ/cpss101.htm.

Governance requirements enhance self-discipline. The banking, NBDT and insurance regimes place obligations on firms to have robust governance frameworks with independent directors.

Market discipline reduces the information asymmetries referred to earlier. We pioneered disclosure requirements for banks in the 1990s; other countries have followed and indeed disclosure is now widely recognised as a key plank of Basel III.

We recognise, though, that these two pillars are not always sufficient to achieve our objectives of promoting a sound and efficient financial system. Our risk appetite (a proxy for the risk appetite of the public) is lower than that of market players because we take account of the externalities associated with a failure of one or more institution. This leads us to impose minimum requirements that are designed to be more conservative than management would choose in the absence of regulation.

This is most apparent in our capital settings, which are conservative by international standards. Insurers, for example, will be required to hold enough capital or reinsurance for the financial consequences of a 1 in 1000 year earthquake. This is on the basis that (a) post-catastrophe is the very time when we most need the insurance sector to be resilient and able to meet all claims and (b) the government support of AMI in 2011 may have led to expectations of future support in distressed situations – a moral hazard argument. This capital or reinsurance requirement is more conservative than the Australian equivalents, which are moving to a 1 in 200 year level of protection (i.e. catering for less extreme events), but we make no apology for that. Our role is to ensure that capital settings are suitably calibrated for New Zealand conditions.

On the banking side, our capital framework is conservative[7]. We have never allowed innovative hybrid instruments to count as capital – these were a feature of the capital base of some large international banks that failed during the GFC and have now been disallowed within the Basel III framework. Moreover, our risk weightings are conservative, especially in housing and agriculture, the two areas where banks are most heavily exposed and where the systemic risk is highest. For example, our housing risk weights average between 25 percent and 35 percent but can be as low as 5 percent in other countries.[8]

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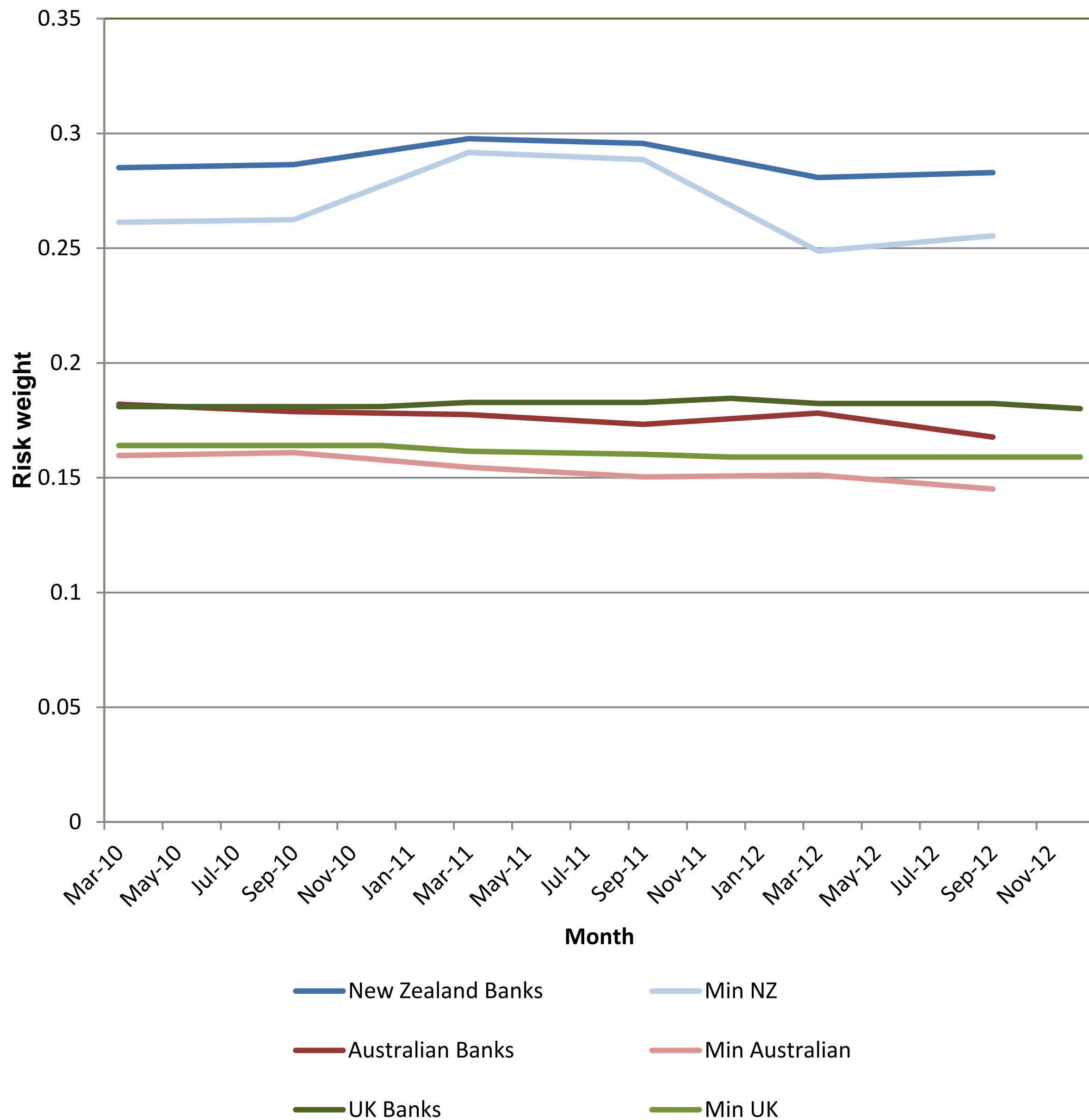
[7] See for example Hoskin, K and S Irvine (2009) "Quality of bank capital in New Zealand" 72 *Reserve Bank of New Zealand: Bulletin* 5 available online at http://www.rbnz.govt.nz/research/bulletin/2007_2011/2009sep72_3hoskinirvine.pdf .

[8] See Kyoon Jang B and M Kataoka, 'New Zealand Banks' Vulnerabilities and Capital Adequacy', IMF Working Paper WP/13/7 (2013) at p 12 available online at http://www.imf.org/external/pubs/ft/wp/2013/wp1307.pdf.

Average risk weights applied to residential mortgages by country



Source: Bank disclosure statements
New Zealand banks include: ANZ NZ, BNZ, Westpac NZ; Australian banks include: ANZ, Commonwealth, NAB, Westpac; UK banks include: Barclays, TSB Lloyds, RBS.

The NBDT capital framework is simpler than that for banks (albeit no less conservative), reflecting the nature of the sector. We impose relatively high capital requirements on property development lending, which in part reflects recent experience with finance companies.

Moral hazard

Moral hazard occurs when the incentive for a firm's management, shareholders or other stakeholders to minimise the risks of failure may actually end up encouraging more risk-taking. Regulatory intervention or implicit government support can thus increase moral hazard (and risk-taking behaviour) because stakeholders may take more risks if they believe the Government will provide taxpayer support or that they have 'done enough' by complying with minimum regulations. This can be a serious problem and, in the context of large banks that were deemed "too big to fail", has been extensively discussed in the GFC post-mortem.

We seek to minimise moral hazard in New Zealand in three main ways:

- We ensure that management must do their own due diligence and not place any reliance on a supervisor's assessment of their loan book or underwriting practices. We do not conduct detailed on-site reviews;
- Our standards are very clear and we seek to minimise complexity. Complexity of regulation can obscure the true risk (the black box effect);
- We are very clear that there should be no expectation that government will support even a large, interconnected entity. Supervision in no way implies or creates government protection of depositors or other creditors. Our Open Bank Resolution (OBR) policy is an important part of this story, allowing authorities to keep a bank open without full taxpayer support[9].

Overall nature of the regime

> The regime as I have described it – conservative but non-intrusive and with a strong emphasis on director and management responsibilities – helps keep the probability of failure of a bank or insurer low. There are tough penalties for non-compliance and no implicit promise of government support in the event of failure, all of which help to align incentives for the boards and management to minimise the risk of failure.

The regime continues to evolve. In the 1990s, a greater relative emphasis was placed on full disclosure. More recently, we have reduced disclosure requirements. We have also stepped up our engagement with the senior management and independent directors of the larger and more significant firms. We have established a programme of regular dialogue with key decision makers and influencers within the banks.

Our liaison with our international counterparts is also of critical importance. Given the Australian dominance of ownership of New Zealand banks – and their importance, albeit a lesser one, in ownership of the insurance industry, we have built excellent relations with APRA, the Australian Prudential Regulatory Authority.

The Reserve Bank is responsible for financial stability with no separation between prudential supervision and financial stability as is seen in some other countries. As a full-service small central bank, we can quickly access a range of market-based information and other policy thinking that can inform our work. We are, of course, active in financial markets. And at the height of the GFC, information about liquidity flows, including cash withdrawals, was helpful to us in assessing the pressures coming to bear on the banks.

[9] See Reserve Bank of New Zealand (2013) 'Handling bank failures' available online at http://www.rbnz.govt.nz/speeches/5218305.html.

The Reserve Bank is also responsible for the deployment of macro-prudential tools[10]. These tools are available for prudential purposes and may be deployed when risks to financial stability are especially high (e.g. during a strong credit upswing). They are a complement to the set of micro-prudential tools and are not intended to replace or supercede them. For example, bank capital requirements are already calibrated to a very low probability of failure and macro-prudential tools can further supplement them at times of extreme cyclical risk.

Looking ahead

Let me offer a few thoughts on the forces for change in prudential regulation in New Zealand and how these might play out over the coming years.

The international context is important here but first, I will just mention one initiative that we are promoting in New Zealand: a review and overhaul of our framework for overseeing payment and settlement systems. This was the subject of a recent consultation[11].

Payment systems are often referred to as the plumbing of the financial system – an apt metaphor. Nobody notices the plumbing when all is well, but when there is a problem, it quickly affects us all. Some payment systems are 'systemic' in that a failure would have serious and immediate repercussions for the economy and for people's daily business. The problem we identified in our recent consultation paper is that we have no power to require such systems to be subject to regulatory oversight, and that our powers over such are blunt and poorly targeted. After reviewing feedback from the consultation we will put forward firmer proposals as to how to address this gap.

The Reserve Bank looks to implement international standards in banking, insurance and financial stability as appropriate for New Zealand conditions although, as we are not a member of any of the relevant committees, we are not obliged to. At the international level, there are three key issues that are currently exercising key standard setters (Basel Committee, Financial Stability Board and IAIS).

The first is the question of 'SIFIs' (Systemically Important Financial Institutions). Following the GFC, authorities recognised that the size and interconnectedness of some firms meant that they posed much greater risks to the system as a whole. They drew up a list of about 30 'G-SIFIs' (the G stands for global, these are globally important banking groups whose failure could lead to serious contagion effects across the global financial system). No New Zealand or Australian banks are designated as G-SIFIs. National supervisors are expected to require their G-SIFIs to hold higher levels of capital and to be subject to more intense supervision.

Having established the G-SIFI framework, the FSB and Basel Committee are now proposing a D-SIFI regime whereby entities that are systemically important domestically (the D stands for domestic) should be similarly subject to regulatory overlays, albeit of a lower magnitude than G-SIFIs.

We are not convinced of the relevance of a D-SIFI framework for New Zealand. Our regime already has a system-wide focus at its heart as we calibrate our regulatory settings and our work (capital and solvency requirements, supervisory programme, etc.) to protect against

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[10] See "Memorandum of Understanding between the Minister of Finance and the Governor of the Reserve Bank of New Zealand: Macro-prudential policy and operating guidelines" (13 May 2013) available online at http://www.rbnz.govt.nz/finstab/macro-prudential/5266657.html.

[11] See Reserve Bank of New Zealand (2013) 'Consultation Document: Strengthening Statutory Payment Oversight Powers' available online at http://www.rbnz.govt.nz/finstab/payment/5195423.pdf.

system-wide risk. We already have conservative requirements compared to the rest of the world. These requirements apply to all entities, large banks / insurers as well as small banks / insurers, and essentially mean that we already have a D-SIFI overlay - one that is applied to the whole system.

The second area of international focus is 'shadow banking'. This is defined as "credit intermediation involving entities and activities outside the regular banking system"[12]. It ranges from micro-finance in developing countries to complex US securitisation structures– the latter being the original impetus for the work. We feel the initiative has limited relevance for New Zealand. Our finance companies are probably the most significant 'shadow banking' sector, but they are small currently and likely to remain so for the foreseeable future given the brand damage from the multiple failures over 2006-2009.

We are currently undertaking a review of the NBDT regulatory regime and will report to the Minister of Finance in September. A key question for us is how to ensure that the regime is future-proof against a repeat of the failings of the last decade (without trying to build an inefficient zero-failure regime), and that everyone who should be is subject to the regime. We need to guard against the emergence of any new 'shadow banking' sector, structured to avoid being caught by the regulatory framework. In the same vein, we are also alert to the risks of a shadow banking sector emerging that might circumvent the traditional sector and blunt the effectiveness of macro-prudential tools. Over recent years the world has witnessed the severity of distress, both to individuals and the economy, which can be caused by major house price readjustments. Accordingly, we expect everyone to recognise the importance of, and work not to undermine, measures the Reserve Bank may take to curb risky lending and the formation of asset price bubbles.

The final area of international focus is that of keeping things simple. The thesis that banking and regulation (especially Basel II) had become too complex was well articulated in a speech by Andy Haldane of the Bank of England "The Dog and the Frisbee"[13]. The problem, in essence, is that complex models can appear sophisticated and indeed work very well in normal times, but may miss one or two key, albeit low, probability, risks. Should the world not move to a simpler regulatory regime that relies more on a few key broad-based ratios?

We have sympathy with this perspective. We have always been sceptical about reliance on 'black boxes' and apply relatively straight forward minimum overlays to banks' risk models (which we approve for the large four banks under the "internal models approach[14]). Our insurance solvency framework is not complex and we do not allow specific models for solvency purposes.

But there is a balance to be struck as too much simplification (e.g. a simple leverage ratio) can be misleading and potentially dangerous. It can lead to more risk taking as firms shift to higher risk / higher return businesses that carry the same amount of capital.

Another argument for simplicity is that there are limits to how much a prudential supervisor can achieve. Our knowledge is limited, and our freedom and speed of action can be (rightly) constrained, for example by the legislation under which we operate. Equally, there is the risk – as happened before the GFC – that supervisors make the same mistake about the real state of the world as industry and commentators, perhaps believing hype about a 'new paradigm'.

[12] Financial Stability Board (2012) 'Global Shadow Banking Monitoring Report' available online at http://www.financialstabilityboard.org/publications/r_121118c.pdf.
[13] http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf .
[14] See Reserve Bank of New Zealand (2013) 'Capital Adequacy Framework (Internal Models Based Approach)' available online at http://www.rbnz.govt.nz/finstab/banking/regulation/3272068.pdf.

Philosophically we would align ourselves more with the 'simplifiers' – but not unreservedly. This remains an area for further policy work.

Concluding comment

If the Martian approached me today and asked how we had responded to the GFC and other challenges such as the earthquakes over the last 5 years; and what we are intending to do next, I would say:

- We have strengthened and built on the key features of our regime. This includes an early tightening of liquidity standards, reflecting the adverse liquidity shock experienced in the GFC. More broadly, we have been fast adopters of the tougher Basel III standards, with some tailoring to New Zealand conditions;
- We have extended our already conservative capital adequacy framework for banks and introduced a similar approach for insurers and NBDTs;
- We have also maintained an emphasis on market discipline and strengthened self-discipline – through robust governance requirements across banks, NBDTs and insurers; and
- Finally, we have embedded the OBR policy, ensuring that banks are pre-positioned to open on the next business day after a failure event.

And in terms of what we will do next:

- We will fill in the obvious gap in our regulatory response kit – that of oversight of systemically important payment and settlement systems.
- We will look for opportunities to simplify the regimes, as well as to harmonise across sectors.
- We will continue to be vigilant and forward-looking in our supervision with a focus on key risks, key business drivers and board accountability.
- Although failures are unlikely, we will remain prepared and will develop our response toolkit, drawing on insights from international experience.

Ultimately, we have a delicate balancing act to perform. We have to understand and respond to the concerns of current commentators and the regulated community; and we will also be judged by our success over the long haul in keeping the New Zealand financial system sound and efficient.