

Taking stock of financial sector regulation

A speech delivered to the New Zealand Banker's Association in Auckland

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Introduction

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

I want to talk today about an important initiative at the Reserve Bank – to undertake a stocktake of our regulatory framework for banks and non-bank deposit takers.

There has been a considerable amount of financial sector regulation in recent years, both globally and locally in New Zealand. In large part this has been a response to the major financial and economic costs of the global financial crisis.

While the New Zealand banking system fared relatively well in the GFC, the unprecedented severity and scope of the financial shocks made it clear that the prudential regulatory regime needed to be strengthened, and that this should be coordinated on a global front.

Five years on from the GFC, with most of the Basel III regime in place, we now have a considerably stronger prudential regime which we are broadly happy with. But it is also more complex and it has expanded at a rapid pace.

We feel it is now opportune to take a step back and review where we have got to. We want to make sure that the reforms meet their intended objectives, are efficient and do not create misplaced incentives or impose large compliance costs that could outweigh the broader benefits of the reforms to society.

Our aim here is not to fundamentally change or roll back the regulatory framework. We want to shape and thin the stock of regulation, not undertake a major reformulation of the system.

I will set out the context and motivation for the review and then discuss how we will go about it. But first we should remind ourselves why we have financial sector regulation.

The Role of Financial Sector Regulation

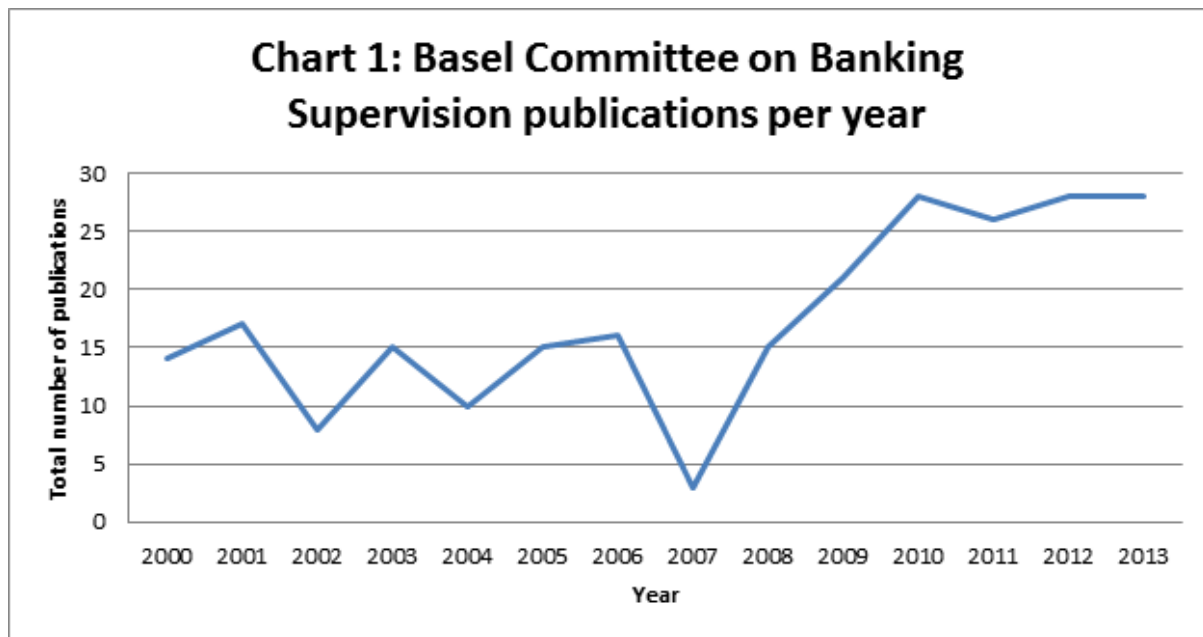
The Reserve Bank's prudential framework plays an important role in New Zealand's economy. Its objective is to promote the maintenance of a sound and efficient financial system. In the case of the insurance regime, the objective is a sound and efficient insurance sector. Prudential regulation is necessary to achieve these objectives because of the existence of significant externalities in the financial system.

The externalities are costs to the broader economy and society that are not taken into account in the commercial decisions of financial institutions. The interests of banks and NBDTs can differ from those of society at large. For example, they may face incentives to increase leverage and risks in the expectation of achieving higher returns, without bearing all the costs if things turn out badly. Banks in particular 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. These externalities can be significant – we estimate the potential cost of a serious financial crisis to be between 10 and 20 percent of GDP.¹

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/regulation_and_supervision/banks/policy/4932427.pdf

The international expansion of regulation

The concerted effort of the major economies to bolster the global banking regulatory regime post-GFC has been coordinated within the G20 and associated bodies – specifically the Basel Committee on banking supervision (BCBS) and the Financial Stability Board (FSB). The emphasis of the reforms has been focussed on the large internationally active banks based in the G-20 economies. However, the reforms have been broadly implemented across most domestic banking systems. The growth in Basel Committee publications since the GFC is shown in Chart 1.



New regulation under the broad banner of Basel III has generally been prescriptive in order to maximise international consistency and minimise the scope for regulatory arbitrage. This has contributed to an increasing complexity in financial regulation as new regulations have attempted to accommodate differences between the major banking systems. For example, Basel I (the first international capital standard in 1987) was 30 pages in length, the Basel II standard 347 pages, and the new Basel III standard 616 pages.²

Further complicating the international regulatory environment have been the extensive “domestic” reforms of the US and EU³ which have major extra-territorial implications for international banks based in the US/EU and, importantly, for banks dealing with US/EU banks.

New Zealand’s approach to the evolving international framework

New Zealand is not a member of the Basel Committee or the FSB/G20 and as such is not obliged to follow the Basel rule book. However, we agree with the underlying rationale of the international reforms. New Zealand banks did not suffer a serious credit shock in the GFC but we saw how quickly bank capital could be eroded in global financial institutions. And our banks experienced real difficulties in funding and liquidity management that required official

² Andrew G Haldane, “The Dog and the Frisbee” available at: <http://www.bis.org/review/r120905a.pdf>

³ See for example, the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (the Dodd-Frank Act) at: <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>, and the EU reforms outlined at: http://ec.europa.eu/internal_market/bank/index_en.htm.

support. We have therefore acknowledged the need to increase the safety of the financial system by enhancing the prudential regulatory regime.

Given that Australia is a member of the G20 and BCBS, the parents of our major banks are required to comply with Basel Committee standards. Further, New Zealand is a debtor country that has relied on the major banks to fund its current account deficits over many years. The access of the banks to the international capital markets could be hindered if they were seen to be non-compliant with the key Basel and FSB standards.

In short, as a small debtor country hosting foreign banks and reliant on international capital markets, we cannot afford to be too far removed from the Basel tent. I note that the current Australian Financial System Inquiry has recently reaffirmed this same position for Australia⁴.

Over the past five years we have reviewed the emerging Basel III reforms and shaped our financial regulations to suit New Zealand circumstances. This has been something of a balancing act. We have not adopted all the Basel reforms (for example we have not adopted the leverage ratio) and we have introduced some policies that differ from the Basel standards (for example the Reserve Bank's liquidity standard, BS13), in order to better reflect New Zealand conditions.

In doing this, our general approach to prudential standards has been relatively conservative, and we have tended to be early rather than late adopters of the new standards.

A conservative approach to standard setting is consistent with our governance based approach to supervision. Under the New Zealand model, the responsibility for implementing the standards is very much sheeted home to the directors and executives of the regulated institutions. The Reserve Bank's supervisory engagement with the banks is focussed on governance, strategic direction and risk management. It is not based on in-house reviews to check compliance with the standards.

Non-bank regulatory frameworks

Outside of the banking sector, the Reserve Bank's role as prudential supervisor has expanded into new areas, largely due to domestic rather than international considerations.

New Zealand suffered a major series of failures in the finance company sector, with 45 finance companies entering into liquidation, receivership or moratorium between 2006 and 2011. Legislation providing for the prudential regulation of non-bank deposit takers (NBDTs) was first passed in 2008, and substantially came into effect in 2010. More recently, additional legislation was passed last year providing for the licensing of NBDTs by the Reserve Bank.

Our broad approach to NBDT regulation is based upon a version of the regime for registered banks, with generally less demanding standards that are tailored to the circumstances of the NBDT sector. Trustees are responsible for the day-to-day supervision of NBDTs, while the Reserve Bank regulates the sector, and sets and enforces prudential requirements.

New Zealand's insurance sector was also very lightly regulated until legislation was passed in 2010. The goal of the new regulatory framework was to reduce the potential impacts on policyholders of an insurer failing, and diminish the broader impact on the economy in the event of more widespread problems in the insurance sector.

⁴ Financial System Inquiry: Interim Report, July 2014, available at: http://fsi.gov.au/files/2014/07/FSI_Report_Final_Reduced20140715.pdf

We have since licensed 100 insurers, and are developing a framework for the day to day supervision of licensed insurers. Our regulatory approach is based upon the three pillars of self, market and regulatory discipline, and seeks to combine international standards and the particular characteristics of the New Zealand insurance sector.

While the NBDT regime is in the scope of the regulatory stocktake, we feel the insurance regime is too recent to be included. We are however, reviewing insurance solvency standards as a separate exercise.

Motivation for the stocktake

In light of the international trends and the approach we have taken in New Zealand to financial sector reform, why do we need to undertake a review?

First, it is sound practice to review a regulatory regime from time to time, particularly where it has been subject to rapid change. We need to review whether the regulation and the processes we follow are as rigorous, transparent and fair as they should be.

Second, the burst of post-GFC regulation, particularly around capital adequacy, has produced a layering of requirements on top of the Basel II reforms that were finalised in 2008. A fresh look at the body of regulation in each key area should offer scope for simplifying the framework, including the removal of redundant regulations.

Third, we need to step back and look at the consistency and coherence of the whole regulatory regime. For example, do the changes to capital and liquidity requirements have implications for the prudential policies in other areas such as disclosure or governance? Is our alignment with international standards appropriate? Do we have a consistent approach between banks and non-banks?

Improving the efficiency, clarity and consistency of prudential standards

In reviewing the specific prudential requirements applying to banks and NBDTs, our objective is to improve the efficiency, clarity and consistency of these requirements.

Efficiently designed regulatory requirements should achieve their objectives while minimising compliance costs as far as possible. Some of the questions we will be asking about the efficiency of existing requirements include:

- Are all of the prudential requirements necessary to maintain a sound and efficient financial system?
- Do the requirements serve their original purpose? Should they be cut back, removed, or replaced?
- Does alignment with international standards or the requirements of other jurisdictions help to improve efficiency by avoiding the need for banks with foreign parents to comply with multiple sets of rules?

We also want to make sure that the prudential requirements applying to banks and NBDTs are as clearly presented as possible. In particular, the Banking Supervision Handbook has evolved organically over time and this has inevitably resulted in some aspects of the Handbook not being presented as logically and coherently as we would like.

The scope of the review

Included in the scope of the review will be the regulatory documents, regulations and legislative provisions containing the prudential requirements for banks and NBDTs.

For banks, this means all of the standard conditions of registration, guidance and Orders in Council that make up the Banking Supervision Handbook, and that contain requirements relating to everything from capital to OBR pre-positioning.

For NBDTs, it means the regulations and legislative provisions that establish their specific prudential requirements.

The project will not be looking at changes to the Reserve Bank Act itself, or the recently enacted Non-bank Deposit Takers Act 20135. As such, it will not be looking at the supervisory approach adopted in the two sectors, or the matters that were considered as part of the review of the prudential regime for NBDTs that we undertook last year, such as the role of trustees in NBDT supervision.

The key planks of the prudential framework will not be revisited, including the need for banks and non-banks to: hold sufficient capital; maintain sufficient liquidity; implement robust risk management systems and policies; and have strong governance regimes.

A full list of the key planks is included in the terms of reference for the project that were published on the Reserve Bank's website this afternoon.

As noted earlier, the stocktake will also exclude the insurance regime, although a separate review of the insurance solvency standards is currently underway and will consider many of the same themes around efficiency, clarity and consistency. The broader insurance regime is too young to include in the review.

The process for developing prudential regulations

The second part of the stocktake will review the processes we use for developing prudential regulations. This will extend to how we identify potential threats to financial stability, how we assess actual versus intended effects of policies, and our approach to communications. I know that many of you will have views on these matters.

Consultation periods are another matter that we will be looking at closely. Over the last three years we have carried out approximately 25 consultations relating to the banking sector, with the average consultation period being four to six weeks (although the shortest consultation period was three weeks and the longest six months).

We want our general approach to the length and nature of industry consultation to be consistent and transparent, although there may still be occasional instances where the need to move quickly may force us to shorten the timeline.

Co-ordination of policies with other government departments and agencies with an interest in the banking or NBDT sectors is clearly important.

⁵ With the possible exception of those parts of the Act that contain specific prudential obligations such as those relating to governance and risk management.

Many of you here will be aware that the Reserve Bank is a member of the Council of Financial Regulators (along with Treasury, MBIE and the FMA) that meets quarterly to discuss work programs and emerging issues.

The Council has recently established a subcommittee, called the banking forum, which is intended to help ensure that government agencies see the big picture of regulatory initiatives affecting the banking sector at any given time. The exchange of information at the forum will help agencies to sequence regulatory reforms and consultations so that pressures from bunching are avoided.

Process for carrying out the stocktake

We are enthusiastic about the stocktake project, and believe it can lead to positive outcomes for the public, the Reserve Bank, banks and NBDTs, and other stakeholders.

We anticipate that the project will take about 12 months, and involve several stages as set out in the indicative timetable below:

Indicative timetable

Stage 1 Initial Scoping	
Industry workshop / discussions with industry bodies/ Establishment of expert panel	Late July 2014 – Early August 2014
Stage 2 Formulation of draft proposals	
RBNZ and expert panel analyse bank and NBDT prudential requirements	August 2014 – February 2015
Industry workshop / discussions with industry bodies	October 2014
Industry workshop / discussions with industry bodies	February 2015
Stage 3 Public Consultation and Conclusion	
Discussion document prepared	March 2015 – April 2015
Discussion document out for comment	May-June 2015
Industry workshop / discussion with industry bodies	May 2015
Analysis of submissions and formulation of draft proposals	July 2015 – August 2015
Industry workshop / discussions with industry bodies	Late August 2015
Conclusions finalised, Summary of submissions and report on conclusions published	September 2015

The first stage will scope ideas that should be considered as part of the stocktake. As part of this process, we will shortly be holding a workshop with industry participants.

The second stage will be the detailed formulation of draft proposals. This will last from August through to March next year. As part of this stage of the project, we are proposing to hold two further workshops with industry around October and February. We will also be assembling a small panel of financial regulation experts (from outside the banks themselves) to help formulate draft proposals.

The third stage of the project will involve a public consultation on the proposals. It will seek input from all stakeholders, after which specific changes will be agreed upon. We expect to hold workshops with industry during this stage.

Ahead of the workshops, one thing I would like industry to think carefully about is how they assess regulatory costs. Different banks and people within banks give us different perspectives. For some the impact on directors work programmes is the main issue; for others it is the cost of capital; for others it is the resources tied up in consulting on and implementing regulatory change.

Keeping in mind that the fundamental building blocks of conservative capital, liquidity, risk management and governance are taken as given, we would be interested in industry views on what one or two big things would really increase the efficiency and effectiveness of the regulatory regime.

Conclusion

To sum up, the Reserve Bank is committed to delivering a world-class regulatory framework. That means one that fully supports the soundness and efficiency of the New Zealand financial system, and is lean, easy to use and as cost-effective as possible.

The non-bank sector had serious issues earlier on which led to a strengthening of regulation in that sector. However, the banking sector came through the Global Financial Crisis in very good shape by international standards, which is a testament to the industry and to the regulatory environment. It is important though that we work to continuously improve the regulatory framework. We look forward to working with you all towards that end.

Thank you.