RESERVE BANK
OF NEW ZEALAND
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**Embargoed:**
**Not for publication before 5:45pm (NZ time)**
**4 February 2016**

# Regulation and the Importance of Market Discipline

## A speech delivered to the NZ Bankers Association and Bank of New Zealand in Auckland

*On 4 February 2016*

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Introduction

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

Before I start, I would like to thank the large number of people in the room who contributed to the regulatory stocktake throughout the course of the project. Many of you attended workshops and/or made formal submissions on the consultation document. We very much appreciate the time you took to provide feedback. I would like to thank the Expert Panel for testing our ideas and stimulating our thinking. Let me also thank NZBA and BNZ for organising this event.

I'd like to focus my comments on the prudential regime for banks, and in particular, the importance of market discipline within this framework. This is a key aspect of supervision that the Reserve Bank puts considerable emphasis on. I'll also cover the conclusions of the regulatory stocktake, and the forthcoming IMF Financial Sector Assessment Programme (FSAP) review of New Zealand, which will be a major focus for the Reserve Bank this year.

Part 1: The importance of market discipline and how it fits within our Three Pillars approach

*What is market discipline?*

As many of you will know, our regulatory and supervisory framework is based on the three pillars of self, regulatory and market discipline.What do we mean by market discipline in this context? In summary, market discipline refers to the way in which market participants influence a financial institution's behaviour through monitoring its risk profile and financial position. Anybody providing funds to a financial institution is an investor, from depositors to professional investors in sophisticated debt instruments. Investors can exercise market discipline through the price they charge financial institutions for supplying funds, or simply by withdrawing their funds.

Effective market discipline requires certain conditions to be in place.

First, market participants need to have access to useful information. This means that disclosed information must be both relevant and timely.

Second, market participants must be able to process that information, which means it must be accessible and meaningful.

Third, market participants must have incentives to monitor banks. Some aspects of the regulatory framework, such as the Open Bank Resolution Policy (OBR) and no deposit insurance, reinforce these incentives. Measures to encourage greater financial education and awareness will also assist.

Finally, there must be the right mechanisms available for market participants to exercise market discipline. This means enabling a competitive environment that makes it easier for depositors and other investors to shift their investments between banks according to their assessments of relative risk and return.

For most industries and in most circumstances within the financial services industry, market discipline will deliver, and historically has delivered, good outcomes. Very few people would wish to revert to a world where the banking system was directly controlled. Most of the time and in most places, the financial system does prove an efficient way for savings to be channelled to productive investment. But, because of the presence of externalities, market failures and the extremely high

cost of financial crises, prudential regulators add certain regulatory requirements. These can relate to self, market or regulatory discipline.

*The role of market discipline in the prudential framework for banks*

I will focus most of my remarks today on market discipline. It has formed a key part of the Reserve Bank's prudential regime since the mid-1990s. Back then, the Bank's prudential regime placed a heavy emphasis on market discipline backed up by comparatively simple regulatory requirements. As remains the case today, market discipline was supported by detailed disclosure rules backed up by director attestations, which require a bank's directors to attest to the accuracy of the disclosed information, with penalties for the disclosure of false or misleading information. Most of the information available to the Bank was available to the market, though the Bank had the right to require additional information. Regulatory requirements were primarily focused on minimum capital ratios.

Since the 2000s, regulatory discipline has been bolstered, with the introduction of Basel II and III, and some local initiatives such as the Outsourcing policy and OBR. Our new capital and liquidity requirements for banks have been tailored to New Zealand circumstances. The Reserve Bank now collects more private data, although still significantly less than is required under comparable regimes internationally.

The regulatory requirements fall into three main categories. They either:

- boost the self and market discipline pillars (governance, disclosure); and / or
- lay down relatively simple and conservative minimum criteria to reduce the risk of failure (capital and liquidity rules); and / or
- minimise the impact of a failure (OBR, outsourcing).

In this context, the three pillars work together and often support one another. Boosting one pillar can strengthen rather than weaken, the other two. For example, improved governance within an organisation can result in better disclosure, and vice versa.

The importance we place on market discipline is strongly reflected in our prudential framework. We adopted a less intrusive supervisory approach than is standard internationally.

It's also one of the reasons that we don't have, and are not advocating, deposit insurance – a clear difference between New Zealand and most other developed countries. Deposit insurance blunts incentives for banks and depositors to monitor and manage risks properly. Research by the World Bank finds that deposit insurance lowers banks' interest expenses and makes interest payments less sensitive (though not insensitive) to bank risk and liquidity.[1] While these effects could be ameliorated somewhat by risk-based pricing of deposit insurance, in practice this is extremely difficult to achieve. It also favours some parties relative to others: for example, people with larger deposits and those who manage their affairs to create multiple protected deposits.

A financial system in which depositors can afford to be indifferent to the risk of the bank they invest in will be a weaker financial system – people will chase return with no regard for risk. It is of course true that many people expect governments to stand behind their deposits. That expectation was reinforced by the widespread Government guarantees (including in New Zealand) during the GFC. The existence of an expectation, though, is not a sound reason to adopt deposit insurance. A key

[1] For discussion see Demirgüç-Kunt, A and E J Kane (2002), 'Deposit insurance around the globe: where does it work?', *Journal of Economic Perspectives* 16(2).

virtue of our OBR tool is that it provides authorities with the ability to impose losses on creditors without closing the bank. This supports market discipline and improves incentives on investors and larger depositors to monitor banks.

*The importance of disclosure*

Good disclosure is critical for market discipline and New Zealand was an early pioneer in this field. Over the last few years, we introduced new rules into all three pillars, but less so for market discipline as the fundamental framework was already in place.

Following the GFC, international regulatory bodies recommended enhanced disclosure requirements be implemented so as to provide more relevant and comparable information to the market. In particular, the Basel Committee on Banking Supervision issued revised standards aimed at improving the comparability and consistency of bank information to enable market participants to better assess a bank's overall capital adequacy and risk profile.[2] These revisions are based on five key requirements for disclosures including that they be clear, comprehensive, meaningful to users, consistent over time and comparable across banks.

Recent studies indicate that disclosure can significantly affect a bank's cost of debt.[3] This result tends to support the conclusion that disclosure facilitates effective market discipline.

We reviewed and refreshed our disclosure requirements in 2011, and looked at them again in the context of the Stocktake with the aim of reducing unnecessary costs and enhancing the market discipline pillar of our framework. It is to the Stocktake that I now turn.

## Part 2: The Regulatory stocktake

The conclusions of the stocktake were published late last year.

The primary objective of the stocktake was to ensure the efficiency, clarity and consistency of prudential requirements applying to banks and NBDTs. We looked for measures that would result in tangible cost reductions and improve overall efficiency within our three pillar approach to prudential regulation. We also looked for areas where we could further enhance the transparency and effectiveness of our current policy making processes.

*Disclosure and reporting requirements*

A key focus of the stocktake was the existing disclosure regime for banks, which requires them to publish disclosure statements on a quarterly basis (we previously reviewed this regime in 2009-11 and made a number of improvements). We looked again at whether off-quarter disclosure statements add sufficient value ("off-quarter" refers to the quarters that are three months and nine months after a bank's financial year-end).

We concluded that, for locally incorporated banks, some form of off-quarter disclosure remains a necessary support for market discipline.

[2] See Basel Committee on Banking Supervision (2015) 'Revised Pillar 3 disclosure requirements.'

[3] For discussion of these studies, see Kleymenova, A (2014), 'Consequences of mandated bank liquidity disclosures', University of Chicago Booth School of Business, *Working Paper* and Peristian, S, Morgan, D P and V Savino, (2010), 'The information value of the stress test and bank opacity', Federal Reserve Bank of New York *Staff Reports*.

In our view, the market needs information more frequently than six-monthly. It also needs comparable information, where investors can compare banks across standard metrics, over the same time period.

We think there should be more efficient ways to design these disclosure requirements. While New Zealand's approach may have been "state of the art" in the 1990s, international standards are evolving and New Zealand needs to evolve as well. It's also important to keep in mind that the effectiveness of disclosure in supporting market discipline is determined by the quality, relevance, and accessibility of the data being disclosed, rather than simply by the volume of that data.

With this in mind, we will shortly be consulting on a "dashboard" concept. The dashboard fits in well with our efforts to look ahead to improve the use of technology in our regime, and to best meet the needs of the market.

*The Dashboard*

The dashboard would be an electronic form of reporting that is more accessible, comparable, and timely, and which should also reduce costs for banks. The dashboard will help enhance market discipline in two key ways:

- It will make it easier to compare the relative risks and financial position of different banks, which in turn should influence the decisions of depositors and investors (the dashboard will be drawn from templated, standardised returns that banks currently provide to us privately);
- Disclosure should be more timely than in disclosure statements. The process for providing information in the dashboard will involve electronic delivery of data that banks are already producing. Consequently, depositors and investors should be making decisions based on more up to date (and hence relevant) information.

In our 2011 Disclosure Review, we reviewed the requirement that banks make hard copies of their disclosure statements available in their branches. As many of you highlighted in your submissions on that consultation, very few users were walking into branches, looking for information on paper regarding individual banks. As a result, we changed our disclosure rules to require banks to make the information available electronically, and readily accessible on their websites.

In the stocktake, we again surveyed current users of bank disclosure statements. All were accessing the information electronically, and looking to compare data over time and across banks – often with the aim of making this analysis more widely available. A key aim of the dashboard is to best meet the needs of these users, to provide them with the information that they require, in the format they require it, in order to most effectively exert market discipline. The dashboard might also expand the current set of users of this data. By making the data more relevant, timely and easier to access, and by raising awareness about the existence and importance of the data, the dashboard could expand the base of users who are exerting market discipline on banks.

We also expect that the dashboard will reduce costs for banks as it is intended to be largely based upon reports they already produce, and not require the same director attestations.

Some of the detailed design issues we will be considering for the Dashboard are:

- The precise content of the Dashboard;

- How the Dashboard interrelates with the full and half year disclosure statements that banks will still be preparing; and
- How soon after the end of each quarter the Dashboard should be published.

We will consult banks and other stakeholders on these matters within the next 1-2 months. This consultation will also note the alternative option of a more scaled down off-quarter disclosure statement focused on the kinds of capital and asset quality disclosure that is recommended under Pillar 3 of the Basel framework. This alternative approach is not our preferred option though, as we think it is likely to have significantly fewer benefits than the Dashboard approach.

As some of you may have read, several submitters argued that we should publish all of the information we receive through private reporting, potentially publishing a monthly dashboard of this information.

While this principle has some appeal, there are two main reasons why we do not consider it appropriate.

First, the potential trade-off between timeliness and data quality. We sometimes accept a marginal reduction in data quality in private reporting in exchange for receiving the information quickly. While this is appropriate for supervisory purposes, public disclosure needs to maintain a high minimum accuracy in order to support the credibility of the regime. This is underscored by the penalties in the legislation for false disclosure, and is an issue we are giving careful thought to in the design of the dashboard.

Second, there is the issue of commercial sensitivity. Often the private data we received is commercially sensitive, or might be open to misinterpretation if released without the appropriate context – especially if this was occurring in a situation of rapidly rising financial system risk.

Given this context, our current focus is on a quarterly rather than a monthly dashboard, covering a sub-set of the information we receive through private reporting.

Our intention is not to apply the dashboard to branches of overseas banks. For them, we intend to remove the off-quarter disclosure requirements. Information on a branch tells New Zealand branch investors very little about the health of the whole bank and therefore the riskiness of their investment. Investors in the branch also have little ability to exert market discipline on the whole bank, and to influence the behaviour of the whole bank. These two considerations make the cost/benefit analysis different for branches compared to locally incorporated banks.

We also concluded that various other technical changes to the content of disclosure statements should be made, again with an eye to supporting more effective market discipline. For example, requiring banks to only disclose non-standard conditions of registration in their disclosure statements (with standard conditions being made more easily available on our website), potentially consolidating covered bond disclosures under a single heading, and in the long term, reviewing the disclosure of credit risk mitigants.

*Other changes relating to particular policies*

Numerous other changes also arose out of the Stocktake. I don't propose to go through all of them, but would like to say a few words about some of the most important.

Firstly, our Banking Supervision Handbook has evolved "organically" over time, which has led to a number of problems (of language, consistency etc) identified by Handbook users and the Reserve Bank. Like our disclosure standards, the Handbook needs to be modernised to make it clearer and easier to use. We will be redrafting and restructuring many aspects of it. This isn't a trivial task but we believe the payback will be significant.

Secondly, we will be refining the suitability assessment process for the directors and senior managers of banks by adopting a more focused definition of senior manager and new rules relating to the ongoing suitability of directors and senior managers.

We will also be creating a standing obligation to report breaches to the Reserve Bank, as soon as possible. Public disclosure of breaches in disclosure statements will remain a part of our framework as it provides a strong incentive for banks to comply with their conditions of registration.

*Policy making approach*

The Stocktake also recommended several technical enhancements to our policy-making approach, applying across sectors (banks, NBDTs, insurance and payments).

We are largely compliant with Treasury best practice guidance in this area. For example, all of our significant policy proposals are accompanied by a RIS, and we have a high degree of interaction with stakeholders, both through formal consultations and informal discussions.

However, there are a number of areas where we can continue to enhance the transparency and clarity of our policy making approach. For example, we will:

- Finalise a public document that articulates our approach to policy-making;
- Communicate with industry through a regular newsletter, and will continue our efforts to improve coordination between regulators via the Banking Forum; and
- Seek to lengthen consultation periods (aiming for a standard 6 to 10 weeks wherever possible).

Some submitters suggested that we publish all written submissions on our public consultations. Our current approach is based on prior feedback, which indicated that respondents prefer to keep their submissions private on the grounds of commercial confidentiality. We will test this more rigorously with stakeholders. The alternative would be to publish all submissions by default unless submitters ask for them to be withheld or redacted.

Part 3: The Financial Sector Assessment Programme

I would like to conclude with a few words about the forthcoming Financial Sector Assessment Programme (FSAP), which will start in the middle of the year and should be completed in early 2017 when the findings and recommendations will be made public. As many of you know, the FSAP is a comprehensive assessment of a country's financial sector by the IMF. Amongst other things, it covers vulnerabilities and risks, an assessment of the quality of regulatory frameworks that cut across the financial sector, and an evaluation of financial safety nets. In relation to the Reserve Bank's areas of responsibility, the IMF will be assessing the regulatory frameworks that are in place for the banking and insurance sectors, non-bank deposit takers, and financial market infrastructures. Our new macro-prudential policy framework will also be reviewed.

The last FSAP of New Zealand was in 2004 before the GFC. Much has changed here and internationally since then. The FSAP will provide us with a comprehensive external assessment of our financial sector and our prudential regime in a post-GFC environment.

We won't know for some time what recommendations the FSAP may make and the extent to which they will be consistent with our current regulatory and supervisory approach. However, we believe the New Zealand story is a good one. Our banking system remains sound and well capitalised. Our relative emphasis on market mechanisms is greater than in most countries and is bolstered by prudential requirements that are conservatively calibrated in key areas such as capital. Our overall framework is coherent without being purist. We recognise the benefits of regulatory discipline in many areas, while wishing to retain and indeed strengthen the market discipline pillar. As a result, we are not advocating for measures such as deposit insurance that could reduce market monitoring incentives, or watering down disclosure obligations.

The FSAP will involve various departments and agencies, and banks themselves. We expect the FSAP to be a major focus for us in the coming year, and our team at the Reserve Bank has begun working on the initial phase of the project.

Conclusion

Looking ahead, the next 12 months will be extremely busy for our team at the Reserve Bank.

The decision making stage of the Stocktake is now complete (with the exception of the dashboard proposal). However, we have a lot of work to do to develop and consult on the dashboard, and to implement the other changes arising out of the stocktake. We will also be focussed on the FSAP and have other important initiatives under way, including our balance sheet redevelopment project and review of outsourcing requirements.

Engaging with stakeholders is an important part of all of this work. We value the effective engagement that has taken place on the Stocktake project, and look forward to continuing this as we progress with this and other important projects in the year ahead.

Our team at the Reserve Bank is very much looking forward to 2016 and beyond, and to all of the challenges and opportunities it brings. I am sure that you are as well.

Thank you again for the opportunity to meet with you today.