THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: 2010 Review of Financial Market Regulation

Date:	12 October 2009	**Report No:**	T2009/2296

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Read** in advance of the Financial Systems meeting. **Note** this report includes some discussion questions for the Financial Systems meeting.	4.15pm, Wednesday 14 October 2009

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
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Minister of Finance's Office Actions (if required)

None.

Enclosure: **No**

12 October 2009

Treasury Report: 2010 Review of Financial Market Regulation

Purpose of Report

1. This report provides you with information about the proposed 2010 review of financial market regulation for discussion at the Financial Systems meeting on 14 October 2009.

Analysis

Financial regulation is a placeholder topic for regulatory review in 2010

2. Financial market regulation has been identified as a placeholder for the government's regulatory review program in 2010. You are the Minister responsible for this review. Cabinet invited responsible Ministers to report to the Minister of Finance and Minister for Regulatory Reform with terms of reference for regulatory reviews by the end of December 2009. Cabinet also invited you, in consultation with the Minister of Regulatory Reform, to report to EGI by December 2009 confirming the regulatory review program for 2010 (CAB Min (09) 6/5A refers).

3. In late 2008 the Treasury proposed that financial market regulation be included as a placeholder for the regulatory review program for 2010 in case a fundamental review was required. At the time there was uncertainty about the future state of world financial markets and any regulatory responses that may be required either at the international or domestic level (EGI (09)5 refers).

We propose this work initially be progressed outside of the regulatory review program

4. The Treasury have given further consideration to what the scope of the financial market regulation review should be. In doing so, Treasury have focused on:
   - Issues the global financial crisis has raised that could have implication for New Zealand's domestic policy settings.
   - Areas with broad fiscal and/or economic implications.
   - Areas that are not being considered already through other processes.

5. Figure 1 (page 4) illustrates some of the changes that have been made to financial regulation in New Zealand as the result of new challenges raised by the global financial crisis, and other pressures or tensions on regulatory frameworks.

6. The MED-led review of the Securities Act is looking to address any pressure points the crisis has raised for securities market regulation. Our focus has, therefore, been on identifying any issues the crisis has raised in the prudential area.

7. While our starting point was that this work would be considered as an item on the government's regulatory review agenda for 2010, we think there are advantages to initially doing this as a work program outside of the regulatory review program. Given there may be sensitivities and concerns from banks and other groups particularly around issues such as increased capital requirements, we think there would be value in at least the initial phase of this work being done as a "within government" exercise. Progressing this work outside of the review program, at least initially, provides more flexibility about the nature and timing of information that is released publicly and consulted on. We are also unsure how well the nature of this review fits within the

umbrella of the 'less, better, smarter' objectives of the regulatory review program, given that this review would largely be focused on managing high-impact/low-probability economic and fiscal risks. We also propose that this work be a joint Treasury and RBNZ project given the policy focus of the work.

8. We understand the Regulatory Quality Team (RQT) will be discussing the overall composition of the 2010 regulatory review program with you in the next few weeks.

Discussion questions:

- *Are you comfortable with this work initially being progressed as a work program outside of the government's regulatory review program? This means we will need to delay the review in the current regulatory review timetable.*

We propose the review focus on issues associated with 'too-big-to-fail' institutions

9. The global financial crisis has demonstrated that the distress of a major financial institution can lead to significant fiscal costs as governments have shown their willingness to intervene to prevent failure, for a combination of economic and political reasons. This experience has generated an active debate around the world about what can be done to minimise the economic and fiscal risks created by having financial institutions that are 'too-big-to-fail'. For example, capital injections, asset buying and guarantees on debt issuance during the recent crisis have totalled 22.6% of GDP in the Eurozone and 18.1% of GDP in the United States of America (BNP Paribas, 28 September 2009).

10. The issue of too-big-to-fail has a unique slant in New Zealand because our banking system is heavily dominated by four foreign-owned banks. While the New Zealand banking system has fared the crisis well, it seems timely to explicitly ask the question about what too-big-to-fail means for our regulatory system.

Some key questions

11. Some of the key questions that this work would likely need to address are:

    - Does New Zealand have institutions that are too-big-to-fail? What would be the likely economic and fiscal costs of distress of a too-big-to-fail institution?
    - Does the introduction of guarantees strengthen perceptions of too-big-to-fail institutions or change the boundaries around these perceptions, with the associated impacts on market discipline?
    - Are the economic and fiscal costs of too-big-to-fail being optimally managed? Do the current arrangements do this or do the lessons from the crisis suggest that something different is required?

There are no clear answers despite active debate around the world

12. Solutions raised internationally to address the too-big-to-fail problem seem to fall into two broad categories:

    - Accepting the implicit government guarantee and either taking steps to reduce the likelihood of distress, for example through more intrusive regulation or higher capital buffers, or sharing the costs of the guarantee, for example through charging for the guarantee, or through mechanisms such as bank creditor recapitalisation (BCR).
    - Retrenching the implicit government guarantee by taking actions to credibly signal that even major financial institutions are not considered too-big-to fail, for example through requiring institutions to have in place plans for their orderly resolution should they get into distress, capping the size of financial institutions,

forcing creditors to take a “haircut” through BCR, or developing new resolution regimes including the role of deposit insurance as a mechanism that contributes to the more orderly failure of institutions.

13. Analysis of whether any of these options would better manage risks in New Zealand presented by too-big-to-fail would need to consider the credibility of the intervention in enhancing market discipline and reducing moral hazard, the impact on the cost of capital and credit availability, wider capital market implications and trans-Tasman implications.

14. We have previously discussed the issue of deposit insurance with you. In these previous discussions we discussed that deposit insurance would make the implicit government guarantee explicit (i.e. institutions would have to pay for it) and whether New Zealand could remain the only country in the OECD without some form of deposit insurance. We also discussed that deposit insurance may reduce the likelihood of a bank run by promoting depositor confidence and increase failure management options (Financial Systems meeting, 3 June 2009). Given the linkages between deposit insurance and too-big-to-fail issues, we propose bringing the deposit insurance work to a conclusion as part of the financial regulation review.

15. An additional issue which has been raised by the global financial crisis is macro-prudential regulation. This is an issue already being progressed by the RBNZ and the Treasury through other avenues and accordingly we suggest this issue is not included as part of the review.

Discussion questions:

- *Are you comfortable with a review focusing on managing the economic and fiscal risks presented by institutions considered ‘too-big-to-fail’?*
- *Are there any other banking sector regulation issues that you would like us to consider as part of the review, or any factors that you would like us to give particular consideration to?*
- *Are you comfortable with bringing work on deposit insurance to a conclusion as part of this work program, given the linkages between deposit insurance and ‘too-big-to-fail’ institutions?*

Figure 1: Financial regulation – the context has changed

Financial regulation – the context has changed a lot

Securities markets – regulation of financial products

- Disclosure-based regime – focus on ensuring that investors have information required to make informed investment decisions.
- Regulator's focus on preventing unfair or fraudulent behaviour

Prudential regulation - regulation of financial institutions

- Harness and enhance market disciplines and where this is not sufficient, use tools that directly constrain market choices.
- Regulator has working knowledge of the institutions it's supervising but does not undertake on-site inspections

Core principles underlying regulatory approach

'New' challenges raised by the global financial crisis

Securities markets:

- International tide towards more prescriptive regulation
- The creation or enlargement of 'consumer protection agencies'

Prudential regulation:

- International tide towards more hands-on regulation of major financial institutions
- What does the introduction of the guarantees mean for a disclosure-based regime? Can we still rely on market discipline?
- How to minimise the economic and fiscal costs of institutions that are 'too big to fail'? What role does deposit insurance play here?

Other pressures or tensions on regulatory frameworks

Securities markets:

- Finance company failures have raised questions about whether a disclosure-based regime provides adequate investor protection
- Issuers feel current disclosure requirements unduly costly
- Securities markets likely to be a focus in SEM work program

Prudential regulation:

- More institutions to be subject to prudential regulation – RBNZ is now prudential regulator of NBDT's and insurance companies
- Evolution towards more active regulation by the RBNZ eg implementation of Basel II

Wide-ranging review of the Securities Act is underway.
Is likely to conclude that a disclosure-based regime remains appropriate but look to refine to ensure disclosure is meaningful to non-sophisticated investors.

What government-wide processes are in place to consider the implications of these pressures and ensure the system is fit for purpose for next decade or so?

Nothing formal in place related to prudential regulation of banks.

In the next few weeks we will provide you with the terms of reference for this work

16. The Treasury and RBNZ, in consultation with MED, will report back to you in the next few weeks with a project plan and governance arrangements for the work on too-big-to-fail. We are envisaging providing you with an initial report by March 2010. The report back to Cabinet will need to note the reasons for initially progressing this work outside of the regulatory review program.

Recommended Action

We recommend that you:

a **agree** to financial market regulation work initially being progressed outside of the government's regulatory review program;

Agree/disagree/to discuss

b **note** that the Cabinet program for regulatory review will need to be amended accordingly;

c **note** that there will be a joint Treasury-RBNZ work program, initially within Government focused on managing the economic and fiscal risks presented by institutions that are considered 'too-big-to-fail';

d **note** that work on deposit insurance will be progressed and brought to a conclusion as part of this process, given the close links; and

e **note** that we will provide you with a project plan for the work on too-big-to-fail in the next few weeks.

Joanna Gordon
Manager
for Secretary to the Treasury

Hon Bill English
Minister of Finance