Development of a framework for closer integration of Trans-Tasman Banking Regulation

July 2004

1. EXECUTIVE SUMMARY

1. Following your meeting on Friday 30 January 2004 on *Enhancing the trans-Tasman Business Environment*, you announced a proposal for mutual recognition and harmonisation in prudential regulation of Australia's and New Zealand's banking systems.

2. To this end, a joint working party comprising officials of the Australian Treasury, the Reserve Bank of Australia (RBA), the Australian Prudential Regulation Authority (APRA), the New Zealand Treasury and the Reserve Bank of New Zealand (RBNZ) was established, which would jointly report to you by 30 June 2004 on a framework for closer integration in prudential regulation, supervision, crisis management and failure management. (The full terms of reference, which have been made public, are at Attachment 1).

3. The terms of reference you agreed required consideration of options including:

    - separate regulatory frameworks but greater co-ordination in crisis and failure management;

    - mutual recognition of regulation and supervision, and co-ordinated crisis and failure management; and

    - harmonised rules for regulation and supervision for respective authorities, and co-ordinated crisis and failure management.

4. In considering possible approaches, officials were required to take into account:

    - safety, stability and efficiency of both financial systems; and

    - business law co-ordination, interaction between tax and regulatory regimes and other international obligations.

5. The Report has been prepared in the wider context of CER and your shared objective of moving to a single economic market.

6. In the case of banking, business integration is well advanced with some 85 per cent of New Zealand banking market owned by the four major Australian banks. Australian-owned New Zealand subsidiary and branch operations represent the largest overseas exposure of Australian banks

and account for some 15 per cent of their total assets.

7. The existing regulatory frameworks in Australia and New Zealand have the same high level objectives of promoting efficiency, safety and stability of the financial system in each country. Australia also has an explicit requirement to act in the interest of depositors. The frameworks do, however, differ in approach.

8. Australia's framework emphasises intensive supervision by APRA and has a depositor preference regime covering deposits in Australia for all locally incorporated authorised deposit-taking institutions (ADIs). This is in addition to the disclosure and other requirements imposed on banks under the provision of the Corporations Act 2001 in Australia.

9. New Zealand emphasises disclosure and oversight through its corporate governance regime, including a pivotal role for bank board directors and market disciplines. New Zealand does not have depositor preference. The approach is intended to complement and not duplicate the work of APRA in its oversight of Australian-owned banks' New Zealand operations.

10. Authorities in both countries have been concerned to ensure that they have the ability to head off any crisis in their banking system, or respond to the failure of a systemically important bank should the need arise. Against this backdrop, Australia and New Zealand have been keen to develop a framework for greater harmonisation and mutual recognition of regulation.

11. Two models are outlined: the first an enhanced home-host model based on greater harmonisation and co-ordination between two separate supervisory authorities; and the second based on New Zealand recognising APRA as the supervisor of the New Zealand operations of Australian-owned banks.

12. Under the first model, both countries would look to further harmonise prudential regulation to the mutual benefit of both countries, and to further develop protocols for closer co-operation through:

    - enhancing opportunities for information sharing between both countries;

    - more closely harmonised disclosure requirements;

    - better co-ordination of on-site examinations and third party reviews; and,

    - a more co-ordinated approach to crisis management, including through understandings on liquidity support and burden sharing where government support is required.

13. Under the second model, there would be more comprehensive integration of supervisory frameworks, including extension of the formal coverage of APRA oversight and failure management of Australian banks operating in New Zealand and, consistent with this, the extension of depositor preference to New Zealand domestic depositors of Australian-owned banks.

Enhanced Home-Host Model

14. There is scope for further mutual recognition and harmonisation of prudential regulation and greater co-ordination in supervision and crisis and failure management, while retaining separate regulatory frameworks. This would see the further development of existing working arrangements, and addressing these arrangements between APRA, the RBA and the RBNZ, through a revised Memorandum of Understanding (MoU), on information sharing and crisis and failure management protocols.

15. Under these arrangements:

    - there would be reciprocal undertakings in relation to information sharing;

    - efforts would be made to adopt a consultative approach to the development of new regulations (including capital adequacy, operational risk, and disclosure requirements); and

    - while both Australia and New Zealand would continue to be responsible for crisis and failure management of all banks in their respective countries, arrangements and understandings for responding to crisis events would be developed between New Zealand and Australian authorities.

APRA Supervision and Failure Management of Trans-Tasman Banks

16. Under this model APRA would supervise trans-Tasman banks and Australia's system of depositor preference would be extended to New Zealand depositors of trans-Tasman banks.

17. Trans-Tasman banks would be free to choose between branch and subsidiary structures, and would be subject to a single regulatory regime with one set of regulatory rules, prudential standards, directions powers and failure management powers. APRA would set capital requirements, conduct on-site visits and formalise its data collection functions.

18. Under these arrangements:

    - APRA, the RBA and the RBNZ would each have a role in crisis management;

    - as in Australia, APRA would be responsible for the failure management of Australian-owned banks in New Zealand;

    - in terms of implementation this would require legislative change in both Australia and New Zealand;

    - it would see APRA consider establishing a physical presence in New Zealand, and New Zealand being offered membership of APRA's

executive group, and membership of the Council of Financial Regulators in Australia; and

- APRA would report to the New Zealand Parliament for matters related to its actions in New Zealand in the same way it does to the Australian Parliament.

Assessment of Models

19. The report explores the impact of these two models on the stability and efficiency of the Australian and New Zealand financial systems. The potential benefits need to be assessed against the backdrop of the already significant business integration of the trans-Tasman banking market.

20. The **enhanced home-host approach** offers stability gains, particularly in terms of information sharing and crisis management protocols. The efficiency gains depend upon the extent to which it is possible to harmonise rules, and on avoiding unnecessary duplication of regulatory activity. Australia believes that potential efficiency gains may be constrained if – in developing an outsourcing policy to ensure that New Zealand has the capacity to operate banks on a stand-alone basis – this were to lead to substantial additional costs for Australian banks.

21. Australian officials are of the view that having **APRA as supervisor for trans-Tasman banks,** supported by the RBNZ and the RBA in crisis management roles, would more closely align the regulatory infrastructure with the current ownership structure of the trans-Tasman banking market. It would allow the current Australian banks to treat Australia and New Zealand as a single market for financial services: the regulatory and respondent burden may be reduced without compromising the over-riding objective of financial stability; and, at the same time, banks would be able to deploy their capital and structure their businesses, including back-office operations, more efficiently.

22. This model raises a number of significant issues for New Zealand. In particular, the model would require that New Zealand forego the capacity for an independent response to any crisis or failure in the banking system, while at the same time, still bearing some of the economic and financial consequences of such an event. While the extension of depositor preference would put Australian and New Zealand depositors on an equal footing, New Zealand is not attracted to models that provide preference to national depositors over other creditors.

23. In terms of stability, New Zealand officials are of the view that this model would not deliver gains beyond that which could be achieved through greater co-ordination. In terms of efficiency, New Zealand officials do not share the view that this model would yield significant savings in terms of compliance costs on banks, and at the same time, may also raise issues of competitive neutrality with respect to non-Australian owned banks in the New Zealand markets, and may raise some fiscal risks.

24. Australian officials are of the view that, given the existing market perception of the link between New Zealand subsidiaries and their Australian ADI parents this model would not materially alter the competitive neutrality impact of banking regulation. Australian officials appreciate the concern about fiscal risk. In this regard, clarity about respective roles and responsibilities in the event of a banking failure or re-capitalisation would be important.

International Developments

25. The report also reviews **international developments** in relation to cross-border prudential regulation and crisis and failure management.

26. There has been growing interest internationally in ensuring better co-ordination between supervisors, recognising the global nature of the banking industry and the contribution of efficient and stable financial institutions to economies generally. The Basel Committee on Banking Supervision has published a number of documents and principles on the supervision of cross-border banking. The EU has agreed a MoU on high level principles of cooperation between the banking supervisors and central banks of the EU in crisis management situations. This has the aim of facilitating the operation of branch banking across member states. There is also a MoU between the central banks of the Nordic countries.

27. The report outlines the key elements of these protocols, which are designed to strengthen the quality of supervision, improve cross-border co-operation, prevent unnecessary duplication and clearly articulate home and host country responsibilities. Under these models, the lead for supervision on a consolidated basis rests with the home country, while at the same time recognising the needs and responsibilities of host country supervisors, particularly where banks operate as subsidiaries, although some of the arrangements remain ambiguous. Australia and New Zealand have an opportunity to develop a best–practice model.

28. Regardless of the choice of model for advancing trans-Tasman integration of banking, both Australia and New Zealand will need to work closely to respond to the challenges posed by the increasing global character of financial markets. The extent of the business integration in the trans-Tasman banking sector means that, in practical terms, this would require close co-ordination between APRA, the RBA and RBNZ and both Governments.

2 INTRODUCTION AND CONTEXT

29. The Australian and New Zealand banking systems are highly integrated. The same four large Australian-owned banking groups account for the majority of banking assets in both countries.

30. The Australian banking system is predominantly Australian-owned, with over three quarters of the assets of authorised deposit-taking institutions (ADIs) being held by Australian-owned banks. New Zealand assets account for more than 15 percent of the total assets of Australian ADIs. By contrast, the New Zealand banking system is predominantly foreign owned – over 98 percent of registered bank assets in New Zealand are held by overseas-owned entities and Australian-owned banks account for over 85 percent of these assets.

31. The banking groups operating in both markets arrange themselves in a variety of ways. One bank operates on a stand-alone basis while the other trans-Tasman banks operate with varying degrees of integration in their functionality.

32. While the banking markets in Australia and New Zealand are relatively integrated, prudential regulation has remained the responsibility of national supervisors. Supervisory authorities in both Australia and New Zealand are responsible for a sound and efficient financial system.

33. In Australia, APRA is prudential regulator for the financial services industry and is responsible for reducing the risk of, and responding to, bank failures. In its role as home country supervisor for Australian-owned banks, APRA supervises on both a stand alone ADI and consolidated group basis. APRA's prudential standards can be incorporated as part of group policies into the systems of Australian banks in New Zealand. However, APRA has no legal enforcement powers in New Zealand in relation to its prudential standards. APRA focuses on the group and does not monitor or enforce the application of specific prudential requirements (eg limits on large exposures, minimum liquidity, capital adequacy) at the level of individual New Zealand subsidiaries. The RBA is responsible for broader stability of the Australian financial system including the provision of liquidity support in a crisis.

34. In New Zealand, the RBNZ is the prudential regulator of banks and is responsible for bank failure management and liquidity provision in crises. The RBNZ supervises the New Zealand operations of banks, and also carries responsibility for the provision of New Zealand dollar liquidity.

35. In light of the high degree of integration in the banking market the Australian and New Zealand governments have established a working group to investigate a framework for the closer integration of prudential regulation and failure management, including through mutual recognition and harmonisation of the prudential regulation and supervisory regimes. In considering options, the general principle as set out in the terms of reference is that the respective regulatory frameworks should aim to allow

integration of the two markets to the greatest extent possible, while maintaining the safety and stability of both financial systems.

Overview of Prudential Regulation

36. Before examining options for closer integration of trans-Tasman banking regulation, this report provides a brief overview of the respective systems as they interact with each other and the banks operating in both countries.

37. Each country has its own prudential rules and supervisory approaches, albeit with common international frameworks, principles, and standards in mind. A high level objective of prudential regulation in both countries is to achieve a sound, stable and efficient financial system. In New Zealand this 'systemic' focus is the only objective. Australia also has a systemic focus with an additional requirement to act in the interest of depositors. New Zealand places stronger emphasis on market and self discipline than Australia, whilst in Australia this is complemented by a pro-active oversight of ADIs by APRA. Neither the RBNZ nor APRA take responsibility for the day-to-day operation of banks.

38. The two approaches to banking regulation draw on some similar tools. However, the two approaches have some potentially important differences in the emphasis they place on the tools available.

39. In terms of the current prudential rules, APRA has established a range of prudential standards for banks to comply with on a stand-alone and consolidated group basis, whereas there are a smaller number of prudential rules in New Zealand. Australian banks may, as part of group risk management practices, implement in New Zealand policies that are consistent with prudential requirements which APRA imposes on consolidated groups - as long as each New Zealand bank's directors can attest that the policies appropriately manage the risks the New Zealand bank faces. The application of specific policies at individual New Zealand subsidiary levels are, however, not monitored or enforced by APRA.

40. In the areas where both regulators have prudential rules, there are only a few areas of material difference between the rules. APRA imposes a number of specific prudential requirements not applied in New Zealand (e.g. liquidity and large exposures, on-site visits) whilst the RBNZ plays a more active role in specifying disclosure requirements for banks in New Zealand.

41. In the area of capital requirements, the requirements of both countries are currently broadly consistent with the Basel capital accord. This is unlikely to change under Basel ll, although in some areas more than one approach is acceptable.

42. Under Basel II, the four major Australian banks are expected to adopt the advanced approaches for operational and credit risk. They will also need to hold capital under Pillar 2 requirements for other risks such as interest rate risk, credit concentration risk, business/strategic risk and cyclicality risk. Several other local banks have developed programs to implement the

advanced approaches but most of these are expected to seek accreditation on a slower timetable. Other banks will adopt the standardised approach. While preliminary indications suggest that, under the advanced approaches, there could be sizeable falls in the amount of capital required to be held under Pillar 1 requirements for Australia banks on a consolidated basis, APRA has made it clear that it will only accept a moderate overall outcome once the additional Pillar 2 considerations are taken into account.

43. The RBNZ has yet to make a final decision on how to implement Basel ll, although it has indicated a preference for the standardised approach for all banks in New Zealand. However, it is likely that the level of capital for banks in New Zealand would not be significantly lowered.

44. In the outsourcing area, APRA's policy allows arrangements where the service provider is outside Australia and is applied in a flexible manner if the outsourcing arrangement is to another regulated entity within a banking group. The policy requires arrangements to be in place in the event that a service provider becomes insolvent, including arrangements for a bank to take over ownership of, or have access rights to, software and computer hardware.

45. The RBNZ is in the process of developing a flexible outsourcing policy[1]. The policy is likely to focus on each bank's ability to continue operating in the face of the failure or dysfunction of a major outsourcing provider to the bank. As a host country to all its systemically important banks, New Zealand faces considerable operational risk. The RBNZ's thinking on effective risk management of banks' outsourcing activities is similar to that of APRA, the UK Financial Services Authority and the Hong Kong Monetary Authority, each of which has issued guidance on these matters. As such, the RBNZ wishes to ensure that the New Zealand board of any systemically-important registered bank, or a New Zealand statutory manager, has unambiguous legal authority and practical ability to control all the functions, systems and management capacity necessary to operate a bank on a stand-alone basis if and when necessary.

46. In times of crisis, these issues are time critical. Hence, pre-prepared arrangements are needed. The RBNZ does not intend to be prescriptive about how the systemically-important banks may best meet these objectives and is still finalising its generic outsourcing policies.

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[1] The type of issues the RBNZ is considering are how:

- a New Zealand bank is able to meet its core daily settlement and other time-critical obligations, to avoid disruption and damage to the financial system;
- any statutory manager is able to clarify the New Zealand bank's risk position immediately after any failure, and contain any damage to the New Zealand bank's balance sheet; and

options for loss-sharing and recapitalisation of the bank are identified and made available to the New Zealand authorities.

47. Australia appreciates that New Zealand does not intend to apply this policy prescriptively and that the policy will be applied on a case-by-case basis following intensive consultation with the banks. Notwithstanding this, and recognising New Zealand's legitimate concerns in this area, Australia would be concerned if such a policy were to involve significant establishment and on-going costs for Australian banks.

48. Both countries are currently involved in the supervision of the New Zealand operations of Australian banks – RBNZ from a New Zealand perspective and APRA from a consolidated perspective. The Australian approach emphasises close oversight of banks by APRA to ensure compliance with prudential standards. APRA also monitors the health of banks more generally through a combination of on-site examinations of banks, consultations and discussions with banks, and analysis of information collected from banks.

49. The New Zealand approach emphasises bank directors having primary responsibility for the prudent operation of their bank, which is reinforced by requirements for regular public attestations by bank directors and no depositor protection objective. It also places emphasis on public monitoring (e.g., by other banks, credit-rating agencies) of banks through public disclosures by banks. New Zealand also undertakes off-site monitoring, regular consultations with the banks, and oversight of the New Zealand banking and wider financial system. APRA does not currently have detailed disclosure requirements but is comfortable with the continuous disclosure requirements mandated for its listed banks under stock exchange rules, and the detailed reporting which has developed to satisfy market needs. APRA will be seeking a more active role in prescribing disclosure of prudential information in order to meet its obligations under Basel II Pillar 3 requirements.

50. At present, due to the New Zealand focus on public information, director attestation, offsite supervision, and system-wide monitoring there is unlikely to be material duplication of information collection and oversight by regulators. While there is relatively good information sharing between regulators at present and recently a MoU on information sharing was signed between APRA and the RBNZ, there is scope for improvement in co-ordination between supervisors.

51. Both countries have sovereign crisis and failure management arrangements, though there are currently few formal co-ordination arrangements for communicating and co-ordinating in times of crisis or bank failure. Both countries have policies designed to ensure they have the ability to effectively manage the failure of a bank. In New Zealand, banks that are systemically important, or have inadequate disclosure or are from countries with domestic preference laws and have over $200 million in retail deposits, are required to be locally incorporated. Otherwise banks are free to operate in branch or subsidiary form. In Australia branches are generally not permitted to accept retail deposits and other branch depositors are not subject to depositor protection provisions, although exceptions have been made to this rule based on historical

relationships.

52. In addition to well-designed prudential rules for limiting the likelihood of failures within the trans-Tasman banking system, the maintenance of financial stability also requires the establishment of agreed procedures and understandings for dealing with a distressed institution. Since the availability of liquidity plays a vital role in sustaining confidence during periods of stress, an important part of these procedures and understandings will relate to the provision of emergency liquidity support. In addition, the RBNZ and APRA have powers to deal with situations where liquidity support is not appropriate and there is a need to manage the consequences of a failure.

53. The RBA and the RBNZ have similar policies for responding to liquidity shortages in the banking system. Having sufficient liquidity is the banks' responsibility and where possible both central banks would look to market solutions to problems. If emergency liquidity assistance were provided this would be on a discretionary basis and both the RBA and the RBNZ would only do so where they are satisfied that they were dealing with a sound financial institution. In Australia, this assessment of underlying soundness would fall on APRA as the supervisor of banks. In New Zealand, the RBNZ would come to its own decision reflecting its dual role as bank supervisor and as lender of last resort.

54. A number of challenges arise in coordinating cross-border liquidity support arrangements. The first is the need to ensure prompt information sharing between regulatory authorities in both countries. This principle of information sharing is already reflected in the MoU between APRA and the RBNZ. The second challenge is that there may be differences of view between the RBA and the RBNZ on the merits of providing liquidity support. This could arise for a number of reasons, including situations in which APRA and the RBNZ have different opinions on the soundness of the banks concerned.

55. In the circumstance of a systemically-important bank in severe financial difficulty, and where market solutions have been exhausted, the question may arise as to whether it would be better to keep the bank open, rather than to liquidate it. To keep a bank open may require it to be recapitalised. This could be affected by creditors or by government(s) and might need to be supported by government guarantees. Where a bank is operating in branch form in Australia and New Zealand, the issues surrounding this decision may be more complex.

56. Given the common ownership of the Australian and New Zealand banks, this is likely to be an issue that the Governments of both countries will face simultaneously. At present it is possible that the Governments, for legitimate national interest reasons, could come to different views about the best course of action in relation to such a bank. This could include, for example, one country's authorities deciding to provide assistance to a bank where the financial difficulties primarily affect its operations in the other country, as it considers that the failure of a related entity would be

detrimental to its financial system and national interest. The other country's authorities may decide not to provide assistance.

57. If governments take incompatible actions, it will most likely reduce the effectiveness or increase the costs of those actions in at least one country (and maybe both countries).

58. To the extent possible then, it is important to minimise the possibility of situations arising where regulators and/or governments take incompatible actions. This would mean agreeing understandings between regulators and governments relating to failure management processes and strategies, and information sharing.

Issues to Address

59. The current regulatory arrangements and approaches raise a number of issues to consider. In particular, whether:

- the current situation gives rise to unnecessary inefficiencies and compliance costs on banks from complying with the two regulatory regimes;
- there is scope to improve the stability of the banking sector;
- there is scope to facilitate better services and lower cost banking for consumers and increased competition;
- greater coordination of supervision activities would improve information flows between supervisors and thereby reduce the probability and severity of crises;
- the supervisors have the necessary powers and access to information to fulfil their role as home and host supervisor; and
- there is scope to improve crisis management preparedness.

60. Integration of regulation should only be undertaken to the extent that it is to the mutual benefit, in terms of stability and efficiency of each country. Taking this into account, we consider the potential for integration or cooperation with regard to the prudential rules, supervisory arrangements and failure management frameworks. The working party considered both the potential for broadly-based recognition by New Zealand of the rules applied by APRA to banks operating in Australia for their New Zealand operations (the APRA as supervisor and failure manager model), as well as the scope for harmonisation and greater co-ordination of regulation and supervision on an area-by-area basis (the enhanced home-host model).

International Developments

61. The issues raised by increasing integration of global financial markets and the emergence of cross-border financial institutions pose new challenges for governments and supervisors.

62. The Basel Committee has established a number of high-level principles relating to cross-border supervision. The European Union (EU) has taken significant steps to co-ordinate banking supervision to reach its goal of a single market and to remove impediments to cross-border branching and provision of services. While, these tasks are challenging, there is also a clear commitment to an integrated approach to banking supervision and crisis and failure management. The Nordic countries' supervisory authorities have established protocols for cross-border supervision (see Appendix 1).

63. The 2001 EU Directive on the reorganisation and winding up of credit institutions seeks to clarify responsibilities in this area, in particular with regard to insolvency proceedings, as has the recent MoU on the high-level principles of cooperation in crisis management situations. The Nordic countries have established a MoU between central banks on cross-border crisis management, including for liquidity support.

64. While the EU and the Nordic countries have made progress in establishing protocols for crisis and failure management, for these (and other) countries there have been difficulties of coverage and implementation. There are a number of difficulties involved including:

- wider sovereignty concerns;
- provision of liquidity support and burden sharing by governments;
- material differences in legal systems, including in relation to insolvency laws ; and,
- the status of creditors, notably depositors.

65. For Australia and New Zealand, the Nordic countries are arguably the most comparable countries – the Nordea Banking Group has operations in five separate countries and is systemically important in four. Compared to the EU, the Nordic countries do not have the same degree of political and institutional integration, but banking sectors are highly integrated in a business sense. The Nordic countries are grappling with the same issues as New Zealand and Australia – how to supervise banks that operate on a cross-border basis to enable them to operate more efficiently and manage risks more effectively.

66. Over the last decade, the potential benefits of integration have driven harmonisation efforts in Europe. The European experience suggests that full integration can be a slow process and the hoped for efficiency gains may take time to materialise. That said, the potential commercial benefits of globally integrated banking operations and the scale economies which

derive from technological innovations in, for example, information and risk management systems, will see national authorities under continuing pressure to determine an appropriate supervisory response to the complexity of cross-border banking and the issues that this raises for financial stability.

67. By international standards Australia and New Zealand are already highly-integrated markets with similar legal systems, which provides an opportunity to build cooperative arrangements covering prudential supervision and crisis management that are more comprehensive and effective than other groups of countries have so far been able to achieve. For Australian and New Zealand authorities, the challenge will be to balance efficiency, stability and sovereignty concerns.

3 ENHANCED HOME-HOST APPROACH

Key Characteristics

- Australia and New Zealand continue to work towards a best practice home-host supervision model;
- APRA, the RBA, and the RBNZ retain their prudential regulation and crisis and failure management responsibilities in their respective jurisdictions;
- Both countries continue to seek to integrate their approaches, using the Basel principles as a guide;
- Strengthened information-sharing arrangements between regulators to avoid duplication, while maximising information available to regulators;
- Greater mutual recognition and harmonisation of regulation;
- Enhanced cooperation and consultation in supervision and failure management; and,
- A clear and tangible recognition of each regulator's roles and responsibilities in less favourable times.

Supervision

68. The enhanced home-host model would build on and enhance the home-host model of supervision of cross-border banks that is widely used around the world with both countries striving to deliver a world best home-host model. The home-host model has each regulator responsible for banks in their own jurisdiction and APRA responsible for the consolidated supervision of Australian-owned banks operating in both jurisdictions. As such, both regulators would retain responsibility for regulation and failure management in their jurisdiction, with their own associated objectives, approaches, and national interests.

69. Already, the two approaches interact reasonably well, and in some ways the relationship between APRA and the RBNZ is already closer than the minimum detailed in the Basel home-host principles. The enhanced home-host model would seek to further integrate the two supervision approaches to allow each regulator to undertake more effective supervision of banks in their jurisdictions, and on a consolidated basis, without banks being subject to materially different and/or duplicated regulation.

70. Regular and timely information sharing, and a clear and tangible recognition of roles and responsibilities, would be an underlying principle

of the approach. This strong presumption, where appropriate, in favour of sharing information between regulators would assist, for example, in:

- ensuring a minimisation of duplication in the information collection each supervisor does;
- improving each regulators depth of knowledge on banks in their jurisdiction; and
- ensuring that each regulator considers the impact of its action on the other's jurisdiction.

71. The two regulators largely share similar objectives and interests in supervising banks operating in both jurisdictions. As another principle underlying the enhanced home-host model, regulators would leverage off their common interest through greater cooperation and consultation in their supervisory actions. Examples include:

- co-ordination in collection of information, such as in on-site examinations and use of third party reports on banks;
- cooperation in the training of staff; and
- coordinating actions against a particular bank or banks when action is taken in both jurisdictions (e.g., by co-ordinating investigations into a bank).

Prudential Regulation and Supervisory Rules

72. In several areas of prudential regulation, Australian-owned banks already apply policies that are consistent with APRA group requirements to their individual New Zealand bank subsidiaries. The RBNZ approach accepts this application of policies consistent with APRA standards if each New Zealand bank's directors are able to attest that those policies appropriately manage the New Zealand bank's risks. For example, if an Australian bank were to develop a group credit risk management policy, it could be applied across both the Australian and New Zealand operations if the New Zealand directors were comfortable that it was able to adequately manage the New Zealand bank credit risks.

73. The enhanced home-host model would continue to recognise the adoption of group practices by the RBNZ approach. However, where both countries have prudential rules, those rules may differ. In most situations differing rules reflect the particular circumstances in each country.

74. Where there is material difference in rules between countries, the enhanced home-host model would seek to minimise those differences, subject to the different objectives and circumstances that the two

regulators have. To effectively minimise the impact of any such differences in prudential rules, the enhanced home-host model would seek to:

- cooperate in rule setting by consulting each other on proposed policy changes, and where appropriate co-ordinating policy development processes; and

- harmonise or mutually recognise prudential policies where that is sensible.

75. The following section details some potential areas for near-term harmonisation. Appendix 2 provides an overview of how Australian and New Zealand prudential policies currently compare.

Priorities for Co-ordinated Supervision and Rule Setting under Enhanced Home-host Model

76. There are several moves towards co-ordination in supervision and rule setting that could be near-term priorities under the enhanced home-host model model, such as:

- strengthening the MoU between APRA and the RBNZ. Changes to the MoU would include:

    - developing understandings where information could be shared between regulators in areas of common interest, such as information on financial system developments, the health of the financial system, data (such as stress test results) and bank-specific information where appropriate;
    - a commitment to more cooperation in the training and development of staff, such as secondments between institutions to build staff capacity and to develop each institution's understanding of how the other operates and joint staff training initiatives;
    - a shared understanding of the need for each supervisor to provide early warning to the other of significant adverse events or of an intention to take material enforcement action against a bank operating in both jurisdictions;
    - an expectation that each regulator would inform the other of impending changes to their legislative framework or prudential rules;
    - an undertaking that regulators look at using sensible opportunities to harmonise or mutually recognise prudential policies; and
    - ‘standing’ obligations where sensible in the area of information sharing and access to banks.

- harmonising disclosure requirements that are applicable to banks in both countries, so that banks could standardise their reporting systems in both countries. These disclosure requirements come from a range of regulators, in addition to market participants;

- the RBNZ and APRA committing to consult each other while developing their plans for the implementation of Basel II, and seeking to avoid adding unnecessary compliance costs for banks in their implementation of Basel II;

- the RBNZ considering the introduction of liquidity and large-exposure requirements for New Zealand banks. Policies in both these areas would give APRA greater confidence about the operations of the New Zealand subsidiaries of Australian banks, and assist in APRA's consolidated supervision of Australian-owned banks. As a starting point for developing liquidity and large exposures policies, the RBNZ will consider APRA's policies and seek to harmonise any policies developed with those policies where sensible;

- APRA and the RBNZ seeking to better co-ordinate their collection of information from banks – such as offering opportunities for RBNZ staff to observe APRA on-site examinations and for APRA staff to observe RBNZ third party reviews. This could include some co-ordination between APRA on-sites at an Australian bank and RBNZ third party assessments at the New Zealand subsidiary; and

- exploring co-ordinated enforcement actions against banks operating on both sides of the Tasman. For example, if the Australian and New Zealand operations of a bank were concerning both supervisors, they could co-ordinate their investigation and enforcement actions.

Crisis and Failure Management

77. Under the enhanced home-host model, there is scope for improving co-ordination arrangements between Australia and New Zealand. Some central elements in improving co-ordination include:

    - active exchange of relevant information and early warnings, as discussed previously;

    - development of agreements and understandings on a number of issues discussed below; and

    - conducting regular "exercises" using realistic scenarios to check that the arrangements work properly, and as intended.

78. New Zealand considers that these improvements would be facilitated if the RBNZ became a member of the Council of Financial Regulators in Australia. Given that APRA will not have formal responsibilities across the Tasman under this model, the Council does not see a need to extend its

membership to the RBNZ at this point in time. However, the Council could meet with the Governor of the RBNZ annually or on other occasions where this is warranted.

Liquidity Crises

79. The liquidity crisis management arrangements adopted by the regulatory authorities in Australia and New Zealand must be capable of dealing with three main kinds of liquidity crises. First, there may be a general increase in the demand for liquidity across the banking sector due to a shock to the financial system or to the economy more generally. Second, there may be an operational failure that leaves a bank or some banks short of liquidity but there is no question as to solvency. Third, a bank may be unable to obtain funding in the market, perhaps because of some question as to its soundness

80. Some of these problems may be confined to just one market and can be dealt with by the respective central bank. In other cases, particularly if there are concerns around soundness, the common ownership of trans-Tasman banks means that it is unlikely that the liquidity crisis will be quarantined to just one jurisdiction. This means that an effective crisis management plan needs to provide for close and effective cooperation between the Australian and New Zealand authorities from the outset. The RBA, the RBNZ and APRA should have clear understandings of their respective responsibilities and roles in different situations. Effective liquidity co-ordination arrangements are desirable regardless of the structure of trans-Tasman supervisory arrangements.

81. A number of questions will need to be worked through, and some clear protocols developed. The issues include:

- the extent to which subsidiaries would be able to look to parents for support;
- the extent to which parents could withdraw funding from subsidiaries to provide liquidity to other parts of their operations (including to liquefy themselves);
- the form of assurances that the RBA and/or the RBNZ could reasonably expect to receive on solvency from APRA or the RBNZ (as supervisor);
- whether and how any losses arising from liquidity support could be shared between the RBA and the RBNZ; and
- the extent to which RBA and RBNZ might want to look to each other for comfort or guarantees in relation to any credit risk they accept.

Failure Management – Continued Operation of Systemically Important Banks

82. If a systemically important bank is in trouble in either country, it may have to be re-capitalised by government(s) and/or supported by guarantees. New Zealand is also currently working towards the option of using creditors' funds to re-capitalise a bank. In general, the crisis event would be managed on a national basis. The government and creditors in each country would have the benefit of the assets of the respective legal entity or, in the case of a branch, of the branch assets.

83. Failure management would be more efficient, effective and acceptable if there is an agreed framework that reduces, to the extent possible, any legal and practical uncertainties over assets ownership and reduces the likelihood of unnecessary operational disruptions.

84. Shared understandings could include:

- a robust and efficient framework for handling the information sharing, decision-making and implementation processes amongst the regulatory agencies and governments so that problems can be dealt with promptly and effectively. The framework would also ensure that legal processes (including the declaration of statutory management) are managed coherently;

- commitments about the ongoing provision of essential management, technological and support services so that a bank's operations can continue without disruption; and

- agreements as to the recognition and priority in each country of voidable claims with particular reference to claims that might arise because of breaches of each country's regulations.

4 APRA SUPERVISION AND FAILURE MANAGEMENT OF TRANS-TASMAN BANKS

Key Characteristics of Model

85. This model involves extending APRA's prudential regulation and supervision to all Australian-owned deposit-taking banks that operate in both Australia and New Zealand, referred to as 'trans-Tasman banks'. The model would involve providing APRA with the legal platform to exercise its regulatory powers and functions in New Zealand as well as extending Australia's depositor preference provisions under the Banking Act 1959 (Banking Act) to New Zealand depositors of APRA prudentially regulated Australian banks in New Zealand. The supervisory function and powers of the RBNZ, in relation to prudential oversight of these banks, would be removed. Effectively, this model creates a single prudential regulatory framework for trans-Tasman banks with APRA exercising all of its powers and functions in both Australia and New Zealand.

86. The model encompasses failure management, requiring APRA to consider the impact of decisions on New Zealand depositors as well as Australian depositors when using its failure management powers. In a situation involving the possible provision of liquidity support by the RBA and/or the RBNZ, APRA would be called upon to provide judgements about an institution's solvency. To reflect APRA's responsibilities in New Zealand, APRA's governance arrangements would be extended to allow a New Zealand representative as an APRA member where matters relate to the prudential regulation of banks. APRA would remain primarily accountable to the Australian parliament and the Treasurer, but there would be a limited form of accountability through reporting to the New Zealand Parliament and the New Zealand Minister of Finance for its actions in New Zealand.

87. This model represents a significant change for both countries. Both jurisdictions recognise that this model would require more time to undertake a detailed assessment of what is needed to implement it and the implications for not only the relevant banking and regulatory laws in each country, but also a number of other areas of law, including insolvency and corporations laws.

Supervisory Powers and Regulatory Rules

88. Under this option, APRA would have a formalised presence in New Zealand supported by legislative powers. All of APRA's regulatory rules and supervisory powers would legally extend to the New Zealand operations of Australian banks (with the RBNZ no longer having a prudential regulatory role for these banks). In some instances, this would formalise current practices and in other areas extend APRA's reach.

89. This would mean that trans-Tasman banks would be subject to one set of regulatory rules, including APRA's prudential standards, directions powers and failure management powers. For example, APRA would have the ability to set capital requirements, conduct on-site supervisory visits, give directions, use enforcement action, access banks' information and continue its data collection functions, as currently performed in Australia.

90. In performing and exercising its functions and powers, APRA would balance its objectives of financial safety and efficiency, competition, contestability and competitive neutrality in both the Australian and New Zealand banking markets. In addition, where a bank may be unable to meet its obligations APRA would perform its functions under that part of the Banking Act (essentially relating to supplying information and ADI statutory management) with the intention of protecting both Australian and New Zealand depositors equally.

91. The single regulatory regime would allow trans-Tasman banks to choose between adopting a branch or subsidiary structure for their operations in Australia and New Zealand.

Crisis and Failure Management and the Protection of Depositors

92. APRA's role as a supervisor, when an institution is in financial difficulty and likely to be unable to meet its obligations, is to exercise its powers and functions for the protection of the depositors of the institutions that it regulates. Specifically, section 12 of the Banking Act provides that "it is the duty of APRA to exercise its powers and functions under this Division (Division 2) for the protection of the depositors of the several ADIs".

93. APRA's powers in the event of an institution experiencing financial difficulty are contained in Division 2 of the Banking Act. These powers include APRA's ability to appoint a statutory manager and run the affairs of the bank. Extending these powers to trans-Tasman banks would require APRA to consider the impact of any decisions that it made on New Zealand depositors, as well as Australian depositors of banks, including decisions that may effect the provision of systems and other resources to New Zealand operations.

94. The depositor preference provisions would be extended to encompass New Zealand depositors, giving depositors in New Zealand equal priority with depositors of the bank in Australia in the distribution of assets in Australia and New Zealand. Australia's preferred model is that in the event of a failure of a trans-Tasman bank, the assets of the Australian ADI and the New Zealand subsidiary bank would be pooled and distributed amongst Australian and New Zealand depositors in priority to all other creditors. It is recognised that this would likely require consideration of insolvency laws in both countries, which could be a difficult issue. Additionally, further consideration of how such a mechanism may work in the event that a failure was confined to one market will be necessary.

95. Crisis management co-ordination involving liquidity support is an area that requires further consideration and a detailed examination of arrangements under this model. As APRA does not have access to significant funds, the RBA and/or the RBNZ would be responsible for providing liquidity support to a troubled bank. Should this situation arise, APRA would be called upon to provide judgements about the solvency of the institution(s) to the RBA and the RBNZ.

96. The single regulatory framework achieved by this model would still allow the RBA and the RBNZ to co-ordinate their response to a liquidity crisis if this was the appropriate choice of action.

Institutional and Governance Arrangements

97. Under this model, APRA would be required to exercise its powers and functions on both sides of the Tasman in respect of those trans-Tasman banks captured by the arrangement.

98. The RBNZ would retain prudential supervision of the remaining banks operating in New Zealand (and equally APRA would regulate solely Australian banks). The RBNZ would not have a role in the prudential regulation and supervision of trans-Tasman banks. In terms of responding to a crisis situation in any of those banks it would share a similar relationship with APRA as the RBA.

99. As a result of APRA's standing and responsibilities in New Zealand, it would be appropriate to amend APRA's governance arrangements to allow New Zealand representation as a part-time member of APRA where matters relate to the prudential regulation of banks.

100. Under this particular arrangement, New Zealand would be offered representation on the Australian Council of Financial Regulators (creating an expanded body).

Accountability of APRA to both Australian and New Zealand Parliaments

101. The Australian Treasurer is the minister who has responsibility for the Australian Prudential Regulation Authority Act 1998 (APRA Act) and the associated financial sector regulatory acts (such as the Banking Act). This includes the Treasurer having responsibility for making recommendations to the Governor General on the appointment of APRA members and the Treasurer's power to give APRA a written direction about policies it should pursue, or priorities it should follow, in performing or exercising any of its functions or powers.

102. As an Australian Government agency, APRA is accountable to the Australian Parliament through Parliamentary committee scrutiny of its annual report and through Senate committee estimates proceedings. Both of these processes often involve parliamentarians directly questioning APRA officials about any aspects of their activities and operations. APRA is also required to advise the Minister of certain situations, for example APRA is required to advise that a body regulated by APRA is in financial

difficulty.

103. Under the proposed model, such scrutiny, and APRA's responsibility to provide advice to ministers, could be extended to the New Zealand Minister of Finance and the New Zealand Parliament for matters related to APRA's role and responsibilities in New Zealand - reflecting the requirement on APRA to act in the interests of both countries and their depositors. It is not envisaged that the power to issue directions to APRA would be extended to the New Zealand Minister of Finance.

104. Changes to APRA's powers through legislation and regulation are also subject to Parliamentary scrutiny. Prudential standards under the Banking Act will become disallowable instruments from 1 January 2005 (due to the passage of the Legislative Instruments Act 2003). On an industry level, it is APRA policy to provide wherever possible industry with a minimum of three month consultation period on proposed new prudential standards or amendments to prudential standards.

105. Given the change in the regulatory reach envisaged by this model it would be appropriate for APRA to also consult with the RBNZ, relevant New Zealand Ministers and other appropriate bodies in New Zealand on new or amended regulations and prudential standards that would impact on the prudential regulation of trans-Tasman banks. Paired with New Zealand representation through APRA membership, this would allow New Zealand interests to be taken into account in the prudential regulatory approach adopted by APRA.

106. The amount of funding allocated to APRA is determined through the Australian Government's budget process with funding allocated from the consolidated revenue fund. Subsequently, industry is levied on a broad cost recovery basis to cover the operational costs of APRA. Each year, levies are determined and raised from institutions according to the Financial Institutions Supervisory Levies Collection Act 1998 and six supervisory levy Acts that apply to individual sectors of the financial system (including ADIs).

107. Under this model, the budget arrangements and the determination of levies would remain the responsibility of the Australian Parliament but with the New Zealand Minister of Finance being consulted on budget proposals. The model would involve the extension of APRA's ability to collect levies from New Zealand subsidiaries viewed as separate entities, including consultation with the trans-Tasman banks on proposed levy amounts.

108. It is recognised that the model poses some difficult questions around reaching an arrangement that provides to New Zealand appropriately weighted representation and scrutiny of APRA's performance and functions.

Implementation

109. Australia has sought formal legal advice on the legality of the option and the high-level legislative changes that would be needed to implement this model. New Zealand has not sought separate advice on this issue, nor formally reviewed the Australian advice. This section provides a summary of the legislative changes Australia would need to undertake and an indicative opinion on the necessary changes needed to New Zealand legislation. The option presents a range of challenges and further detailed legal advice would need to be obtained if this option is to be pursued further.

110. The Australian legal advice indicates that this model is legally possible and each respective parliament have the necessary constitutional power to extend the Australian banking laws to Australian banks and their New Zealand subsidiaries operating in New Zealand.

111. Implementing this model would require amendments to New Zealand legislation to apply the relevant Australian legislation as New Zealand law in New Zealand. This would ensure that APRA's powers and functions are enforceable in New Zealand. Correspondingly, the banking laws as they relate to prudential supervision in New Zealand would need to be 'dis-applied' to trans-Tasman banks. This would legally empower and recognise APRA, its regulatory rules, supervisory powers, enforcement actions and failure management powers and to provide protection from liability to APRA staff and APRA members in the exercise of their powers, functions and duties.

112. These legal powers and functions include its powers under the APRA Act and the Banking Act and also include regulations, prudential standards, and guidance notes, and would also extend to other prudential laws, such as the Financial Sector (Transfers of Business) Act 1999. Further legislative change may also be required in New Zealand to allow the application of the depositor preference regime to New Zealand assets and liabilities of trans-Tasman banks, perhaps based on the legislation already applying to Westpac Banking Corporation in New Zealand.

113. Similarly, Australian legislation would have to be amended to recognise the application of the relevant Australian laws as New Zealand law to allow APRA to operate in New Zealand and to extend the depositor preference provisions to New Zealand assets and liabilities (i.e., deposits) of banks regulated by APRA. APRA would also require the power to levy the trans-Tasman banks on a cost recovery basis to recover the costs of extending its prudential regulation and supervisory role to the New Zealand operations of trans-Tasman banks.

5 ASSESSMENT OF MODELS

114. This section assesses the models in terms of their potential contribution to financial system efficiency and stability.

Assessment of co-ordinated supervision model

115. The enhanced home-host model is well understood, and is underpinned by home-host supervisor responsibilities as laid out in the Basel Committee principles. The model would not require legislative changes and would not raise issues for other areas of public policy.

116. This model would allow both countries to retain their policy objectives, and particular approaches to supervision, tailored to the circumstances in that country. It would also ensure that both countries have the ability and responsibility to manage distress independently. APRA would continue to have access to Australian-owned banks' New Zealand operations, which would facilitate supervision on a consolidated basis.

117. In terms of efficiency, any gains are likely to be modest, in part because the two approaches to regulation and supervision already complement each other reasonably well, resulting in little duplication of regulatory activity and already capturing many of the gains from closer integration. It will be important to recognise the existing degree of both commercial and regulatory integration in any changes either country may contemplate. In Australia's view the potential for New Zealand to introduce new requirements as to the location of key functionalities and information technology platforms and out-sourcing may have an important bearing on the scope for efficiency gains.

118. More significant gains appear possible in relation to stability under the enhanced home-host model. Measures such as information sharing enriching the set of information available to both regulators, cooperation in policy development, and co-ordination in enforcement all suggest that the soundness of both financial systems will be improved.

119. The most significant, and meaningful, benefits for both countries from the enhanced home-host model are likely to come in relation to crisis management. Developing arrangements and understandings in relation to crisis management will make each country's actions more effective through greater co-ordination in these situations.

Assessment of APRA as Supervisor Model

120. The APRA as supervisor model offers potentially greater efficiency gains, although there are differences in view as to their materiality.

121. The APRA as supervisor model would allow trans-Tasman banks to choose whether they operated through a branch or subsidiary structure, and also choose the location and degree of centralisation of functionalities and systems for their trans-Tasman operations. In practice, Australian

banks operating in New Zealand already comply with most APRA requirements but a move to a single regulator could see modest gains in terms of compliance costs, including in the area of capital measurement.

122. Facilitating the highest possible integration, including the pooling of assets on a consolidated basis, should allow banks to have greater diversification of risk, which could contribute to the stability of both markets. In Australia's view, the more intensive supervision offered by APRA and the reassurance offered by equal treatment of depositors in the trans-Tasman banks also should contribute to greater stability.

123. This model would see APRA take a central role in crisis and failure management arrangements. A single supervisor would see one institution assessing the solvency of troubled institutions. The model would see the RBNZ have the same relationship with APRA as does the RBA. In Australia's view this could add to stability by formalising the requirement for APRA to provide formal and prompt advice on the solvency of a troubled bank where decisions about liquidity support are required.

124. The APRA as supervisor model raises a number of issues for New Zealand. In particular, New Zealand would lose the option of an independent response to a banking crisis in New Zealand should the need arise, but nonetheless would continue to bear the financial and economic consequences of such a crisis. New Zealand would also forego the right to determine the balance of overall objectives for prudential regulation in New Zealand, to determine the instruments to achieve these objectives, or to set prudential requirements designed to address New Zealand-specific issues.

125. The extension of deposit preference would place New Zealand and Australian depositors on an equal footing. However, New Zealand is not attracted to models that provide preference to national depositors over other creditors.

126. In terms of efficiency, New Zealand is of the view that the proposal is unlikely to result in any significant reduction in compliance costs. New Zealand is also concerned that the proposal may raise competitive neutrality issues with respect to non-Australian owned banks in New Zealand, in that it may advantage the incumbent systemically-important banks compared to their smaller competitors or new entrants. Australian officials are of the view that, given the existing market perception of the link between New Zealand subsidiaries and their Australian ADI parents (including the application the application of APRA regulation) the APRA as supervisor model would not materially alter the competitive neutrality impact of banking regulation.

127. New Zealand authorities would forego the right to determine the appropriate response to distress in the New Zealand banking sector, but that New Zealand taxpayers may nonetheless be expected to share the fiscal cost of any intervention. In addition, this model may also increase risk to the New Zealand tax base. Australian banks are likely to have some incentive to attribute assets and profits to Australia rather than New

Zealand. While profits could potentially be shifted under either a branch or subsidiary structure, this is likely to be easier under a branch structure. Australia and New Zealand have different views as to the materiality of this risk.

6 WIDER ISSUES - IMPLICATIONS ON BUSINESS LAW, TAXATION REGIMES AND INTERNATIONAL OBLIGATIONS.

Implications for Other Areas of Regulation

128. In developing a framework for trans-Tasman banking regulation, the implications for other areas of regulation need to be considered. In addition, the wider regulatory framework of both jurisdictions would need to be able to facilitate the implementation of more integrated trans-Tasman banking regulatory regime.

Implications of Enhanced Home-Host Model

129. The enhanced home-host model in chapter 3 builds on the existing regulatory framework by strengthening the relationships between Australian and New Zealand regulatory agencies and more closely aligning regulations. Consequently, there are unlikely to be any further implications for other areas of regulation from improved information sharing and co-ordination arrangements. The extent to which there may be implications for other areas of regulation will depend on the level of harmonisation of banking regulation.

Implications of APRA Supervision and Failure Management of Trans-Tasman Banks

130. Corporations law, financial reporting, and accounting standards – the consistency of each of these areas with APRA regulation would need to be examined. Each of these areas of business law place requirements on businesses, including banks, which may or may not be consistent with APRA regulations.

131. Insolvency laws – if APRA is responsible for managing the failure of trans-Tasman banks the cross-border insolvency laws between the two countries may need to be strengthened to ensure depositors and other creditors on both sides of the Tasman are treated equally. Some aspects of insolvency law are already being looked at in the context of the trans-Tasman relationship (see below).

132. Wider financial sector regulation – there is a degree of consistency in New Zealand regulations across the financial sector with a strong focus on disclosure. APRA supervising the Australian owned banks in New Zealand changes the style of regulation for a large proportion of the New Zealand financial sector and this could potentially create level playing field issues that would need to be considered. Note, however, that APRA post Basel II will be seeking to expand prudential disclosure requirements applied to ADIs such that any differences in disclosure requirements may be narrowed.

133. Australia does not consider that either of the models outlined in this report would have direct implications for its taxation regimes.

134. In New Zealand's view, where banks are free to branch and organise functionality without constraint, and disclosure requirements are relaxed, there may be an increased risk to the New Zealand tax base. In this environment there may be strong incentives for Australian banks to attribute risk weighted assets (and therefore capital) to Australia rather than New Zealand. This may also mean a shift in profits from the New Zealand base to Australia. Profits can be shifted under both structures, but under a branch structure this is potentially easier, particularly if there are no constraints on the location of functionality.

Trans-Tasman Arrangements

135. The development of a framework for banking regulation across the Tasman should be considered in the context of official trans-Tasman agreements. The agreement to explore models for closer integration in banking regulation across the Tasman was announced as an important step towards the single economic market objective under the Australia and New Zealand Closer Economic Relations Trade Agreement (CER). There is significant scope to move the regulatory framework for banks in line with the already high level of integration of the banking markets across the Tasman.

136. The CER, which commenced in 1983, has the objective of removing impediments to trans-Tasman trade and developing a common regulatory framework with the ultimate goal of a "seamless" trans-Tasman economy.

137. The MoU between Australia and New Zealand on Co-ordination of Business Law, signed in 1988 and updated in 2000, aimed to recognise the importance of accelerating, deepening and widening the trans-Tasman relationship within a global market, through increased co-ordination of business law. This MoU outlines that co-ordination does not necessarily mean the adoption of identical laws, but rather that the focus should be on minimising impediments to the development of trans-Tasman business activity.

138. A number of other joint regulatory arrangements have resulted from these trans-Tasman agreements including product safety standards, food standards, pharmaceuticals and therapeutic goods. Also, the trans-Tasman Mutual Recognition Arrangement ('TTMRA') provides mutual recognition for the supply of goods and occupational registration.

139. Considerable work in the financial services and corporations law areas has led to some convergence of regulatory requirements. However, there is still significant scope for further work to be done and a number of projects are underway to develop options for closer integration of the two jurisdictions. Developments in these areas would be consistent with proposals to more closely integrate banking regulation across the Tasman.

140. A discussion paper on trans-Tasman Mutual Recognition of Offers of Securities and Managed Investment Scheme Interests was released for consultation in May 2004. The paper sets out a proposal for the establishment of a trans-Tasman mutual recognition regime governing offers of securities and interests in managed investment schemes, which is intended to contribute to the broader goal of achieving a single market for goods, services and capital. The mutual recognition proposal set out in the discussion paper is intended to complement the TTMRA in the context of a trans-Tasman securities market.

141. A trans-Tasman advisory group has been established to advance cooperative initiatives in relation to accounting standards. The advisory group will advance measures to ensure greater consistency between standards in the two jurisdictions as well as considering a strategic plan to ensure greater leverage at the international level in terms of standard setting. The advisory group will also examine how greater regulatory consistency in the financial reporting area could be pursued.

142. A Terms of Reference is currently being progressed for the Australian Productivity Commission to undertake a study examining the potential for greater cooperation, coordination and integration of the general competition and consumer protection regimes in Australia and New Zealand. Once both countries have in place legislation to implement the UNCITRAL Model Law on Cross-Border Insolvency, considerations will be given to developing more detailed protocols that could be applied in a trans-Tasman insolvency situation.

143. Australian and New Zealand officials have been asked to scope a project for cross recognition of companies across the Tasman. At this stage the project is looking at information-sharing arrangements between Australian and New Zealand company regulators that would allow investors on both sides of the Tasman direct access to information held by regulators in both jurisdictions.

International Obligations

144. In the context of increasing globalisation of trade between jurisdictions it is important to consider the implications of Australia's and New Zealand's other international options for trans-Tasman banking regulation.

Australia

145. Under relevant Australian international obligations, such as the General Agreement on Trade in Services (GATS), the Singapore-Australia Free Trade Agreement (SAFTA) and the Australia-United States Free Trade Agreement (AUSFTA), there is generally an exceptions clause stating that nothing in these agreements shall prevent a Party from taking measures for prudential reasons, with prudential regulation being broadly defined to include protection of investors, depositors, policyholders, or persons to whom a fiduciary duty is owed by a financial institution or cross-border

financial service supplier, or to ensure the integrity and stability of the financial system. The AUSFTA was signed on 18 May 2004 and is currently going through domestic approval processes in Australia and the US, with the aim of bringing it into force by 1 January 2005.

146. At the same time, both the GATS and AUSFTA contain provisions governing the recognition of the prudential measures of another country. These provisions allow the Parties to these Agreements to recognize the prudential measures of another Party, or of a non-Party, whether accorded autonomously, achieved through harmonization or based on an agreement with the other country. However, a Party recognizing another country's prudential measures must be prepared to provide adequate opportunity to another Party to demonstrate that circumstances exist that would allow it to negotiate accession to the agreement or arrangement, or to negotiate a comparable one. The circumstances that might be relevant include the existence of equivalent regulation, oversight, implementation of regulation and procedures for the sharing of information.

147. These provisions do not impose any automaticity to the recognition of another Party's prudential regulations. The onus would be on the other Party to demonstrate that the circumstances exist which warrant the extension to it of the recognition already accorded to another country. Although Australia and New Zealand share a unique relationship, Australia would need to be mindful of its obligations under these trade agreements when entering into an arrangement with New Zealand. However, it is important to note that these provisions are primarily concerned with the treatment provided to services providers, and ensuring that services providers are not treated on a discriminatory basis because of arbitrary recognition of the prudential measures of one country but not of other countries similarly situated in terms of their regulatory regimes. While it is possible that these provisions could mean that Australia has to consider extending the treatment provided to New Zealand to other countries, this needs to be seen in the light of the fact that this treatment would not appear to be providing advantages to New Zealand financial services providers offering their services to Australians which are not enjoyed by financial services providers of other countries (e.g. relief from certain Australian regulatory requirements).

New Zealand

148. New Zealand will need to be mindful of its international obligations under the General Agreement on Trade in Services (GATS), the Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), and the Singapore/New Zealand Closer Economic Partnership (SNZCEP) when drafting any legislation.

149. As noted above with respect to Australia, GATS (in the Annex on Financial Services) and the SNZCEP include an exceptions clause stating that nothing in these agreements shall prevent a Party from taking measures for prudential reasons, with prudential regulation being broadly defined to

include protection of investors, depositors, policyholders, or persons to whom a fiduciary duty is owed by a financial institution or cross-border financial service supplier, or to ensure the integrity and stability of the financial system. However, these measures are not to be used as a means of avoiding commitments or obligations under the GATS. The Annex on Financial Services also allows members to recognise prudential measures in another country through harmonisation or otherwise, and based on an arrangement, agreement or accorded autonomously. New Zealand would need to be careful to ensure that any prudential regulation being developed fits with the definition and interpretation for "prudential measures" as used in the GATS (a term so far untested in the WTO dispute settlement process).

150. The Services Protocol to ANZCERTA also contains a provision that allows differences in treatment of services by New Zealand against Australia (and vice versa) where the difference is no greater than necessary for prudential reasons. While New Zealand is conscious that the purpose of the proposed framework is in fact to achieve greater co-ordination and consistency between Australia and New Zealand, both countries will also need to keep these ANZCERTA obligations in mind as the framework progresses.

7 LOOKING AHEAD:

151. Two models are canvassed in this report – one based on greater co-ordination of supervision and crisis management between the home and host countries and harmonisation of regulation where feasible and beneficial to both parties, and the other based on recognition of home country (Australian) supervision and failure management. Both models seek to reduce any unnecessary compliance costs on banks operating cross border.

152. Models that combine selected characteristics of the two models described in this report are likely to be problematic for a variety of reasons. It is difficult to envisage a model that assigns the supervision responsibility to one agency and the crisis and failure management to another as workable.

153. Other more ambitious models for integrated supervision have not been explored in this report.

154. Common issues to address in moving to any model, however, would be harmonisation of policy objectives, prudential rules, and supervisory approaches; and clarity of roles and responsibilities in crisis management.

155. Further progress towards closer integration of banking supervision would require work on a number of key policy and institutional issues, including:

- arrangements to ensure equal say for both countries over significant prudential policy issues in relation to the relevant country;
- effective exchange of supervisory information between the respective authorities in both countries;
- clear understanding of respective roles and responsibilities in crisis and failure management (including the option of an independent response if required), and agreement on who would bear the costs of intervention; and
- effective accountability to the Government and Parliament of both countries.

156. In addition to prudential and crisis management arrangements, some other significant policy issues would need to be addressed – including competition policies, cross-border insolvency arrangements and tax issues.

157. These are difficult policy issues and will pose considerable challenges for decision-makers and legislators. Nonetheless, the degree of business integration in the banking sector, and the wider aspirations of Australia and New Zealand for a single economic market, suggest that work to underpin a vision of a seamless banking sector should continue.

APPENDIX 1

INTERNATIONAL CROSS-BORDER ARRANGEMENTS FOR BANKING REGULATION

158. This annex outlines some of the initiatives that other regions, particularly the EU and Scandinavia, are undertaking in response to the increasing cross-border nature of banks, as well as coming from a starting point of far less integration than in Australia and New Zealand. The lessons for us from the experience of other countries are mixed. Particular circumstances, such as the extent of banking integration and the degree of political integration, shape the initiatives that countries choose to pursue.

159. The jury is still out on the success of the European experience. The perception of how well the initiatives have worked to date is varied, with host-country supervisors tending to view the experience as less satisfactory than home-country supervisors typically do. Moreover, many of these initiatives are relatively untested, and some of the outcomes they are designed to achieve are yet to eventuate. In part, this reflects the range of difficult issues that still need to be resolved to fully implement these models.

European Union (EU) Single Banking Market[2]

160. The single banking market has been in place since 1 January 1993, when the second banking co-ordination Directive came into force. The purpose of the single market is to eliminate obstructive differences between laws and rules of the Member States to which credit institutions, including banks, are subject. The approach adopted involves harmonisation necessary and sufficient to secure mutual recognition of authorisation and prudential supervision systems, making possible the granting of a single licence recognised through the European Community – to allow credit institutions to set up branches and offer services throughout the EU, competing on an equal footing.

161. Under the EU model, the home-country regulator is responsible for supervision on a consolidated basis and must be able to effectively exercise its supervisory functions. The host-country regulator retains

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2 *Activities of the European Union: Summaries of Legislation: Banking*

Banking: introduction: http://europa.eu.int/scadplus/leg/en/lvb/124002.htm
Reorganisation and winding-up of credit institutions:
http://europa.eu.int/scadplus/leg/en/lvb/124008.htm
Deposit-guarantee schemes: http://eurpoa.eu.int/scadplus/leg/en/lvb/124012.htm
The taking up and pursuit of the business of credit institutions:
http://europa.eu.int/scadplus/leg/en/lvb/124234.htm
Financial Services: Framework for action:
http://europa.eu.int/scadplus/leg/en/lvb/124050.htm

responsibility for the supervision of subsidiaries, and for branches retains responsibility for supervision of liquidity and monetary policy, and may require compliance with specific provisions with it own national laws or regulations on the part of institutions not authorised as credit institutions in their home country (subject to a number of conditions). The supervision of market risk must be the subject of close cooperation.

162. There are three pillars of the single banking market. These are:

- harmonisation of laws and practices governing access to banking activity, capital requirements that cover credits and market risks, the limitation of large exposures and the form, content and valuation rules of the annual and consolidated accounts published by banks;

- home-country control, reinforced through cooperation between national supervisory authorities – which means that a bank operating (in branch form) in other Member States will be supervised by the authorities in the country of origin. In addition, the subsidiaries of credit institutions are supervised on a consolidated basis; and

- mutual recognition by the national supervisory authorities of the rules and regulations in the countries of origin of the banks operating (in branch form) on their territory. Mutual recognition permits credit institutions authorised in their home country to carry on banking activities[3] in Member States by establishing branches or by providing services.

163. To participate in the single market, a member country must have a minimum level of harmonised rules in at least the following areas:

- laws and practices governing access to banking activity;

- deposit-guarantee schemes;

- the concept of "own funds";

- the capital required to cover market and credit risks and the monitoring of these risks;

- the definition of a solvency ratio;

- the limitation of large exposures;

- the preparation, publication and reporting requirements for annual and consolidated accounts; and

- preventing the use of banking system for money laundering.

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[3] Any or all of the activities listed in Annex 1 of the Directive 2000/12/EC of the European Parliament and of the Council, of March 2000, relating to the taking up and pursuit of the business of credit institutions.

164. Under the EU directive, all jurisdictions participating in the single market must have a deposit-guarantee scheme so that depositors with banks under another jurisdictions control have the same protection as depositors with banks under home-country control. The deposit-guarantee scheme must extend to depositors of branches of home country controlled ADIs.

165. In relation to failure management, a winding-up is subject to a single bankruptcy proceeding initiated where the institution has its registered office, (i.e., the home State) and is governed by a single bankruptcy law. A Directive outlines certain rules and protocols to address conflicts of jurisdiction and ensure creditors across jurisdictions are treated equally.

166. Supervisors of institutions that operate in multiple jurisdictions cooperate closely and have put in place MoUs and other information sharing arrangements. To aid information sharing at an EU level the European Commission has established two new committees, the Committee of European Banking Supervisors and the European Banking Committee under a new committee structure for the financial sector.

167. The EU has recently agreed on a MoU on the high-level principles of co-operation between the banking supervisors and central banks of member countries in crisis management situations. The principles identify responsible authorities, required flows of information and provide for the setting-up of logistical infrastructure to support cross-border co-operation between authorities. The MoU contributes to other co-operation arrangements that involve Ministries of Finance, deposit insurance funds, securities and insurance supervisors and third-country authorities.[4]

168. Basel II will be incorporated into EU law and will be applied to all banks and investment firms, not just internationally active banks. The European Commission expects to release a draft directive in June 2004.

Cross-Border Cooperation in the Nordic region

169. The Nordea Banking Group, domiciled in Sweden, is the largest financial services group in the Nordic area and ranks between the first and third largest bank in each of the four Nordic countries: Sweden, Finland, Denmark and Norway. The group currently operates a series of locally incorporated banks in each county, however, it is expected to convert all of its cross-border subsidiaries to branches to reduce the complexity of its current structure, improve operational and capital efficiency and lower operational risk.

170. In response to the Nordea Banking Group's proposed restructure, the four Nordic countries have established a framework for the supervision of the entire conglomerate, which includes a MoU on cross-border cooperation on the supervision of the group.

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[4] 10 March 2003, European Central Bank Press Release, *Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations.*

171. The framework for cross-border cooperation will also establish a cross-border supervision committee, a cross-border crisis management group and requires the development of supervision, information sharing and decision-making protocols. These measures are aimed at ensuring that there is efficient information exchange between supervisory authorities, that a global risk assessment framework of the conglomerate based on the home country's rating model is undertaken and results from on-site inspections are co-ordinated (among other things).

172. To facilitate cross-border supervision and co-operation, Sweden's deposit insurance scheme will most likely be amended to operate across all markets in which the Nordea Banking Group operates.

Basel II[5]

173. The Current Accord, Basel I, which became effective in 1988, was designed to align the capital requirements of banks that competed across boundaries. Basel II updates the original accord and introduces additional options for the measurement of capital that utilise banks' internal risk management systems to obtain more quantitative assessments of risk. Basel II consists of three mutually reinforcing "pillars": Pillar 1, minimum capital requirements; Pillar 2, supervisory review of capital adequacy; and Pillar 3, public disclosure.

174. The Basel Committee on Banking Supervision has just published a new framework. The standardised and foundation approaches will be implemented from year-end 2006 and the advanced approaches will be implemented at year-end 2007.

Pillar 1 – Minimum Capital Requirements

175. Regulatory capital is broken into three parts under Basel II to match credit risk, market risk and operational risk. The methods that banks and supervisors may use to measure the risks that they face have been updated under the New Accord. There will now be three options for calculating credit risk and three others for operational risk – each option allows for increasing risk sensitivity. The market risk element is essentially unchanged. Also, the definition of regulatory capital and the minimum required ratio of 8 percent will remain unchanged under the New Accord.

Pillar 2 – Supervisory Review of Capital Adequacy

176. Based on a series of guiding principles, banks are required to assess their capital adequacy positions relative to their overall risks and for supervisors to review these assessments and take appropriate actions in response to these assessments.

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5 Basel Committee, *Overview of the New Basel Capital Accord: Consultative Document*, April 2003.

177. The changing nature and increasing complexity of banking means that these elements are seen as necessary for effective management of banking organisations and for effective banking supervision. Pillar 2 is also important because judgements of risk and capital adequacy should be based on more than an assessment of whether a bank complies with minimum capital requirements.

Pillar 3 – Market disclosure

178. A set of disclosure requirements will allow market participants to assess key information about a bank's risk profile and level of capitalisation. The objective of enhanced disclosure is to improve market discipline, which is turn should help banks and supervisors manage risk and improve stability – reinforcing the regulatory process.

High level principles for the cross-border implementation of the Basel II[6]

179. The Basel Committee has recognised that the New Accord will require more cooperation and co-ordination between home country and host country supervisors, and has outlined six high level principles for the cross-border implementation of the New Accord.

- Principle 1: The New Accord will not change the legal responsibilities of national supervisors for the regulation of their domestic institutions or the arrangements for consolidated supervision already put in place by the Basel Committee on Banking Supervision.

- Principle 2: The home country supervisory is responsible for the oversight of the implementation of Basel II for a banking group on a consolidated basis.

- Principle 3: Host country supervisors, particularly where banks operate in subsidiary form, have requirements that need to be understood and recognised.

- Principle 4: There will need to be enhanced and pragmatic cooperation among supervisors with legitimate interests. The home country supervisor should lead this co-ordinated effort.

- Principle 5: Wherever possible, supervisors should avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation burden on the banks and conserve supervisory resources.

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[6] Basel Committee, *High-level principles for the cross-border implementation of the New Accord*, August 2003.

11 May 2004, BIS Press Release, *Consensus achieved on Basel II proposals*.

- Principle 6: In implementing the New Accord, supervisors should communicate the respective roles of home country and host country supervisors as clearly as possible to banking groups with significant cross-border operations in multiple jurisdictions.

APPENDIX 2

MAIN DIFFERENCES BETWEEN THE AUSTRALIAN AND NEW ZEALAND SUPERVISORY REGIMES

180. The main differences between Australian supervisory arrangements and New Zealand supervisory arrangements are as follows:

Institutional arrangements

181. In New Zealand, the Reserve Bank (RBNZ) has responsibility for supervising registered banks and groups headed by registered banks and for acting as lender of last resort. In Australia, the Australian Prudential Regulation Authority (APRA) supervises banks, other authorised deposit-taking institutions (ADIs), non-operating holding companies of ADIs incorporated in Australia and the groups headed by such institutions. The Reserve Bank of Australia (RBA) is responsible for acting as lender of last resort.

Objectives

182. New Zealand does not have an explicit depositor protection objective and unsecured creditors rank pari passu with depositors in a winding up. For locally-incorporated ADIs, APRA has a depositor protection objective and depositors in Australia of these institutions have a priority claim in a winding up.

Role of Minister

183. In New Zealand, ministerial consent is required before the RNBZ can exercise some crisis management powers (including its direction powers) or require a bank to be deregistered. In Australia, APRA has unilateral authority to exercise its powers (including direction and crisis management) other than those relating to ADI mergers. In Australia the Minister can give APRA written directions provided these are published and do not relate to a specific case, whereas in New Zealand the Minister has no power to direct the RBNZ.

Application of supervisory requirements

184. In Australia, regulatory requirements are typically imposed through prudential standards, associated guidance notes and conditions on authorities, whereas in New Zealand, disclosure Orders in Council and director attestation requirements, together with conditions of registration, are the main supervisory tools. Both countries generally apply requirements on a uniform basis but reserve the right to vary requirements between banks. APRA uses on-site visits as an important tool in its supervisory oversight, applies a systematic risk assessment framework (such as its Probability and Impact Rating System) to its supervision of

ADIs and generally has a more hands-on approach. The RBNZ conducts regular consultations with banks' management and Boards, and is intending to introduce independent third party reviews.

Liquidity

185. APRA requires ADIs to establish liquidity management strategies and to demonstrate that they have sufficient liquidity to enable them to keep operating for at least 5 business days in a 'name' crisis scenario. New Zealand does not have any specific liquidity requirements but requires director attestation and disclosure of information about systems and procedures.

Asset quality

186. APRA establishes a framework for ADIs to identify and report non-performing loans. It also requires ADIs to implement security valuation and provisioning processes and requires ADIs involved in commercial lending to have credit grading systems. The RBNZ relies primarily on accounting standards and disclosure requirements, and director attestations.

Capital adequacy

187. The minimum capital for a bank is NZ$15 million in New Zealand and A$50 million in Australia. Australia applies higher minimum ratios where it considers this appropriate whereas New Zealand applies the standard 4 per cent /8 per cent requirement to all banks. There is a difference in the nature of eligible capital and the way capital adequacy is measured (including with respect to market risk). New Zealand has a more conservative approach to capital adequacy treatment of securitised assets and innovative capital instruments.

188. Australia is committed to allowing major banks to adopt an internal-ratings based models approach under Basel II. New Zealand has not yet made a firm decision on the approach it will be taking, but has indicated a preference for adopting the Basel II standardised approach for all banks.

Crisis management

189. APRA and the RBNZ each have a similar range of crisis management powers such as the ability to give directions and place a bank in statutory management, but these differ in detail. APRA can issue directions to ADIs other than in crisis scenarios. New Zealand uses changes to a bank's conditions of registration as a way of enforcing special requirements in the absence of a crisis.

Local incorporation

190. APRA does not permit overseas incorporated banks to take retail deposits, while the RBNZ allows some overseas incorporated banks to do so.

Connected exposures

191. APRA applies a limit on exposures to related entities, including subsidiaries. There is no limit on New Zealand banks' exposures to subsidiaries. The limit structure for other connected exposures differs between the two countries.

192. APRA permits ADIs to own insurance companies (and commercial enterprises) subject to compliance with set prudential requirements. The RBNZ does not permit New Zealand incorporated banks to have subsidiaries which conduct any material insurance underwriting business or activities of a non-financial nature. Such activities can however. be conducted in separate entities under a holding company structure.

Risk management systems

193. Audit committees are compulsory for Australian incorporated banks but are not mandatory in New Zealand. New Zealand requires disclosure and director attestations, while Australia requires banks to provide it with information and declarations from the chief executive endorsed by the board in relation to risk management systems and controls. APRA requires ADIs' external auditors to provide reports to it on various matters and it undertakes on-site examinations to review ADIs risk management systems. External auditors are required to disclose to APRA matters relating to breaches of prudential requirements and matters relating to the safety and soundness of ADIs. In New Zealand, auditors are required to disclose to the RBNZ information relating to insolvency or serious financial difficulty if that information would assist the Bank in the exercise of its powers.

Large exposures

194. Australia has large exposure limits and a number of other requirements relating to exposure concentration, while New Zealand relies on disclosure and director attestations to ensure that exposure concentrations are kept at prudent levels. APRA receives information on individual large exposures. The RBNZ obtains some information on large exposures on an ad hoc basis where necessary.

Transfer of business

195. APRA, with the consent of the Minister, can provide the voluntary transfer of assets by an ADI and in a crisis scenario, again with Ministerial approval, can require a compulsory transfer of all or part of an ADI's business to another ADI. Statutory managers appointed by APRA (who may be directed by APRA) also have the power to sell and otherwise dispose of an ADI's assets. In New Zealand, in a crisis scenario the Reserve Bank, subject to the Minister's approval, can approve the sale or disposal of all or part of the business of a registered bank. A New Zealand statutory manager has similar powers.

Fit and Proper

196. Australia's Banking Act provides for the mandatory disqualification in specified circumstances of directors and senior management of ADIs (and their authorised non-operating holding companies). In addition, APRA has the power at any time to disqualify or otherwise direct the removal of directors and senior management deemed to be not fit and proper. APRA may also direct an ADI to remove any external auditors it deems to be not fit and proper. APRA does not prior vet the appointment of directors, senior managers or auditors.

197. New Zealand requires directors of locally incorporated banks and senior managers of all banks to undergo fit and proper tests prior to appointment.

Outsourcing

198. APRA has established prudential requirements governing outsourcing of activities by ADIs. These permit outsourcing of activities to related entities and third parties (within Australia and overseas) subject to compliance with prudential requirements. The RBNZ is in the process of developing a flexible outsourcing policy. The policy is likely to focus on each bank's ability to continue operating in the face of the failure or dysfunction of a major outsourcing provider to the bank.

Controls on ownership

199. Australia limits ownership of Australian ADIs (and their authorised NOHCs) to stakes of less than 15 per cent. The Minister may grant exemptions from the limit. In New Zealand, Reserve Bank consent is required to a change of ownership of 25 per cent or more while the Commerce Commission is responsible for administering legislation relating to market concentration.

Foreign supervisor access

200. New Zealand legislation makes specific provision for the RBNZ to authorise home country supervisors to obtain information from or carry out on-site inspections of New Zealand banks. Australia does not have similar provisions in its legislation.

ATTACHMENT 1

TERMS OF REFERENCE FOR DEVELOPMENT OF A FRAMEWORK FOR CLOSER INTEGRATION OF TRANS-TASMAN BANKING REGULATION

The Australian and New Zealand banking markets are highly integrated and interdependent. This integration has helped to build stronger and more efficient institutions, with corresponding benefits for customers and the economies in general.

While banking markets have become more integrated, prudential regulation and failure management regimes have remained separate.

The increasing interdependency between the Australian and New Zealand banking systems raises the question as to the extent to which regulatory frameworks between the two countries should be more closely integrated. As a core principle, the respective regulatory frameworks should aim to allow integration of the two markets to the greatest extent possible, while maintaining the safety, stability and efficiency of both financial systems.

The development of a framework for closer integration in prudential regulation, supervision, crisis management and failure management for the two countries will involve evaluating the benefits, costs and risks for both countries, including in the context of the wider Trans-Tasman relationship. These are complex issues that touch on a range of issues broader than just prudential regulation and will require careful consideration.

To this end, officials from the Australian Treasury, and the New Zealand Treasury and Reserve Bank of New Zealand will jointly report to their respective Ministers by 30 June 2004 on a framework for closer integration of prudential regulation and failure management regimes, and the policy, institutional, and implementation issues to be addressed.

A working party of the Australian and New Zealand Treasuries and the relevant financial sector supervisory agencies, including the Reserve Bank of New Zealand, the Reserve Bank of Australia and the Australian Prudential Regulation Authority, will be formed to develop policy options for closer integration.

Options to be considered include:

- separate regulatory frameworks but greater coordination in crisis and failure management;

- mutual recognition of regulation and supervision, and co-ordinated crisis and failure management; and

- harmonised rules for regulation and supervision for respective authorities, and coordinated crisis and failure management .

The key stages of the project are:

- ***Policy objectives and supervisory approach.*** The prime objective of Australian and New Zealand prudential regulation is to encourage a safe and efficient financial system. To achieve this objective, New Zealand has emphasised self-discipline and market discipline via governance and disclosure requirements. Australia, in addition to encouraging self-discipline and market discipline, has layers of prudential regulation that address systemic stability and depositor preference, including close oversight by the regulator. Decisions on the extent to which policy objectives and supervisory approaches can be aligned will be needed at an early stage, in order to underpin subsequent consideration of options for greater coordination of prudential regulation regimes;

- ***Crisis and failure management responsibilities***. Any regime would have to allow for the possibility (however remote) of the failure of a systemically important bank or other financial system crisis. This would require the design of robust processes for decision making and intervention, clarity about authority and responsibilities to respond in the event of a crisis;

- ***Governance and accountability***. The alignment of supervisory rules and practices and close coordination of failure management regimes would involve complex issues of governance and accountability for both countries. Consideration will need to be given to the appropriate institutional arrangements to give effect to decisions regarding prudential regulation and failure management;

In considering the possible approaches officials will need to take into account:

- safety, stability and efficiency of both financial systems;

- business law coordination: Banking regulation in both countries rests on important foundations in company law, financial reporting, accounting standards, and insolvency regimes. There may be areas of business law that need to be reformed to support a more harmonised approach to bank regulation;

- interaction between tax and regulatory regimes: The interaction of respective tax systems can generate inefficiencies in financial markets. Care needs to be taken that regulatory regimes do not exacerbate these pressures, nor undermine respective national tax bases; and

- other international obligations (for example, trade agreements).

Australian and New Zealand Treasury officials will also report to their respective Ministers with their assessment of the costs, benefits, and risks of the options for developing a framework for closer integration in terms of the soundness and efficiency of the financial system in each country, plus any wider benefits from closer integration under each option.