

TERMS OF REFERENCE FOR A REVIEW OF THE PERFORMANCE AND REGULATION OF MAJOR FINANCIAL INSTITUTIONS IN NEW ZEALAND

Background

In early July, a report was submitted to the Minister of Finance entitled 'Development of a Framework for Closer Integration in Banking Supervision.' This report was jointly prepared by the New Zealand and Australian Treasuries, the Reserve Banks of New Zealand and Australia, and the Australian Prudential Regulatory Authority (APRA).

In addition to canvassing two options for closer trans-Tasman bank regulatory integration, the report identified a number of issues that need to be addressed in order to determine the most appropriate level and form of trans-Tasman bank regulatory integration for New Zealand.

These issues included:

- the appropriate balance of policy objectives for prudential supervision;
- the need to maintain New Zealand influence over prudential policy development;
- the need to maintain the appropriate New Zealand capacity to manage a banking crisis;
- the contestability and competitive neutrality in New Zealand's banking system;
- tax and fiscal burden sharing considerations; and
- the impact of closer integration of banking regulation on wider legislation, institutions and financial activities.

Some of these issues are generic to the broader issue of the development of the single economic market.

In June 2004, the IMF also released its Financial Sector Assessment Programme (FSAP) review for New Zealand. This contained an evaluation of New Zealand's financial system, an assessment of our level of compliance with international best practices and some policy recommendations.

Objectives & Scope

To this end, the New Zealand Treasury, the Reserve Bank (RBNZ) and the Ministry of Economic Development (MED) will form a working group to jointly review the regulation of New Zealand's major financial institutions and the contribution that these institutions make to growth and economic development.

The outcome of this review process will include recommendations on:

- how regulation can best support the contribution of financial institutions to growth while maintaining system stability; and
- whether different institutional arrangements, including domestic or trans-Tasman alternatives, could improve the contribution of financial institutions to growth in New Zealand while maintaining system stability

The main focus of this review will be the banking and insurance sectors. However, issues relating to other non-bank financial institutions (NBFIs) and the wider financial

system including capital markets will be identified where relevant. These issues may need to be addressed in a separate process.

The review will draw on existing work, including the FSAP review produced by the IMF and the Law Commission's review of the Life Insurance Act 1908.

Project Governance

The review will be undertaken by a working group resourced by the Treasury, MED and RBNZ.

The working group will report to a steering committee, comprising senior officials from the Treasury, RBNZ and MED and chaired by the Treasury.

Specifics

1. *Assessment of the Performance of New Zealand's Financial System*

How well is the financial system performing in delivering financial services that support growth and economic development in New Zealand?

Officials will assess the contribution of New Zealand's financial system to growth against a number of criteria listed below, with particular focus on the contribution of the banking and insurance sectors.

This assessment will draw on work to hand. Where relevant, comparisons will be made with the performance of the financial system in other countries (including Australia) and the recommendations made by the IMF.

Consideration will also be given to the factors that are likely to drive change in New Zealand's financial system over time and the implications that these may have on the performance of the banking and insurance sectors.

These assessments will be made against the following criteria:

- **Provision of financial services** - the contribution of New Zealand's financial system to growth will be assessed against the depth and breadth of financial services provided. The allocative, dynamic and productive efficiency of the sector will be assessed. In addition, the working group will consider the importance of maintaining local decision-making capacity and knowledge in New Zealand for the provision of financial services to the New Zealand economy.
- **Stability** – an assessment will be made as to how well New Zealand's major financial institutions contribute to the stability of the wider financial system, including in the face of financial or economic stress that originates in New Zealand or abroad. This assessment will take into account expected future trends.
- **Reputation and confidence** - The international reputation of New Zealand's financial system will be considered. This reputation is affected by perceptions of the quality and cost of financial services, the risk of investing, and the return to capital. These perceptions will be shaped by the New Zealand's adherence to

international standards and codes, credit ratings and other external evaluations. Recent FSAP findings will prove instructive in this area. Given its systemic importance, the conduct of institutions and regulators in New Zealand's banking sector will play a major role in influencing external perceptions of the health of our wider financial system.

2. *Policy Implications for Banking and Insurance*

A *Regulatory Effectiveness*

How well does the regulation of banking and insurance companies in New Zealand contribute to the delivery of the desired outcomes that have been identified above? What changes, if any, may be warranted to improve the effectiveness and efficiency of regulation in delivering on these outcomes?

Evaluating the contribution of regulation to the desired outcomes in one includes considering whether it:

- fosters an appropriate level of competition, innovation and neutrality across the financial system;
- does not impede the development of a seamless trans-Tasman market for the provision of financial services;
- provides the right incentives for institutions to act prudently of their own accord;
- allows economies of scale and scope to be captured;
- minimises the regulatory costs on banks and insurance companies (compliance and operational);
- provides an appropriate degree of protection for depositors, investors, and consumers of financial services;
- is consistent with and supportive of tax policy as it applies to banks and insurance companies;
- ensures adequate legal and operational capacity to manage a financial crisis; and
- supports New Zealand's international financial reputation.

The regulatory arrangements to be assessed include the rules and standards that are applied, and the monitoring and enforcement of those standards. Taking account of the assessments in section 1, the review will recommend whether any changes should be made to the prudential regulation of banks and insurance companies to maximise the future contribution of the financial system to growth while maintaining system stability.

B *Domestic Institutional Arrangements*

Would different institutional arrangements for the regulation of banking and insurance contribute to a better outcome for New Zealand in terms of the provision of financial services and the stability of the wider financial system?

Officials will assess whether the regulation governing banks and insurance companies in particular could be re-organised in a manner that would improve the provision of financial services in New Zealand and/or the stability of the wider financial system. This will include consideration, as appropriate, of:

- whether regulation should be organised by functions (e.g., stability, consumer/investor protection) or by institution (e.g., banks, life insurance, general insurance); and
- the desirability of alternative approaches to the way in which regulation of our major financial institutions is organised, including an umbrella approach similar to the institutional arrangements already in place in Australia.

C *Regulatory Control in a Trans-Tasman Context*

Could the provision of financial services or regulation in New Zealand be enhanced through a joint trans-Tasman approach?

Officials will assess whether alternative trans-Tasman institutional arrangements could improve the contribution of the New Zealand financial system to growth, while maintaining system stability. This assessment will be largely made across the range of criteria outlined in section 2A, and will include the competition, consumer protection, legal, tax revenue, and fiscal implications of such an approach.

This assessment will require identifying *inter alia*:

- the costs and benefits of foregoing some decision rights over prudential regulation and supervision; and
- the costs and benefits of foregoing some decision rights over crisis and failure management.

Officials will also consider what governance, legal, operational and accountability arrangements would be necessary for a joint trans-Tasman regulatory institution to at least meet New Zealand's requirements, if not be superior to alternative domestic arrangements.

Timing

A working group progress report will be delivered to the Minister of Finance prior to his next scheduled meeting with the Australian Treasurer on single economic market issues in early February 2005. The working group will maintain regular communication with the Minister's office as these recommendations develop. Final recommendations will be completed by the end of 2005 Q2.