

Joint report: Cover note – Review of the regulation and performance of New Zealand’s major financial institutions

8 January 2005

EXECUTIVE SUMMARY

Early in 2004, the Minister of Finance met with the Australian Treasurer, Peter Costello. As part of the Single Economic Market agenda they agreed to investigate options for closer integration in trans-Tasman banking regulation. The New Zealand and Australian working groups formed reported jointly to the two Ministers in July 2004 on two options for closer integration: APRA being the sole supervisor of trans-Tasman banks and a model based on greater co-ordination and cooperation (the enhanced home-host model). New Zealand officials considered there were considerable difficulties with the first model and preferred the enhanced home-host model.

The above process prompted a review of a number of areas within the New Zealand financial policy framework that included analysis of whether economic benefits would arise from alternative forms of integration with Australia. Cabinet directed that the New Zealand Treasury, Reserve Bank of New Zealand (RBNZ) and the Ministry of Economic Development (MED) undertake a programme of work to assess the performance of the New Zealand’s major financial institutions, the effectiveness of domestic regulation relating to major financial institutions and to evaluate the costs and benefits of integration of trans-Tasman financial regulation. The key focus was on banks, but some areas of insurance were also considered.

This paper summarises the findings of that review. The full report is attached.

RECOMMENDED ACTION

We consider the following actions should be taken in response to this report:

- a Dr Cullen discuss with Mr Costello the benefits of an enhanced home-host model with a formalised committee structure;
- b Treasury undertake some analysis of whether there are benefits to be gained from giving greater clarity to where responsibility for financial stability lies;
- c Minister of Finance to endorse the RBNZ’s decision to publish the FSR on a six monthly basis and invite input from the Ministry of Economic Development and the Securities Commission;
- d **[Information withheld under section 9(2)f(iv) and 9(2)g(i) of the OIA 1982 – maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials, and maintain the effective conduct of public affairs through the free and frank expression of opinions];** and
- e **[Information withheld under section 9(2)f(iv) and 9(2)g(i) of the OIA 1982 – maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials, and maintain the effective conduct of public affairs through the free and frank expression of opinions.**

<p>[.....] for Secretary to the Treasury</p>	<p>[.....] Reserve Bank of New Zealand</p>	<p>[.....] Ministry of Economic Development</p>
<p>Hon Dr Michael Cullen Minister of Finance</p>	<p>Hon Pete Hodgson Minister of Commerce</p>	

ANALYSIS

Assessment of New Zealand's Financial System Performance

1. Many types of financial institution operate in New Zealand. Banks are the dominant intermediary and are significantly more dominant than in Australia.
2. Evidence suggests that New Zealand's financial system is efficient and stable, although vulnerabilities remain. Service delivery has kept pace with overseas and market conditions are sufficient to create competitive pressures. Banks are in a strong financial position and have been very profitable in recent years. Insurance companies are recovering from a period of poor investment returns. The non-bank financial institutions vary in risk level and performance, and are more vulnerable to sudden changes in conditions, but no one player poses significant risks to the financial system.
3. There is a high level of foreign ownership of banks and insurance companies in New Zealand. Foreign ownership brings new ideas and knowledge into New Zealand but creates risks when decision making and key personnel move to the home country.

Domestic Policy Implications

4. Financial sector regulation can improve financial stability and provide consumer protection.
5. The main agencies involved in financial sector regulation are the RBNZ, MED and the Securities Commission. The RBNZ supervises banks for the purposes of maintaining the stability and efficiency of the financial system, and avoiding significant damage to the financial system should a registered bank fail. MED's responsibilities include policy development, and some regulatory responsibilities, for the non-bank financial sector. The Securities Commission performs regulatory responsibilities in relation to the enforcement of securities law.
6. The RBNZ has assumed an overview role in analysing and reporting on the stability of the financial system. At present, the RBNZ performs this role by monitoring and reporting on the soundness and efficiency of the financial system, even though its supervisory role is limited to banks. While in New Zealand the banking sector poses the largest risk to financial stability, the growth of non-bank financial institutions means that financial instability could emerge outside the banking sector. It is important that financial sector regulators communicate to ensure these risks are taken into account.
7. Some countries, including Australia, have split the responsibility for financial stability and bank regulation. These countries have created consolidated regulators responsible for regulating financial institutions whilst the central bank maintains responsibility for financial stability and liquidity provision. At present we do not see any compelling reasons to move to this approach. We come to this judgement because of the dominance of the banking sector, the RBNZ's role in the banking and payments sectors, current differences in regulation applying to banks and non-banks and the costs involved in adopting such an approach. In addition, effective coordination and cooperation already takes place between the regulators operating in the New Zealand market.

8. A number of deficiencies have been identified in the regulation of non-bank financial institutions. MED, with input from Treasury and the RBNZ, is undertaking a number of reviews in the area of non-bank financial regulation. If these reviews result in changes to supervisory arrangements in the financial sector, then the current institutional arrangements will need to be reconsidered.
9. Overall the RBNZ's regulatory regime appears to be effective. The regime is strong in encouraging market and self discipline. Although an approach that focuses on market discipline when banks are healthy is appropriate, increasing supervisory intervention is appropriate as risks emerge. Despite the *powers* of the RBNZ being in line with international norms, historically the regulatory *practice* of the RBNZ has been lighter than its international counterparts. However, the RBNZ is currently increasing its capacity to detect and respond to emerging risks. These changes will bring the RBNZ's regime close to international norms.

Regulation in a Trans-Tasman Context

10. This review considered the following three models of greater integration:
 - Enhanced home-host supervision. This is already being progressed at a working level in relation to banking.
 - The main features of this model are increased sharing of information between regulators and clarity of rules and roles in a crisis situation.
 - Enhanced home-host supervision with a joint committee structure
 - This option extends the enhanced home-host model by setting up a formal co-ordination committee. The committee could meet regularly to share information on supervision and regulation and work together on policy development where appropriate. It could also coordinate responses to financial crises involving banks that are common to both countries and systemic shocks that affect both countries.
 - Joint regulator model
 - This body would be responsible for regulation, supervision and crisis management. The body would pursue an approach to regulation agreed by both Governments and cover the same scope of institutions in Australia and New Zealand.
11. Regulatory integration or co-operation carries benefits and costs. Potential benefits are lower compliance costs, encouraging the development of a seamless market and improving regulatory co-ordination. Costs of integration relate to regulation not adequately taking into account the different economic structure or policy preferences of the two countries and unfair outcomes for both countries.
12. Due to the RBNZ's high-level regulatory approach, which involves little detailed prescription, and the relatively light-handed regulation of insurance, we consider that a joint approach does not reduce compliance costs from regulatory duplication significantly more than the approaches based on co-operation. However, a joint approach would entail the cost of not being able to set best practice regulation for New Zealand policy preferences and conditions. Given the Australian regime is higher cost than the New Zealand regime, smaller New Zealand institutions may find it uneconomic

to comply with Australian rules. We therefore place considerable weight on New Zealand being able to determine policy outcomes itself.

13. Our consultations suggest that the impediments to a seamless market in banking are not regulatory but arise from differences in information technologies and different currencies. There seems to be little link between corporate form and integrated trans-Tasman operations in practice. Consultations also revealed little appetite for APRA-style regulation in the New Zealand banking industry.
14. There are conflicts that could arise between banking and insurance regulators in Australia and New Zealand in a crisis situation that may lead to unfair outcomes and so are important to address. We consider that the risk of unfair outcomes could be reduced through the joint committee structure. An approach based on co-operation and information sharing entails less risk than a joint regulator as it allows New Zealand greater decision-making power and enables independent action to be taken when differences cannot be resolved or problems do not require a joint response.
15. Consequently, the joint committee structure is our preferred approach. We consider that a joint committee offers most of the benefits of a joint institution, but at a considerably smaller cost than a joint regulator. It should also create momentum and commitment to greater harmonisation over the longer term. In contrast, a joint regulator would give rise to risks that New Zealand adopts regulation that is not best practice for our circumstances and is likely to impact on regulatory effectiveness. [.....]
[Information withheld under section 9(2)j of the OIA 1982 – Enable a Minister of the Crown or any Department or organisation holding the information to carry on, without prejudice or disadvantage, negotiations]
16. Further work will need to be undertaken on how the enhanced home/host model and joint committee structure could be applied to insurance regulation within the context of any reviews of insurance that are undertaken following the government's response to the Law Commission Review of Life Insurance.