

Treasury Report: Meeting with the Australian Treasurer – Trans-Tasman Banking Regulation

Date:	28 January 2005	Treasury Priority:	High
Security Level:	IN-CONFIDENCE	Report No:	T2005/75

Action Sought

	Action Sought	Deadline
Minister of Finance	Read the report Discuss its recommendations with the Hon. Mr Peter Costello on 17 February 2005	17 February 2005
Associate Minister of Finance (Hon Trevor Mallard)	Note the contents of this report	None
Associate Minister of Finance (Hon David Cunliffe)	Note the contents of this report	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact

Enclosure: Yes – Aide Memoire for conversation with Peter Costello

28 January 2005

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Executive Summary

Although we do not support a joint trans-Tasman regulator for banking at present, elements of a joint approach are clearly desirable. These include harmonising regulation where appropriate, greater coordination in a crisis situation and the dissemination of knowledge and expertise.

We consider that these elements could be best captured through the formation of a joint trans-Tasman committee for banking regulation. The committee would share information about developments in supervision and regulation, work together on policy development where appropriate, and coordinate preparedness for, and responses to, financial crises that are common to both countries. However, all members of the committee would remain fully autonomous.

In order to ensure that the momentum towards integration is maintained, the committee could be invited to report to the Australian and New Zealand governments once a year on their work programme, progress on key policy initiatives and crisis management preparedness. Consideration may also need to be given to the appropriate level of engagement with the Australian and New Zealand Treasuries in the area of crisis management preparedness and coordination, as it is in a crisis when government involvement is most likely to be required.

The recommendations in this report facilitate, rather than hinder, Ministers reconsidering a joint trans-Tasman regulator for banking, or wider financial sector regulation, in the future, if desirable. Experience with other single economic market (SEM) initiatives, in particular those involving joint institutions, should help to develop our thinking on regulatory integration.

Recommended Action

We recommend that you:

- a **read** this report in conjunction with the 'Review of the Regulation and Performance of New Zealand's Major Financial Institutions';
- b **discuss** the benefits of forming a joint trans-Tasman committee to make concrete progress on further integrating trans-Tasman banking regulation with Mr Costello at your meeting on 17 February 2005; and

- c **seek** agreement that he will discuss with Australian officials setting up such a committee.

for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: Meeting with the Australian Treasurer – Trans-Tasman Banking Regulation

Purpose of Report

1. You are meeting with the Australian Treasurer, Hon. Peter Costello, on 17 February 2005. One of the key issues for discussion will be trans-Tasman banking regulation. The purpose of this report is to brief you on recent work undertaken in this area and how it may assist you in this meeting.

Recent work on trans-Tasman banking regulation

2. Recently, you and the Minister of Commerce received a report [the report] entitled the *Review of the Regulation and Performance of New Zealand's Major Financial Institutions* [the review], prepared by the Reserve Bank (RBNZ), the Ministry of Economic Development (MED) and the Treasury. In August 2004, Cabinet directed officials to undertake this review in response to issues arising from earlier work that examined *A Framework for Closer Integration of Trans-Tasman Banking Regulation* (POLMin(04) 19/3 refers).
3. The report concluded that moving to a joint trans-Tasman regulator for prudential regulation and supervision is undesirable at this time. We do not consider that a joint regulator would offer significant benefits in terms of the efficiency of our financial system, or the provision of financial services to New Zealanders, over and above what could be achieved through more formalised coordination. Moreover, we consider that potentially significant costs are associated with the joint regulator approach. These result from:
 - not being able to tailor policy to local conditions and/or preferences;
 - loss of decision-making power in a crisis; and
 - a reduction in regulatory effectiveness if the functionality and decision-making power of banks is moved out of New Zealand.
4. However, some elements of a joint approach to banking regulation are of clear benefit to both New Zealand and Australia e.g., harmonising regulation where appropriate to minimise the regulatory burden on banks, greater coordination in a crisis situation and the dissemination of knowledge and expertise. The enhanced home/host model proposed by New Zealand officials for progressing integration during 2004 (T2004/1486 refers) sought to capture these benefits. We consider that the formation of a joint trans-Tasman committee would help to formalise the process for implementing many of the initiatives outlined in this model. The committee would:
 - meet on a regular basis to further build familiarity and a dialogue between key institutions;
 - share information about developments in supervision and regulation;
 - progress joint work programmes including on crisis management preparedness; and
 - resolve crises together where appropriate.
5. The key difference between the joint committee approach and a fully joint regulator is that under a committee approach, governments would opt in to joint policy initiatives

where this was of mutual benefit. That is, the relevant institutions would work together where it was in their best interests, but remain fully autonomous thus protecting national interests.

6. Under the joint regulator approach, governments would need to retain the ability to opt out in order to protect national interests should the need arise. This may be problematic in practice.

Assessment of a joint trans-Tasman banking regulator

7. The cost savings from moving to a joint trans-Tasman regulator for banking are unlikely to be large, given the minimal overlap in prudential rules that current exists. The RBNZ is looking to increase its regulatory and supervisory oversight. However, given its commitment to remaining a low-cost regulator, the degree of regulatory intervention will remain limited relative to Australia. Greater information sharing should be sufficient to ensure that duplication is kept to a minimum.
8. Under a fully joint trans-Tasman regulator, banks would face fewer restrictions on outsourcing and corporate form, which could in principle allow for a more integrated service to customers. However, our consultations indicate that the key barriers to the seamless provision of financial services are not regulatory. Customer information does flow between subsidiaries/branches operating in New Zealand and parent systems in Australia when there is sufficient commercial impetus. However, the provision of a more seamless service may be inhibited by the complexity of enforcing loans in jurisdictions outside of where they have been granted, the importance of face-to-face contact for building customer relationships, different currencies and, hence, different pricing of loans. This point notwithstanding, a lack of finance does not appear to be a major barrier for New Zealand firms wishing to expand into the Australian market.¹
9. **[Information withheld under section 9(2)j and section 6 of the OIA 1982 – enable the Crown to negotiate without disadvantage or prejudice and prejudice New Zealand’s international relations]**
10. In addition, regulatory effectiveness may be affected by greater centralisation of decision-making power away from New Zealand. The current regime requires that the New Zealand board manages the New Zealand operations of the bank in the best interests of the New Zealand subsidiary rather than the global enterprise. Absent such regulation, greater hollowing out of the decision-making power of New Zealand banks may occur. The potential for hollowing out, even under current arrangements, emphasises the importance of ensuring that New Zealand’s regulatory framework is appropriate for local niche players to emerge and fill any gaps in the provision of financial services left by the major banks. The legislation applying to many of these institutions is currently being reviewed by MED.
11. The benefits of a joint approach to crisis management are more difficult to assess, partly because of the high cost but low frequency of major banking failures. What is clear is that national interests will not always align in such situations. This substantially raises the cost of foregoing the right to act independently. If, for example, a large Australian bank failed, it may be in Australian interests for the joint regulator to deal with the parent bank liabilities first before dealing with New Zealand operations. Nonetheless, a high degree of coordination between Australian and New Zealand would still be required to ensure a timely and effective resolution and that the actions of

¹ LECG, New Zealand - Australia Economic Interdependence, report prepared for MED, 2004

one regulator did not undermine those of the other e.g., using New Zealand funds to recapitalise the Australian operations of the bank to the detriment of the New Zealand customer base.

Assessment of a joint trans-Tasman coordination committee for banking regulation

12. The formation of a joint trans-Tasman committee for banking regulation would provide a forum through which trans-Tasman coordination and regulatory integration could be advanced and formalised. The committee could comprise senior officials from the RBNZ, APRA and Reserve Bank of Australia (RBA). Whether the Australian and New Zealand Treasuries should be involved in the committee, particularly in the area of crisis management preparedness and resolution, also needs some consideration and is discussed below. Where any of the issues considered by the committee relate to the non-bank financial sector, and have a direct interest for ASIC, the New Zealand Securities Commission or MED, then these parties would be invited to attend the meeting. The committee would need to strike a balance between creating reasonable certainty of coordination in specified circumstances while preserving the flexibility for each country's authorities to take independent steps to protect their own interests.
13. We consider that a committee of this kind offers many of the benefits of a joint institution, but at considerably less cost. It could deal with the key cross-boarder regulatory issues, e.g., policy harmonisation, information sharing and crisis management, without risking national interests being compromised. In addition to the benefits of the enhanced home/host model, the joint trans-Tasman committee would help to ensure that the momentum and commitment towards greater integration of prudential regulation and supervision is maintained where appropriate. The forging of stronger working relationships would also facilitate more effective and timely crisis management should a crisis occur. A joint committee would retain each regulator's ability to make an independent decision if agreement on the most appropriate way to resolve a crisis could not be reached, but would indicate a strong commitment to finding a mutually agreeable solution.
14. We have provided an approach for progressing this below and we suggest that you discuss this with Mr Costello as a practical means to make concrete progress on the SEM agenda. However, should you wish to take an alternative approach on the integration of trans-Tasman banking regulation, we can provide you with additional information.

Areas requiring further work

15. A number of issues relating to the joint committee proposal would need to be addressed. These include how the committee could be held accountable for ensuring that integration is progressed, where appropriate, and how the MoU to set up the committee could be made most effective.
16. Another issue that would need to be addressed is the degree of involvement of both countries' Treasuries. If the joint committee's work programme was mainly operational, then robust reporting lines between the committee and the two governments may be sufficient to ensure that progress on integration is maintained where appropriate. Moreover, such a relationship would help to preserve the operational independence of some of the institutions involved. However, a larger role for the Treasuries in the area of crisis management preparedness and coordination may be required, as it is in a crisis situation when government involvement would most likely be needed.
17. In order to ensure that the momentum towards integration is maintained, the committee could be invited to report to the Australian and New Zealand governments once a year

on their work programme, progress on key policy initiatives and crisis management preparedness.

[Information withheld under section 6 of the OIA 1982 – prejudice New Zealand’s international relations]

[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]

Going forward

24. The significance of trans-Tasman banking regulation is best considered in the context of the SEM agenda, which comprises a political commitment to identify and progress initiatives that assist in the development of a seamless trans-Tasman business environment. A range of SEM policy proposals are being developed at present alongside the trans-Tasman banking work. Although the success of SEM does not depend on any individual initiative, it is important that at this early stage there are visible signs of success. You will be provided with a briefing on key areas of progress prior to your meeting with Mr Costello.
18. In our view, further progress on integrating the regulation of trans-Tasman banking can be made at this time. The inclusion of banking regulation in the SEM agenda was an obvious choice given the high degree of commercial integration that is already present in the sector. However, the way in which regulatory integration is advanced needs to take account of the particular features of the sector. A joint institution that frequently deals with subjective and qualitative issues (such as a bank regulator) poses considerably more challenges than other joint agencies that have been developed. These have tended to be more scientific in nature and thus resolving differences in policy judgements or national interests requires less attention. In addition, unlike a competition regulator for example, the most difficult challenges for a joint banking regulator are likely to occur in crisis situations when timely and decisive action is most required.
19. However, we consider that the joint committee structure, if designed appropriately, could represent a significant step forward in trans-Tasman integration. It would be possible to design the committee such that, where appropriate, it acted in a manner similar in nature to that of a joint trans-Tasman banking regulator e.g., working together on policy harmonisation and improving crisis management preparedness. The ability to opt in rather than the need to opt out of these arrangements would ensure that progress on integration is made in the areas where it is most required while at the same time protecting national interests if required.
20. We suggest that you seek agreement from Mr Costello that he will discuss with his officials the possibility of setting up such a committee. Although Australian officials welcomed further cooperation under the enhanced home-host model, only limited progress has been made to date. As the joint committee will be seeking to progress many of the initiatives proposed by this model, it is important that both Australian and New Zealand officials are engaged by their Ministers in this process. Ministerial engagement would provide the impetus for the relevant New Zealand and Australian officials to regroup, agree a framework for the committee that is mutually acceptable to all the institutions involved and draft an MoU to establish the committee.

21. You may also want to canvass Mr Costello's views on the design parameters of a joint committee, including accountability arrangements, the nature of the committee's work programme and any "bottom line" features he would prefer to be included in the MoU.
22. The committee proposal also helps make progress towards further integration in future, if that is desired. Looking ahead, we consider that progress in other SEM areas may help in moving further on regulatory integration in banking in the future. In particular, the proposed work on standard forms for joint trans Tasman institutions, together with greater practical experience with joint institutions in other areas, may well help establish firmer criteria for assessing both the desirability and feasibility of joint institutions, and give more confidence about the design of such institutions. In that light, the committee proposal may be better seen as a step along a path of closer integration over time, rather than necessarily the end point.

[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]

