Graeme Wheeler: Address to the 10th Asia Pacific high level meeting on banking supervision

Speech by Mr Graeme Wheeler, Governor of the Reserve Bank of New Zealand, at the Asia Pacific high level meeting on banking supervision, Auckland, 27 February 2014.

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Good morning, and a warm welcome to Auckland.

This morning I'd like to offer a few thoughts on a small country perspective on global financial sector regulatory reform.

But, before doing so, I'll comment briefly on the relationships within the regulatory community.

Relationships

150 years ago, during the American Civil War, Abraham Lincoln said "the best thing about the future is that it comes only one day at a time".

Many of us here felt similarly in September 2008 as the Global Financial Crisis entered a deeper and more perilous phase.

For central banks and banking regulators versed in stress testing, the GFC was an extreme tail risk event.

None of us expected the elements forming the Basel II pillars, including market discipline, to fail in a G7 economy. Nor did we foresee a crisis that would re-price every asset across the globe, and damage financial stability in all our economies.

Naturally, attention quickly focussed on the need to strengthen the capital and liquidity frameworks and broad regulatory architecture across the global banking system. This was necessary in order to help contain the externalities that were very evident in the GFC and build resilience against future crises.

That's why co-operation between central banks and regulators is especially important in all its forms.

We place high value on our relationship with the BIS, EMEAP and with central banks and fellow regulators in the Asia/Pacific Region. Throughout the region, we have deep trade, cultural and political ties, and the region accounts for 60 percent of our trade and capital flows.

EMEAP and its working groups are important channels for building relationships, discussing developments in member countries, and exchanging experiences and ideas on financial stability and regulation. The constructive two-way engagement and information sharing that the forum provides has given us a better understanding of other Asian central banks' perspectives – including on where we differ, where we have common ground, and where we can learn from others.

Small country perspective

I'll turn now to some small country perspectives on global financial sector regulatory reform and illustrate them briefly with New Zealand's approach to prudential supervision.

My main point is that: while it's critical that the global regulatory response addresses regulatory arbitrage, it's important also that small and large countries alike understand each other's needs. These needs include meeting national sovereignty objectives and adapting the regulatory response to local conditions, while also meeting the spirit and desired outcomes of the Basel III standards.

Small open economies differ from their larger counterparts in several respects:

- Their economies are often less diversified and are more vulnerable to external shocks;
- A large portion of their banking system may be foreign owned and regulated by home and host supervisors. Their shadow banking sector is usually smaller and less developed than in the larger economies;
- They tend to have less sophisticated financial market infrastructures, with limited or no opportunities for local central clearing;
- Credit risk is often concentrated in just a few sectors;
- Bank balance sheets are less complex, with a predominance of vanilla banking rather than investment banking; and
- There can be a shortage of highly-rated liquid assets, especially when governments run budget surpluses or small deficits, and where equity and corporate bond markets are small and lack liquidity.

These differences can affect the way small countries choose to implement global standards.

When there's symmetry between financial market practices, small country regulators usually seek to align practices to global standards, so as to minimise the cost for banking groups operating across jurisdictions.

When symmetries aren't apparent, regulators in small economies seek to use the flexibility in global standards to adapt to local conditions.

For some small countries, parts of the global standards have limited relevance or relate to low areas of risk, so their adoption may not be a priority. For New Zealand, shadow banking comes into this area – it's a small sector, which we assess to be low risk.

In other cases the alignment of global standards is influenced more by home regulator rules or market imperatives. For instance, requirements for central clearing and trade reporting of OTC derivatives may be imposed by the home regulator, or by counterparties, independent of any host supervisor requirement.

Before concluding, let me make a few brief comments about New Zealand's approach.

As a financial regulator, the Reserve Bank of New Zealand generally seeks to align with international standards, but uses national discretion to adjust for local conditions as needed. Where we make adjustments we seek to achieve regulatory consistency, mindful also that our approach is:

- to foster market discipline by stressing self discipline by banks in managing risks, and
- to avoid supervisory practices that might erode market discipline or weaken the incentives for a bank to take ultimate responsibility for the management of risks.

I'll give three brief examples where we've used the flexibility in global standards to adapt to local conditions.

- First, farm lending, and especially dairy farming, accounts for a large share of risks faced by New Zealand banks. We've adapted the Basel capital framework to account for the high correlation in bank farm lending losses, and the vulnerability of the New Zealand farm sector to shifts in a narrow subset of global commodity prices.

- Second, our banks have historically relied on short-term funding from offshore counterparties. We developed our bank liquidity requirements ahead of the Basel III requirements, but they achieve very similar outcomes. Our mismatch ratios are very similar to the Liquidity Coverage Ratio, and our core funding ratio is similar to the Net Stable Funding Ratio. Grant Spencer, our Deputy Governor and Head of Financial Stability, will be talking about our liquidity policy during tomorrow's panel discussion.
- and third, the leverage ratio we feel is an unnecessary addition to the risk-based Basel II capital regime. Our banking system is relatively vanilla and we closely monitor risk weights on key assets. Actual leverage is well ahead of the proposed regulatory backstop.

Concluding comments

Small countries are not represented in the main Basel regulatory committees, the Financial Stability Board, or the membership of the G20. Nor do they have global banks.

But they do follow the Basel debates carefully through their relationships in the regulatory community. They know the issues are complex – be they related to cross-border resolution and too-big-to-fail; assessing bank capital adequacy and acceptable tolerances for leverage; or addressing issues around complexity, compliance, and adjustment paths. And they understand the responsibilities all countries carry to close the regulatory net and avoid the regulatory arbitrage opportunities that would otherwise exist.

On the regulatory front, large countries associate with many of the smaller countries as home supervisors, regulators of international infrastructures, and participants in peer reviews and other assessments.

In these roles, it's helpful if larger countries recognise small country differences, as well as the mandate of small country regulators to protect their national interests.

Large countries should support the approaches taken by smaller countries to implement reforms – when they support the intended outcomes of global standards, but in ways that may deviate from large country norms in order to meet local country conditions.