Grant Spencer: Banking regulation - where to from here?

Speech by Mr Grant Spencer, Deputy Governor of the Reserve Bank of New Zealand, to KangaNews New Zealand Debt Capital Markets Summit, Auckland, 2 August 2017.

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Background

I began my present job as Head of Financial Stability at the Reserve Bank in April 2007. That month saw the first straw in the wind of the US sub-prime crisis – the failure of a real estate trust called "New Century Financial". Over the next three years the Reserve Bank was kept very busy attempting to protect the New Zealand banking system and economy from the ravages of the global financial crisis (GFC).

In the aftermath of the GFC from 2010 onwards, we saw a step up in banking regulation globally, epitomised by the G20-sponsored Basel III reforms, Financial Stability Board initiatives, and the Dodd-Frank Act in the USA. The reforms sought to reduce risk-taking by banks, increase capital and liquidity buffers, and improve resolution regimes so that government bail-outs could be more avoidable in the future.

While the Australian and New Zealand banks were less directly affected by the GFC than their Northern Hemisphere counterparts, they were severely tested, particularly when shut out of international funding markets for several months following Lehman Brothers' collapse. It was inevitable and appropriate that the tightening of banking regulation would be felt in this part of the world. The New Zealand banking system is highly integrated with international markets and needs to maintain a strong reputation if it is to continue its lead role in intermediating New Zealand's financial dealings with the rest of the world.

As the post-GFC reforms rolled out internationally, the Reserve Bank endeavoured to tailor the reforms to suit the specific characteristics of the New Zealand financial system and our regulatory philosophy. We did not adopt certain policies such as the leverage ratio and compensation policies, but in broad terms have adopted most of the components of Basel III. That said, some of these policies may be better suited to the major banking systems of the US and Europe, than to New Zealand's relatively vanilla banking system. This raises the question of how closely we need to follow international standards in order to realise the undoubted benefits of international recognition.

We are currently reviewing our regulatory experience over the post-GFC period and thinking how we might shape the New Zealand framework going forward. Two particular catalysts in this regard are the recent IMF Financial Sector Assessment Program (FSAP) report, and our recently initiated review of bank capital adequacy.

To guide our planning we need to revisit the objectives of the regime, our regulatory philosophy, the experience to date with the post-GFC reforms, and the trade-offs involved in deviating from international norms.

Today I will summarise these guiding principles and discuss how they are likely to influence key regulatory initiatives over the coming years. While I will focus my remarks on banking regulation, the principles and key themes apply more broadly to the other financial sectors that the Reserve bank regulates. I will comment specifically on our upcoming review of the insurance regime.

Objectives and regulatory philosophy

The Reserve Bank's mandate is to promote the maintenance of a sound and efficient financial system. While we see soundness as the primary goal of prudential regulation, the secondary goal of efficiency has an important influence on our approach. When setting prudential requirements we need to be mindful of inefficiencies that can be created if they needlessly or disproportionately add to the cost of financial intermediation, stifle innovation or disadvantage some institutions over others.

Broadly speaking, our regulatory interventions aim to improve soundness and safety while as far as possible minimising the efficiency costs of those interventions. We focus our attention on areas where there is strong justification for regulation based on clear market failure and where the benefits to society of regulation are expected to well exceed the costs.

The main source of market failure in banking is negative externalities – which occur when banks do not fully take into account the wider effects of their commercial decisions. For example, the combined effect of mortgage credit expansion on house prices and housing risk is not factored into the risk assessments of individual banks. Nor do bank owners and creditors take into account the systemic costs of failure that can be well in excess of private capital losses. As the GFC demonstrated, governments may feel compelled to commit public funds to rescue failing banks in order to limit the systemic damage from such events. The presence of externalities means that, in the absence of prudential regulation, banks may take on greater risk than is appropriate from the point of view of the broader economy and society.

The prudential framework reinforces incentives for banks and their creditors to understand and manage the risks they take. In some areas, incentives alone are insufficient and we have imposed direct regulatory requirements. Our approach is built on three pillars: self; market and regulatory discipline.[1]

The self-discipline pillar aims to support institutions' internal risk management and governance, and has been at the heart of the Reserve Bank's approach to banking supervision for close to three decades. The primary responsibility for prudent risk management lies with the directors and senior management of banks. Giving boards and management the right incentives to act prudently is the first priority of our regulatory framework.

The market discipline pillar seeks to reinforce incentives for prudent behaviour by requiring the disclosure of financial and risk-related information by banks and also through our own publications (such as our *Financial Stability Reports*). The aim is to increase market participants' understanding of risks in the individual institutions and the wider financial system, enabling investors to differentiate between institutions and thereby apply market discipline to those institutions.

The third pillar of regulatory discipline, which has grown in prominence since the GFC, involves the application of prudential standards intended to reduce various aspects of risk in bank balance sheets, for example via minimum capital and liquidity requirements. While the Basel Committee has promoted global prudential standards, the approaches of different countries span a wide spectrum. At the intensive end are regulators with long lists of prescriptive prudential requirements and supervisory guidance, with extensive compliance monitoring. At the other end of the spectrum are regulators who choose to be less prescriptive, and instead rely on setting higher, more conservative buffers or limits on a narrower set of key variables.

Our preference is the latter. A less activist approach to regulatory discipline is more consistent with our emphasis on self- and market discipline. Those disciplines can be eroded if institutions feel that the responsibility for risk management has been taken over by the regulator. A less prescriptive approach is also less likely to impose excessive compliance and efficiency costs. This more permissive view has guided our approach to loan-to-value ratio (LVR) limits, for example, where we have set broad speed limits on high-LVR mortgage lending rather than outright restrictions.

How close should New Zealand stick to international norms?

In shaping our regulatory approach – with its emphasis on self- and market discipline and being at the more permissive end of the spectrum – we must consider the potential costs of deviating too far from international norms. This is especially important to consider as we seek to tailor the sometimes complex international regulatory environment to New Zealand's relatively vanilla banking system.

The integration of our banking system with international financial markets means that the adoption of the key elements of the Basel framework is desirable; a strong degree of commonality between New Zealand's banking regulations and those of the major countries enhances our financial system's international credibility. Thus, while there might be efficiency gains from a more streamlined regime that is free of unnecessary complexity, there would also be efficiency losses if the New Zealand regime ceased to be recognised as broadly in line with international standards. This could result in a higher risk premium in bank funding costs and potentially reduced access to international capital markets.

As you might expect, much of the "demand" for adopting Basel regulations in New Zealand comes from the four major Australian-owned banks, who generally seek to have a regulatory framework that is closely aligned with the Australian Prudential Regulation Authority's (APRA) requirements. The FSAP report acknowledged the Reserve Bank's close cooperation with APRA and recommended that we strengthen this relationship further. We will continue to develop the relationship with APRA but both sides are well aware of the differences in our circumstances and our different regulatory approaches.

Over recent years we adopted most of the key Basel initiatives even when some have been less than ideally suited to New Zealand circumstances. At the same time the Reserve Bank has taken on additional compliance oversight roles, some of which require specialised skill sets. Two examples are the oversight of banks' internal capital models and the non-objection process for bank capital instruments. Such activities do not sit very well with the regulatory philosophy that I have described. Nor are they easily handled with the limited resources of a small Central Bank. Such an approach has however been consistent with maintaining recognition of the New Zealand regulatory regime by international investors and rating agencies.

The IMF takes the view that our framework needs to be brought more into line with the international orthodoxy. The recent FSAP report[2] on New Zealand found the Reserve Bank's prudential framework to be less than fully compliant with the Basel Core Principles in many areas. This assessment relates more to the Reserve Bank's intensity of supervision than to its adoption of Basel standards per se. The IMF recommends that the Reserve Bank take on significantly more resources in order to: more proactively engage with the banks; issue more comprehensive rules and guidance on key prudential matters; and more frequently verify and enforce compliance.

Can we retain our regulatory approach and still achieve the benefits of international recognition? I believe we can. Notwithstanding the views of the IMF, compliance with the international prudential frameworks is not always a black and white choice; the Basel framework sets minimum standards for key prudential requirements but often offers a menu of choices within those standards, for countries to tailor to their specific circumstances. Further, while Basel Committee members such as APRA are more bound to comply with the Basel standards, a small country like New Zealand implicitly has a greater degree of freedom.

In summary, our objectives are to retain our regulatory philosophy with relative emphasis on governance and market discipline. We want to streamline and simplify the current regulatory regime in a number of areas but at the same time heed the IMF's advice about improving the effectiveness of our supervisory model. Underpinning this, we need to maintain the high international reputation of the New Zealand financial system.

I now turn to how these broad objectives might influence the shape of the Bank's current regulatory initiatives.

Supervisory model

As I mentioned, the FSAP report recommends that we issue more guidance, and be more prescriptive in many of our banking and insurance requirements. The IMF also says we should seek more assurance of compliance via direct on-site verification and validation. The report recommends a significant increase in resourcing to support such changes. The IMF acknowledge that their recommendations imply a departure from the current balance in the three pillars approach and philosophy. However they also take the view that the Reserve Bank needs to increase resourcing in order to effectively implement its current low-intensity model.

The Reserve Bank's preferred approach is to improve the effectiveness of the supervision model through a combination of simpler regulations, some increase in resourcing, and streamlining approval processes.

We will continue to emphasise the quality of banks' decision making processes, with director accountability for compliance through the attestation regime. In this context, current Reserve Bank "non-objection" regimes run the risk of weakening internal incentives for banks to "get it right first time". We will look at these processes closely in the context of our current review of the attestation regime and other governance arrangements which underpin the self-discipline pillar. The review will also consider whether the attestation regime needs to be supported with supervisory guidance and/or verification.

With regard to the broader question of improving verification, we believe the best approach could be through increased use of thematic reviews. These reviews are conducted by our supervisors, and hone in on industry-wide areas of supervisory interest. Recent reviews in banking have looked at outsourcing arrangements and problem loan identification. In the insurance sector we have recently reviewed disclosure compliance. Such thematic reviews achieve the combined purpose of compliance assessment, an improved understanding of risks by the supervisors, and the sharing of best practice across the industry. We are also looking to make greater use of targeted reviews by external experts in cases where serious non-compliance becomes apparent at particular institutions.[3]

Capital review

In a speech in March I outlined the principles that would guide the current review of the capital adequacy framework for locally incorporated banks.[4] The two overarching principles were conservatism and simplicity. Regarding the latter, we do not believe that New Zealand's relatively vanilla banking system warrants a high degree of complexity in its capital regime. We are leaning towards simplifying both the allowable capital instruments and the methods for measuring risk, though we are in the consultative phase and far from making any decisions.

On the allowable capital instruments, many of you will have read our "numerator" consultation paper and we are keen to receive your submissions (the consultation closes on 8 September).[5] It proposes that we remove contingent debt instruments from regulatory capital, which were introduced to the framework in 2013 as part of Basel III. Several factors lean us in this direction.

There is an inevitable interaction between capital regulations and tax law, and an inherent tension with both sets of regulations when an instrument has both debt and equity characteristics. Debt status brings about tax benefits whereas equity characteristics can see an instrument accepted as loss-absorbing capital from the Reserve Bank's perspective. Banks often seek to structure financial instruments to maximise the regulatory capital value of the instrument, while reducing their tax liability. In our experience this often leads to complexity in instrument design, greyness around their true loss-absorbing capacity, and high compliance costs.

Further, it is questionable whether contingent debt has added any real economic value in terms of improving the risk-return options available to issuers and investors. Two thirds of the contingent debt issued since 2013 has been by Australian-owned banks to their parents, with the remainder largely issued to retail investors. The former may be driven mainly by the tax treatment, while retail investors receive an interest premium over deposits but may not appreciate the underlying conversion or write-down risk. In this context, we are concerned that contingent debt may be a financial innovation that is born more of regulatory arbitrage than of market need.

On the risk measurement side, we will be taking stock of the current framework, particularly around the internal risk models used by the four largest banks since 2008. Our experience, and that of other regulators, is that it can be very difficult to assess whether these models provide objective measures of the underlying risks banks face. In theory, internal models allow banks to more accurately manage their risks, and thereby more efficiently align capital with those risks. On the other hand, internal models add complexity to the regulatory framework that may not be warranted in some risk areas, and the banks' assigned risk weights are often lower than would be prescribed by standardised models. While deliberations are on-going, the Basel Committee has signalled its intent to make some major changes to the risk measurement framework, in particular a greater use of floors to ensure modelled outcomes do not deviate excessively from standardised measures. We expect to release a consultation paper looking at these risk measurement issues once the "numerator" consultation is complete, around mid-September.

We also intend reviewing the capital ratios themselves. The key relevant principle here will be conservatism relative to international peers. New Zealand's relatively high risk profile supports such an approach, as does the Reserve Bank's non-prescriptive regulatory philosophy. We are also conscious that the international minimum standards are not calibrated to deal with some of the issues we face in New Zealand, including high industry and portfolio concentration. An interesting issue to address in this part of the review will be the future role and management of conservation buffers, including the counter-cyclical buffer, relative to the minimum capital requirements. We plan to progress these issues later in the year and in early 2018.

The dashboard

Market discipline is a key part of the Reserve Bank's regulatory philosophy. We know market discipline works best when it is supported by the timely and transparent disclosure of financial information. In this rapidly advancing digital age, we have an opportunity to improve the effectiveness of disclosure regimes – the "Dashboard" is an important step in this direction. It will be located on the Reserve Bank's website and will provide market participants and the general public with more timely and comparable quarterly data on New Zealand incorporated banks. The information will cover capital, liquidity and asset quality as well as profitability and balance sheet positions. It will replace existing (off quarter) disclosure statements and make information more easily available and comparable. The information will be available at different levels of granularity to meet the needs of different users.[6]

We see the current Dashboard project as an important step in an on-going effort to support and enhance more effective and efficient disclosure for banks, insurers and other financial institutions. We are working closely with the banks and want to make sure we get it right. We expect to have the first Dashboard published in the first quarter of 2018.

Looking further ahead, we see scope for ongoing advances in effective disclosure and private data management for supervised institutions. Advances in digital services and data management tools are likely to offer a range of new opportunities for assessing and managing the prudential performance and compliance of banks, non-banks and insurers alike. I expect technology will also offer increasing scope for automation in many of these processes. We anticipate greater use of “Big Data” in our supervisory assessments and in providing warning signs of crises or market concerns. But the day of full “robo-supervision” may still be some way off!

Macro-prudential policy

Macro-prudential is a relatively new policy area that we have so far implemented through LVR speed limits, applied in 2013, and modified in 2015 and in October last year. The objectives of the macro-prudential policy framework are set out in the 2013 Memorandum of Understanding between the Governor and the Minister of Finance, which also outlines the instruments we can use to respond to emerging systemic risks.

Macro-prudential policies have been adopted by many countries in recent years as the underlying issues have been global in nature. The very low level of inflation and interest rates in most countries since the GFC has led to rapid increases in leverage and an escalation of systemic risk in property markets, particularly housing. Macro-prudential policies in New Zealand and elsewhere have been aimed at moderating systemic risk by directly limiting housing-related credit risk on banks’ balance sheets.

These instruments are more prescriptive than our baseline micro-prudential tools. They target a specific and significant systemic risk in the form of a leveraged and highly stretched housing market. In a booming housing market, such as we have seen in recent years, we believe the adverse externalities from rapid mortgage credit growth become accentuated, warranting the imposition of temporary macro-prudential measures such as the LVR speed limits.

The Bank currently has a consultation paper out on debt-to-income (DTI) limits. We regard a DTI instrument as complementary to the LVR speed limits. Limits on DTIs reduce the likelihood of a mortgage borrower defaulting, in response to interest rate or unemployment shocks, while lower LVRs help to reduce the risk of banks facing losses arising from a default. They are not just two types of hammer hitting the same nail. Of course, banks already investigate borrowers’ repayment capacity when deciding whether to grant a loan as part of prudent banking practice. At times, however, high volumes of high-DTI lending can contribute to a build-up of risk across the financial system which individual banks may not take fully into account. This is why the IMF and the Reserve Bank believe it is appropriate to have this tool in the macro-prudential toolkit, even though we would not wish to use it while the Auckland and national housing markets continue to moderate.

Thinking more broadly about the macro-prudential framework, we will seek to achieve more broad-based support by ensuring that the policy framework is understood by stakeholders, including the public. It should be positioned consistently with our macro-financial monitoring and our micro-prudential policy and supervision. Policy adjustments should follow a systematic and well-articulated process in response to emerging systemic risks. It is important to be clear what macro-prudential policy can and cannot achieve. For example, while macro-prudential policies can help reduce housing-related risk in the banking system, they cannot control house price inflation.

These broad macro-prudential framework issues will be jointly examined next year by the Reserve Bank and Treasury when the Bank’s Memorandum of Understanding with the Minister of Finance comes up for review.

IPSA review

My comments today have focussed on the future of banking regulation. However, many of the issues around banking are also relevant for the Reserve Bank’s oversight of insurance companies. Certainly our regulatory philosophy applies to insurers (and non-bank deposit takers) just as it does to banks. This includes our key principles of simplicity and conservatism. We will be applying these in the upcoming review of the Insurance Prudential Supervision Act (IPSA), which has now been in place for close to seven years.[7]

We are undertaking the review in recognition of the experience we have gained operating under the legislation, and developments in international standards and guidance. The review aims to ensure a cost-effective supervisory approach that promotes the soundness and efficiency of, and confidence in, the insurance sector.

It is a comprehensive review and the range of issues is wide. It includes the legislative scope (who is required to be licensed), the treatment of overseas insurance business, governance requirements and distress management mechanisms. Earlier this year we published an issues paper, which sought submissions on the scope of the review and areas which the review should prioritise. We are currently reviewing the submissions, and thank those who provided feedback.

The FSAP report on insurance will be an important input to our thinking. While recognising the relative youth of our supervisory regime, and the Reserve Bank's three pillar supervisory philosophy, the IMF assessors made a wide ranging set of recommendations. As in the banking area, we are particularly interested in the FSAP findings that could enhance the oversight framework within the existing three pillars approach. These include the development of clearer and more enforceable prudential requirements, enhancements to verification and improvements to disclosure and market conduct requirements.

Conclusion

Today I have provided some of our thinking on the Reserve Bank's objectives for financial regulation and how these are expected to shape our framework over the coming years. Of primary importance is to maintain the high international reputation of the New Zealand financial system. However we seek also to reinforce our regulatory approach based on the less-intensive supervisory model and simple-yet-conservative prudential requirements. We believe this approach continues to suit New Zealand's small and relatively vanilla financial system.

We will continue to place emphasis on getting the right incentives in place for prudent institutional governance, supported by effective market discipline that increasingly makes use of technology advances. The greater use of thematic and external reviews will enhance our approach to supervision, while maintaining an appropriate balance between the three pillars of the prudential framework. We will also explore how the macro-prudential framework can be made more robust through a well-signalled and understood policy process.

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1 For a more detailed discussion of the three pillars approach, and how it applies across the different sectors we regulate, see Fiennes (2016), New Zealand's evolving approach to prudential supervision.

2 See the *Financial System Stability Assessment* report. The Reserve Bank has published a *Bulletin* article summarising the IMF's recommendations, see Hunt (2017), Outcomes of the 2016 New Zealand Financial Sector Assessment Programme.

3 Under Section 95 of the Reserve Bank of New Zealand Act, the Reserve Bank can require a registered bank to provide the Reserve Bank with a report prepared by a party approved by the Reserve Bank on the corporate, financial, prudential or other matters of the registered bank.

4 Spencer (2017), Review of bank capital requirements. A consultation paper outlining the intended scope of the review is available on the Review of the capital adequacy framework for registered banks page.

5 See the news release for the Review of the capital adequacy framework for registered banks consultation.

6 6 Further information on the Dashboard is available on the Dashboard approach to quarterly disclosure consultation page.

[7] See the news release for the review of the Insurance Prudential Supervision Act and links therein for the Terms of Reference and Issues Paper.