RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Renewing the RBNZ's approach to financial stability

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Renewing the RBNZ's approach to financial stability

Good afternoon, it's good to be here today. I'm going to talk about the Reserve Bank's role in ensuring financial stability and how our approach to prudential regulation and supervision is evolving in line with our own, and society's, risk tolerance.[1]

You'll hear me talk about how the Bank's approach is expanding and becoming more intensive, so that we are more active in addressing vulnerabilities in the financial sector. This is in response to our own experience, and a publicly identified need in formal reviews of our approach.[2] We are building our capabilities to undertake deeper analysis of risks to the financial system and shift to a more intensive supervisory model.

It's a busy time at the Bank as we also undertake with Treasury a fundamental review of the statutory framework for delivering financial stability. The government has announced in-principle decisions to modernise how the Reserve Bank is governed and its objectives, powers and regulatory perimeter. These decisions strengthen our financial stability focus and set the foundations for enhanced performance, capability and accountability of our financial stability functions. Our 'soundness and efficiency' objective is to be replaced with an explicit financial stability objective. The single decision-maker model is to be replaced with a governance board responsible for financial policy. And the artificial distinction between banks and non-bank deposit takers is set to be removed.

Meanwhile, we are reviewing key aspects of the regulatory system, for example upgrading the capital framework for banks and commencing a review of insurance legislation and solvency standards, while the government has declared its intention to introduce deposit insurance.

These significant developments raise the question: how do the different parts of our financial stability regime fit together?

Answering that question is not easy – financial stability is complex and we use a large number of tools to promote it. And there is no single, quantifiable numerical target like the inflation target for monetary policy. Hopefully on conclusion of my speech you will have a greater understanding of the Reserve Bank's role and where we are heading in terms of how the components of our regulatory and supervisory regime fit together.

First I'll outline why financial stability is important, the risks to the financial system and the market failures that create the need for regulation and supervision.

Next I'll set out the Bank's role, alongside regulated entities and other agencies, in supporting a dynamic and sustainable financial system and economy.

Finally I'll focus on the Bank's approach to financial stability, and the outlook in terms of regulation, supervision, strategy and the ongoing modernisation of the Reserve Bank, before covering off some recent announcements that will change the way we work.

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[1] I am very grateful to Piers Ovenden for considerable assistance in the preparation of this speech, along with valuable comments from other Reserve Bank colleagues.

[2] For example the IMF's FSAP recommendations.

Part 1 – Why we regulate and supervise

Financial stability is important

The financial system has a critical role in supporting economic activity. Households and businesses need avenues for saving and credit to fund consumption and investment, payment systems to facilitate local and international transactions, and insurance to manage their risks.

In order to facilitate economic growth, the public need to be confident that banks, non-bank deposit takers (NBDTs) and insurers can and will continue to provide these services, and that the payment and settlement systems will work as expected. The continued and reliable provision of financial services to the economy is a pre-condition for ensuring that the financial system makes its maximum contribution to the prosperity and wellbeing of all New Zealanders.

Financial stability means having a resilient financial system that can withstand severe but plausible shocks and continue to provide the financial services we all rely on. It is something we tend to take for granted – financial crises have been uncommon in this country. But evidence from a wide range of countries over many decades shows us that when they do happen, crises are damaging with long-lasting effects. They impact businesses and households, with reduced economic activity and lost output. They result in increased unemployment and costs for taxpayers. Not only that, recovery can take over a decade and is often halting in nature.

Put another way, financial instability creates inefficiency and waste on a large scale. Reducing the likelihood and severity of these episodes is therefore at the heart of our mission. Our aim is for New Zealand to have a dynamic and efficient financial system that contributes to a sustainable and productive economy.

The financial system is exposed to risks…

Risks to financial stability come from a wide range of sources. External – New Zealand's financial system is heavily reliant on external funding, which makes us vulnerable to dislocation in overseas funding markets. Domestic – risks related to lending to our dairy industry and to our already highly indebted households. And our most recent *Financial Stability Report* notes the risks from technology disruptions, misconduct and cybercrime, insurance affordability and climate change.

We also have to consider the vulnerabilities of our financial system. It is relatively small, and is dominated by a handful of institutions that have similar underlying business models. That means the distress or failure of one of the major institutions is likely to have significant implications for the system as a whole.

And we have to remain alert to new risks. History tells us that there are a wide variety of triggers for financial instability. Every financial crisis is different.

…and is subject to market failures

Financial stability is a common resource that benefits us all. But because it is a common resource, it is also prone to the tragedy of the commons – the risk that it is abused and degraded by individual agents who do not have the right incentives to look after it, or at least to internalise the cost that instability imposes on others. Viewed through this lens, maintaining financial stability depends on market participants being willing and able to identify, price, allocate and manage their risks appropriately.[3]

Information asymmetries – where one party to a transaction knows more than the other – exacerbate this free-riding problem. Small retail savers are likely to find it difficult to detect and price for higher risk-taking at a financial institution, although wholesale investors will exert discipline. In addition there are factors that limit the incentive for financial institutions to internalise the costs to society of a financial crisis. For example, moral hazard can result if institutions believe the taxpayer will bail them out in the event of a crisis. The larger the scale of this distortion, the greater the risk to financial stability and the greater the risk to other regulated entities, investors, depositors and ultimately taxpayers.

These structural market failures tend to be reinforced by behavioural factors. It is well recognised that individually rational people make decisions on the basis of other people's credit and risk assessments.[4] This herd behaviour can create market momentum that drives the price away from the underlying risks and returns. In the absence of objective information about the fundamental economic value of an asset or trade, this reinforces the mis-pricing of risk.

Alongside herd behaviour, add myopic decision making and irrational exuberance and we are well on our way to boom-bust cycles. If asset prices rise, people borrow more and invest more heavily in that asset class. For a time, this becomes a self-fulfilling prophecy. However this also increases the risk of contagion and fire sale dynamics once market sentiment turns. As I said, financial stability is complex.

Part 2 – The Reserve Bank's role

The importance of financial stability as a common resource and the risks and market failures that it is prone to, create the need for prudential regulation and supervision. Nonetheless there is an important role for both the regulator and the regulated in ensuring that the financial stability regime is operating effectively as intended.

The three pillars remain relevant…

The three, inter-dependent, pillars of self-, market- and regulatory discipline remain relevant to our role as prudential regulator. Our regulatory actions do not occur in a vacuum, and there is an important role for regulated entities and market participants in supporting financial stability.

Market discipline refers to the influence that market participants have on a regulated entity's behaviour and risk-taking, where influence is exerted by market participants changing the cost or amount of funding they are willing to provide based on financial and other information about the entity. In a functioning market this creates an incentive for regulated entities to manage their risks appropriately. Transparency initiatives, such as the Financial Strength Dashboard and mandatory disclosure statements support market discipline[5].

Self-discipline refers to a regulated entity's own processes and risk management frameworks, the responsibility for which lie primarily with its directors and senior managers. It

[3] See Orr, A, 'Towards a framework for promoting financial stability in New Zealand', March 2006, https://www.rbnz.govt.nz/research-and-publications/speeches/2006/speech2006-03-22

[4] See Orr (2006).

[5] As noted earlier, market discipline works best at the wholesale level, and is less meaningful for 'Mom and Pop' savers.

remains the starting point of the Reserve Bank's supervisory philosophy. However as the conduct and culture review, the Reserve Bank's attestation review, and various regulatory incidents demonstrate, we cannot assume that it is operating as intended and that self-discipline is effective.

Even when market and self-discipline are effective, they are not enough on their own because of market failures.[6] Regulatory discipline – the imposition of requirements on regulated entities – is necessary to improve the effectiveness of market and self-discipline, and to minimise the costs of that could be visited on the financial stability commons. Our role as regulator means setting robust requirements that are fit for purpose – that address risks and market failures at source, taking into account the costs of regulation and of supervision on our regulated entities and the wider economy.

Setting rigorous but not too stringent requirements is our challenge, informed by research, experience and feedback.[7] We need to understand New Zealanders' appetite for risk, analyse the costs and benefits of regulatory requirements, and have processes for decision-making that provide confidence that in high quality decisions being made.

…and we do not run a zero failure regime

Achieving financial stability does not mean eliminating all risks. This would create inefficiencies of its own – it would potentially stifle new entrants, and remove the incentives for growth, innovation and healthy risk-taking. So we do not run a zero failure regime. Allowing institutions to fail provides the incentives for self- and market-discipline to operate effectively.

However, in order to allow individual institutions to fail we need a robust financial system that can continue to function even when individual entities are experiencing distress or failure. In those situations the Bank is tasked with minimising the impact of distress or failure of an institution on the financial system and the economy.

Our role is dynamic

By necessity our role is a dynamic. The financial system is constantly evolving, as are the risks and challenges. This means that establishing baseline standards is not a set-and-forget exercise. Our requirements and expectations of regulated entities continue to evolve. While it is impossible to predict the future, it is incumbent upon us, when we do impose requirements and set expectations, to think about their effect, and how they might be adapted, in different states of the world.

We monitor the financial system…

We continuously monitor the financial system in order to identify and assess:

- **Structural risks**: ever-present risks related to the composition of the financial system, in terms of its institutions, and their assets and funding. New Zealand is exposed to external shocks and standards must recognise these risks and shield the domestic system and economy.
- **Emerging risks**: risks related to traditional areas of focus like credit or funding risks, or to new and emerging technologies or to climate change. We are particularly

[6] Fiennes, T, 'New Zealand's evolving approach to prudential supervision', September 2016, https://www.rbnz.govt.nz/research-and-publications/speeches/2016/speech2016-09-01

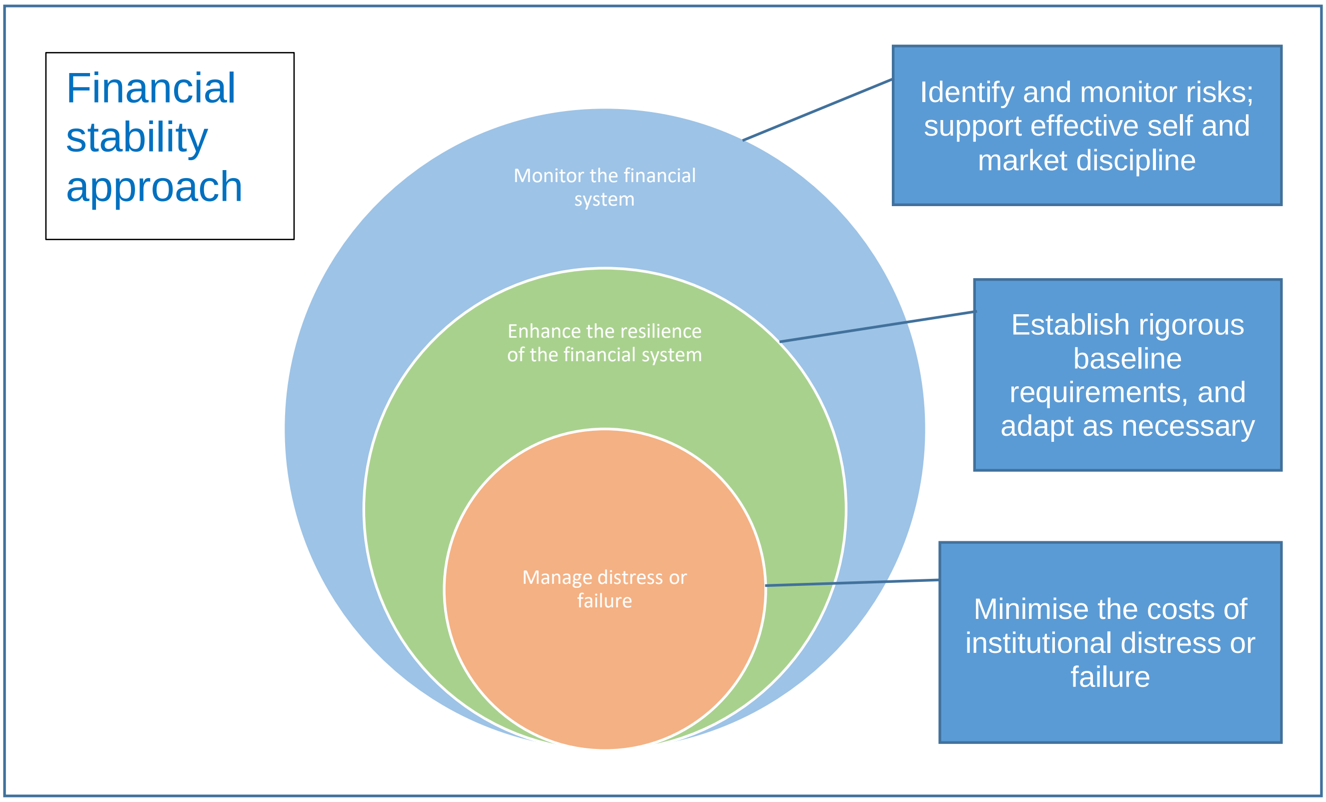
[7] See Bascand, G, 'Financial Stability – risky, safe or just right?', November 2018, https://www.rbnz.govt.nz/news/2018/11/financial-stability-risky-safe-or-just-right.

focused on innovation that presents risks to the regulatory perimeter – whether institutions are operating inside or outside our supervisory and regulatory reach, and whether this is appropriate.

- **Cyclical risks**: the risk that boom-bust cycles are amplified by, and to the detriment of, the financial system, due to the procyclicality of credit and asset price growth, when the failure of participants to account for the broader economic and social costs of their actions is exaggerated.

We publish our assessment of risks in the *Financial Stability Report* both to increase awareness and so that institutions can adapt and develop resilience, and improve their self-discipline.

Supervision has a key role to play both in helping us understand risks to individual institutions, and question whether banks are managing those risks adequately. Our thematic reviews, where we delve into the detail of specific issues, help us and our regulated entities better understand specific risks. Our periodic stress testing, where we subject individual institutions to a significant yet plausible downturn in the economy and distressed funding markets, help us to understand the system's resilience to macro risks.



…enhance the resilience of the financial system…

We enhance the resilience of the financial system by establishing rigorous baseline requirements and ensuring these are complied with through supervision. Our baseline requirements address enduring and identifiable sources of risk to the financial system, with the aim of achieving resilience to most probable shocks or adverse events. We then adapt our regulatory and supervisory approach to reflect newly emerging and/or cyclical risks and the impact they could have on the financial system.

For example, we require banks to meet prescribed capital and liquidity ratios to minimise the risk of insolvency due to sudden losses or a disruption in funding markets (We have been consulting on whether baseline requirements should be set to ensure solvency of the banking system in all but the rarest occasions (a 1:200 year event) or only sufficient for something more frequent). If cyclical risks become excessively heightened we can enhance resilience by increasing capital and/or liquidity ratios. We can tighten loan-to-value ratio (LVR) restrictions if we are concerned about banks' lending standards and the growth of household credit together with the risk of a correction in the housing market.

Our regulatory requirements aim to support effective self and market discipline by providing a basis for directors and the market to assess the well-being of individual institutions. Again, supervision has a key role to play, in verifying that regulated entities are complying with regulations and that self and market discipline are operating as intended.

…and manage the impact of distress or failure

Prevention is best, and most of our effort is focused there. Nevertheless, despite our efforts to monitor and enhance the resilience of the financial system, institutions may become distressed and even fail. This means we need to be well placed, in terms of information and regulatory tools, to manage these events if and when they do occur.

Supervision is crucial in helping us understand the balance sheets, operations and the risks facing institutions. This means working closely with firms on their recovery and resolution plans and having a clearly articulated ladder of supervisory intervention.

The Reserve Bank also stands ready to act as the lender of last resort in situations where a liquidity shortfall threatens the viability of solvent banks and causes a significant tightening in credit supply.

And a new element of our resolution framework is being proposed. The government has stated its intention to introduce a deposit protection regime that, in the event of failure of a deposit taking institution, would provide that deposits in the range of $30,000- $50,000 were insured. While protecting bank customers and taxpayers, this could make it easier to close down a failing institution, sharpen incentives on wholesale investors to exert market discipline, and help reduce the likelihood of financial instability through 'runs' on banks.

The Reserve Bank is uniquely placed…

As a full service central bank we are uniquely placed to fulfil our role in maintaining financial stability. That means that, alongside our regulatory and supervisory function, we undertake monetary policy, we oversee payment and settlement systems, and we stand ready to use our markets functions to provide liquidity in exceptional circumstances.

We also have a role in promoting a vibrant and healthy financial ecosystem. This relies on the input of a wide range of stakeholders, regulators and regulated, as well as the consumers and businesses who rely on the financial system. As a member of the Council of Financial Regulators, we work with Treasury, the FMA, the Commerce Commission and the Ministry of Business, Innovation and Employment to identify, manage and address issues, risks and gaps in the financial system, so that it is both safe and efficient.

We welcome the ten year review of New Zealand's capital markets by the FMA and NZX.[8] Capital markets are a key component of a sound and efficient financial system – they

[8] NZX and the FMA have initiated an industry-led review of New Zealand's capital markets. Capital Markets 2029 is designed to deliver a ten-year vision and growth agenda for the sector. See

diversify the funding sources that businesses rely on, and they perform a crucial function in regulated entities identifying, pricing, allocating and managing risk appropriately. That is more likely to occur when capital markets are liquid and accurately capture the fundamental value of assets.

Part 3 – Our approach to financial stability

Our approach to financial stability is expanding and becoming more intensive, in terms of both regulation and supervision. How do we operationalise our financial stability role, and what aspects of this role are changing?

Our regulatory approach

We choose the appropriate regulatory tool to address the identified risk to financial stability, bearing in mind efficiency costs, the level of effective self and market discipline, and the regulatory framework as a whole. Our requirements are complementary, with some substitutability at the margin – we view them as a package. And as I mentioned earlier, our baseline settings are not set-and-forget, we adapt them as risks and the resilience of the financial system evolve.

We are bolstering the regulatory pillar through a wide range of initiatives. Most notably we are consulting on a material increase in bank capital requirements. Bank capital is a crucially important component of the regulatory framework for banks. 'Skin in the game' reinforces self-discipline – the responsibility on boards and senior managers to manage and disclose risks appropriately. Our proposals reflect our experience and the evidence on the consequences of financial crises.

However, capital is not a complete mitigant. Our other initiatives reflect that banks can fail for many reasons. And it is not efficient to require banks to hold more and more capital in order to address all the different sources of risk. That's why we have a range of policies that aim to address potential problems at source. For example, liquidity standards are important in ensuring banks can meet their cash flow demands; outsourcing requirements are needed so that banks can continue to operate in a situation where a key service provider fails; and macroprudential interventions may be necessary during periods of excessive credit and asset price growth.

Other regulatory initiatives include new legislation to grant us more extensive powers to supervise FMIs. Given our dependence on payment and settlement systems, their lightweight regulation and supervision is a crucial vulnerability. We are working with banks and other stakeholders on a new mortgage bond standard, which will provide banks with an additional funding source, as well as provide banks and investors with a new tradeable instrument. It will also create a larger pool of standardised and transparent securities that the Reserve Bank can lend against as lender of last resort. Phase 2 of the review of the Reserve Bank of New Zealand Act is looking in more detail at our macroprudential and crisis management tools.

The table below illustrates how our prudential banking tools work together to deliver financial stability. Each of our policies contributes to financial stability by addressing a separate risk, with its own transmission channel. Some are more targeted at prevention (limiting the likelihood of a financial crisis) while others are more targeted at management (mitigating the impact of a crisis if it does occur).

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https://www.fma.govt.nz/news-and-resources/media-releases/nzx-and-fma-initiate-industry-review-capital-markets-2029/

<table>
<tr><th></th><th>Purpose</th><th>Relevant tools</th><th>Impact on financial system resilience</th><th>Impact on wider economy</th><th></th></tr>
<tr><td rowspan="5">Crisis Prevention</td><td rowspan="2">Macroprudential policy

Reduce risk that the financial system amplifies a severe economic downturn</td><td>Borrower restrictions (LVRs)</td><td rowspan="2">Reduced losses in a severe economic downturn</td><td>More resilient households and banks reduce potential severity of an economic downturn</td><td rowspan="9">Supervision, oversight and disclosure</td></tr>
<tr><td>Capital and liquidity instruments (CCyB/SCR)</td><td>Lowers incentives on banks to deleverage in a downturn; supports higher credit supply and economic activity</td></tr>
<tr><td rowspan="3">Prudential policy

Maintain baseline resilience of the financial system</td><td>Capital buffers</td><td rowspan="3">Banks remain solvent through the economic cycle</td><td rowspan="3">Maintains market confidence and lowers risk of sudden increases in funding costs for households, businesses and the economy</td></tr>
<tr><td>Liquidity policy</td></tr>
<tr><td>Governance and local incorporation</td></tr>
<tr><td rowspan="4">Crisis Management</td><td rowspan="4">Manage and limit impact of distress or failure</td><td>Collateral standards</td><td rowspan="3">Banks remain functioning parts of financial system</td><td rowspan="4">Maintains availability of credit and banking services necessary for economic activity

Mitigates costs for creditors[9] and taxpayers</td></tr>
<tr><td>Outsourcing</td></tr>
<tr><td>Open Bank Resolution</td></tr>
<tr><td>Minimum capital</td><td>Losses absorbed first by shareholders</td></tr>
</table>

[9] The government has announced its ‘in-principle’ decision to introduce deposit insurance.

There may, at the margin, be some substitutability between our different regulatory tools and settings. However, as I've said, our regulatory tools are intended to be complementary. For example, even if we have higher bank capital ratios, LVRs will continue to have a role to play if there is excessive credit growth in household balance sheets.

Our supervisory approach – a tougher stance

While a robust regulatory approach gives us confidence in the financial system and its stability, it does not imply a lower level of supervisory intensity or that we can shirk our supervisory role. Our supervisory approach is intended to complement our regulatory approach in terms of its reach, and its intensity.

Supervision plays a key role in monitoring, and deepening our understanding of, the financial system and the risks it faces; in enhancing resilience by verifying that our requirements are operating as intended, and enforcing them as necessary. Supervision provides us with the necessary intelligence to manage the consequences of distress or failure of individual institutions.

Effective self-discipline is the starting point of our supervisory philosophy. Firms must want to achieve good outcomes for their customers and owners, not because regulators wish them to. We aim to leverage the incentives on directors, senior managers and shareholders to improve the soundness of institutions, and by extension the resilience of the system as a whole, as efficiently as possible.

However, our experience over the last decade has been that regulations have not always been well applied or complied with, and that tells us that we cannot rely solely on self-discipline. Crucially, it is not just the fact of non-compliance that concerns us – regulated entities have not been as proactive as we would have liked in identifying and remedying issues before the risks become more significant.

Last year's conduct and culture review (run jointly with the FMA) highlighted specific shortcomings in governance and risk management at banks and insurers, notably in relation to sales incentives. The court judgement on CBLI's liquidation stated that "aspects of CBLI's management had indicated a lack of commercial probity". And "a lack of candour in dealing with the company's auditors and the regulator". More recently we revoked ANZ's accreditation to model its own operational risk capital requirement because of persistent failures in its controls and attestation process. It is clear that institutional self-discipline has been lacking.

There is therefore a strong case for further increasing the intensity of our supervisory model in line with the recommendations from the IMF's Financial Sector Assessment Program (FSAP) assessment of New Zealand.[10] This applies even if, on paper, individual regulated entities appear to be sound. Banks should expect our more intensive supervisory approach to apply even if capital requirements are increased as a result of the ongoing Capital Review.

Regulated entities can expect our supervision to be more intrusive, in seeking evidence that attestations are merited and verifying compliance, and that we will intervene and enforce our requirements. We will be more pro-active in holding directors and managers to account, particularly in areas where we have already identified shortcomings.

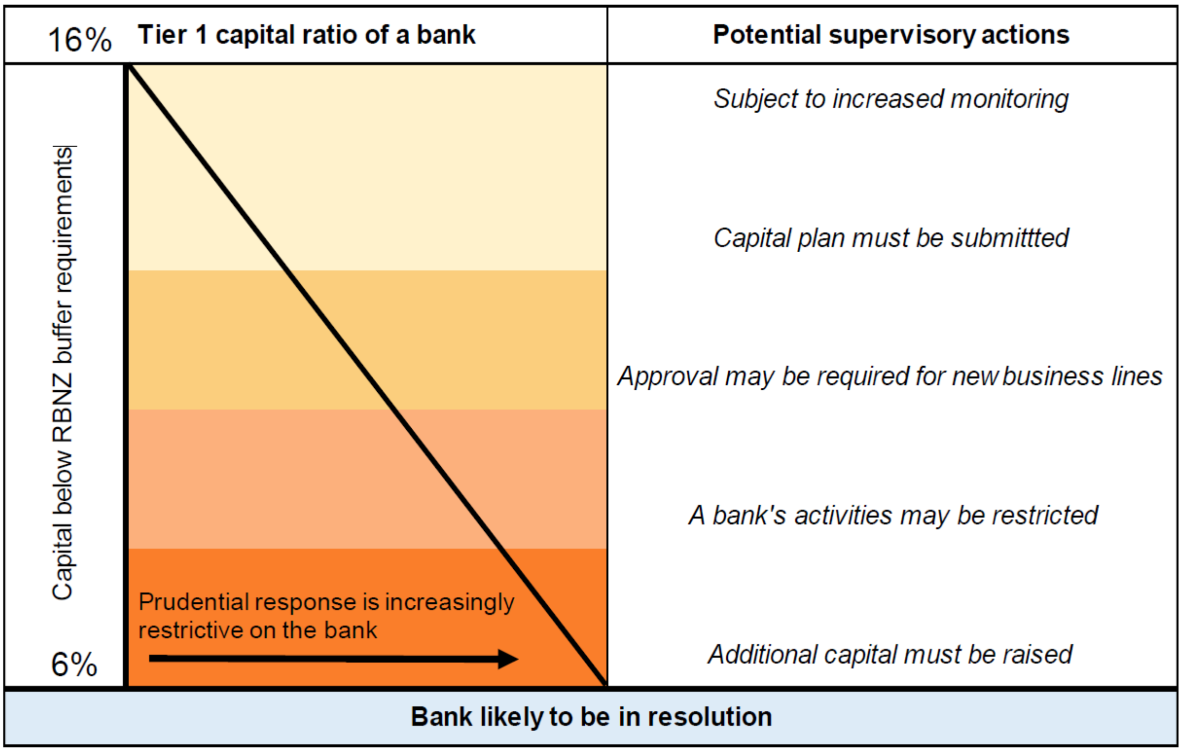
Our regulated population can expect us to continue with our thematic reviews in order to enhance self-discipline and our own understanding of risks. In the near future there will be a

[10] See https://www.imf.org/en/Publications/CR/Issues/2017/05/08/New-Zealand-Financial-Sector-Assessment-Program-Financial-System-Stability-Assessment-44886

thematic review on banks' liquidity standards and another on the appointed actuary regime in the insurance sector. We will continue to periodically stress test the banking system.

We are working towards more transparency about how our supervisory response would escalate if institutions come under stress. As part of the Capital Review we have sought feedback on the proposed supervisory consequences for banks if they breach their capital buffers. The starting principle is that our response will vary depending on the extent to which a bank needs to use its capital buffers to absorb losses. A minor breach of the proposed capital buffers would result in increased monitoring and potentially a formal request for the bank to submit a capital plan detailing how it planned to remedy the breach and by when. More significant breaches could result in increasingly restrictive supervisory actions and requirements.

Figure: Stylised escalated supervisory response



We continue to boost core supervisory capability in order to deliver on our supervisory approach. This means more skilled resource but it also means building and maintaining the necessary monitoring and supervisory frameworks, and it means being analytically strong, suitably sceptical, and willing to act. Being clear and up-front on our supervisory approach – on our greater willingness to intervene and to enforce our requirements – is desirable not only in terms of transparency but also accountability. Setting out our approach publicly, which we will do in more detail in coming months, will help build confidence and commitment to our enhanced supervisory model.

A more intensive approach also means working more closely with industry. We are committed to establishing a 'best regulator-regulated' relationship; to open, knowledgeable and constructive discussions, recognising that that there can be a divergence of views and interests.

Modernising the financial stability framework

Our Statement of Intent (released yesterday) outlines how we are implementing our financial stability approach within the Bank. Our vision of 'great team, best central bank' means we use and maintain rigorous and up-to-date frameworks for regulatory policy development and supervisory decisions. In doing so we take into account the best theory and evidence available. We act as responsible steward of the rules and policies which we create and apply to regulated entities. We consult openly and are committed to communicating our approach in a timely and accessible manner. We work hard to raise awareness across our regulated populations about our objectives, priorities and expectations. We foster co-operation and mutual trust among our domestic co-regulators, wider stakeholders and global peers.

Earlier this week the government announced the 'in-principle' decisions to (a) replace the Reserve Bank's 'soundness' and 'efficiency' objective with a high-level financial stability objective, (b) establish a new governance board for the Reserve Bank with statutory responsibility for financial policy, (c) merge New Zealand's two existing prudential regimes for regulating banks and non-bank deposit takers into a single regime, and (d) introduce a deposit insurance scheme. Further changes are being consulted on in the documents just released by Treasury.

The Governor is scheduled to talk on 11 July about the government's review and what that means for the future of the Reserve Bank and the prosperity and wellbeing of New Zealanders.

Financial stability objective

The new financial stability objective is consistent with how the Reserve Bank has interpreted its responsibilities to date and with our increasingly intensive approach to regulation and supervision. Financial stability – the soundness or resilience of the financial system – relates directly to the existing purpose of our prudential philosophy and is consistent with our intent to have a dynamic regulatory framework; a framework with rigorous and adaptable baseline standards and a more searching approach to supervision.

'Financial stability' has the advantage of clarity, providing a sharp focus for the Reserve Bank, but potentially downplays the importance of efficiency and dynamism that are equally relevant to our over-arching purpose: contributing to a sustainable and productive economy and the prosperity and wellbeing of New Zealanders. Aspects of efficiency – regulatory efficiency and promoting innovation and competition – are expected to be recognised through sub-objectives that are also being consulted on. Increased transparency and accountability for decision-making will also serve to ensure good regulatory decisions are made.

RBNZ Governance board

The Reserve Bank will have a new governance board, with statutory responsibility for financial policy. The board will be accountable for all prudential decisions, including regulation, supervision and enforcement, as well as crisis management. It is expected that the board will be able to delegate powers and the exercise of day-to-day functions and powers to the Governor, and in turn Reserve Bank staff (supported by internal committees as at present). The board will set our risk appetite and scrutinise management's efforts to implement it.

The new governance structure supports our vision and objectives of being a transparent and accountable organisation. Not only will the new board bring diversity of perspectives and experience to key decisions, it will set our strategic direction (our risk appetite, our policy frameworks) and explain its decisions and regulatory outcomes to a broad audience, from the Minister of Finance and Treasury, through to regulated entities and the general public. It will also create more robust accountability by creating a clearer distinction between governance and management functions, and establishing a delegation framework.

ADI perimeter

The government's decision to merge our regimes for regulating banks and non-bank deposit takers into a single regime for deposit takers will create a simpler, more unified regime, more clearly aligned with our financial stability objective. It will minimise duplication and treat similar activities on the same basis, while continuing to allow our risk-based approach to supervision. It will also help future-proof the regime against a shift in lending and deposit-taking activity from banks to finance companies that are currently outside of our banking perimeter, although in a sector as dynamic as the finance industry perimeter issues will never be settled entirely. More work will be required to design the details of this new regime, particularly to ensure that it can be applied proportionately to the biggest Australian-owned bank or the smallest credit union.

Deposit insurance

The government has proposed introducing a depositor insurance scheme with a coverage limit in the range of $30,000 to $50,000. There is still a great deal of detail to work through in terms of how the scheme will be funded and operate but we expect the scheme will complement our role as resolution authority. As we work through the details, we will consider the consequences of the scheme for self- and market-discipline, and the need to adapt other aspects of our regulatory and supervisory framework accordingly.

Part 4 – Conclusion

Financial stability is important for New Zealand and all New Zealanders. The cost of a financial crisis would be significant and wide-ranging. Its effects – in terms of lost output and unemployment – would persist, likely for a decade or more. This means focusing not just on risks to our financial system but on the market failures that can exacerbate these risks and undermine financial stability.

The Reserve Bank's approach to maintaining and promoting financial stability in New Zealand is expanding and becoming more intensive, in terms of both regulation and supervision. We are recalibrating the rules and our enforcement of them. This is in response to our own experience and a publicly perceived need for us to do more, and better.

By necessity our approach is dynamic: we monitor and enhance the resilience of the financial system and intervene in times of crisis in order to manage the fallout. We do this through fit-for-purpose regulation and risk-based supervision. And we do so in a way where each of the moving parts is complementary in creating a financial system that is sound and efficient.

The Reserve Bank is uniquely placed to do this. As a full service central bank we can leverage our different tools and market functions. That means that, not only can we adapt our regulatory or supervisory response as circumstances dictate, we can also use our markets functions to provide liquidity to the financial system at times of stress. We work with other agencies to promote a dynamic and healthy financial system.

We are working hard to set robust requirements that address structural, cyclical and emerging risks in the financial system. Our requirements are not set and forget – we adapt them as vulnerabilities evolve and as risks emerge (and recede). Supervision has a crucial role to play in complementing the regulatory regime, and will continue to intensify. Regulated entities can expect us to verify that self, market and regulatory discipline are operating as intended, and to take enforcement action in cases of non-compliance.

The government's 'in principle' decisions to modernise the Reserve Bank and our financial stability framework give us a clearer objective, a simpler perimeter and strengthen resolution options. The new governance framework, with a board responsible for our regulatory and supervisory approaches, will make us more transparent and accountable in how we deliver on our financial stability objective. These and other changes are being consulted on now and I encourage everyone to read the Phase 2 consultation documents on the Treasury's website and to have their say.[11] We are increasing our capability to deliver our approach and our vision for financial stability within this new architecture.

We expect that together these initiatives will provide the basis for a dynamic and efficient financial system that contributes to a sustainable and productive economy and promotes the prosperity and wellbeing of all New Zealanders.

[11] See https://treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act