Review of the regulation and performance of New Zealand's major financial institutions

Early in 2004, the New Zealand Minister of Finance and Australian Treasurer proposed working towards closer integration in trans-Tasman banking regulation and supervision. The purpose of this report is to assess: (1) the effectiveness of current financial sector regulatory practices and arrangements in New Zealand; (2) their impact on financial and economic development; and (3) whether this could be further enhanced through some new form of trans-Tasman arrangement. While the main focus of this review is the banking sector, insurance is also considered. Issues relating to other non-bank financial institutions are raised where appropriate.

The key recommendations of the report are as follows:

- The Reserve Bank (RBNZ) plays an overview role in analysing and reporting on the stability of the financial system. While this is appropriate, effective coordination amongst regulators, principally the RBNZ, Securities Commission and MED, is necessary to ensure that potential systemic risks emerging from outside of the banking sector can be detected and acted on. In light of this, we consider that the RBNZ should continue to produce its *Financial Stability Report* on a six-monthly basis and that MED and the Securities Commission should be invited to contribute to this report.

- **[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]**

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- Market discipline (mainly through disclosure) and self discipline (mainly through director attestations) should be important pillars of any banking supervision framework, as is the case currently in New Zealand. However, we support the initiatives being undertaken by the RBNZ to enhance its regulatory capacity through improving its ability to detect emerging problems and react accordingly. These include using its powers under section 95 of the Reserve Bank Act to require banks to periodically undergo third party reviews of their financial and accounting systems, risk management systems, internal control and governance arrangements, and undertaking work on crisis preparedness.

- We do not consider that moving to a joint trans-Tasman regulator for prudential regulation and supervision is desirable at this time as the benefits are likely to be small and the costs potentially high. However, we consider that formalising through a joint trans-Tasman committee, the policy harmonisation, information sharing and

coordination work already being considered would ensure that the momentum towards greater integration is maintained where appropriate.

1 ASSESSMENT OF NEW ZEALAND'S FINANCIAL SYSTEM PERFORMANCE

1.1 The financial system and growth

1. A well-functioning financial system is central to a market economy. Financial intermediaries and markets are at the centre of the processes that provide the liquidity and mechanisms that allow firms and households to make payments. These processes also mobilise and allocate savings to investment, enabling long-term projects to be undertaken.

2. Well-functioning financial systems are important for economic growth because they facilitate the allocation of resources to best uses. They can also affect economic growth by increasing physical and human capital accumulation and technological innovation. Increased capital accumulation can have long-lasting effects on the rate of economic growth if it has spill-over effects to other factors of production or productivity. More generally, a robust financial system provides employment, tax revenue and other positive direct and indirect spin-offs to the economy.

3. The main categories of financial institutions that operate in New Zealand are registered banks, non-bank credit and deposit-taking institutions, managed funds (including superannuation schemes, collective investment schemes, unitised life insurance products and venture and private equity funds) and insurance companies. Banks are the dominant category, accounting for 74% of total assets held. This compares to 49% in Australia. The difference in composition partly reflects differences in policy, such as compulsory savings in Australia and some government-provided insurance in New Zealand.

Figure 1: Size of M3 institutions, corporate bond and stock markets & life insurance institutions

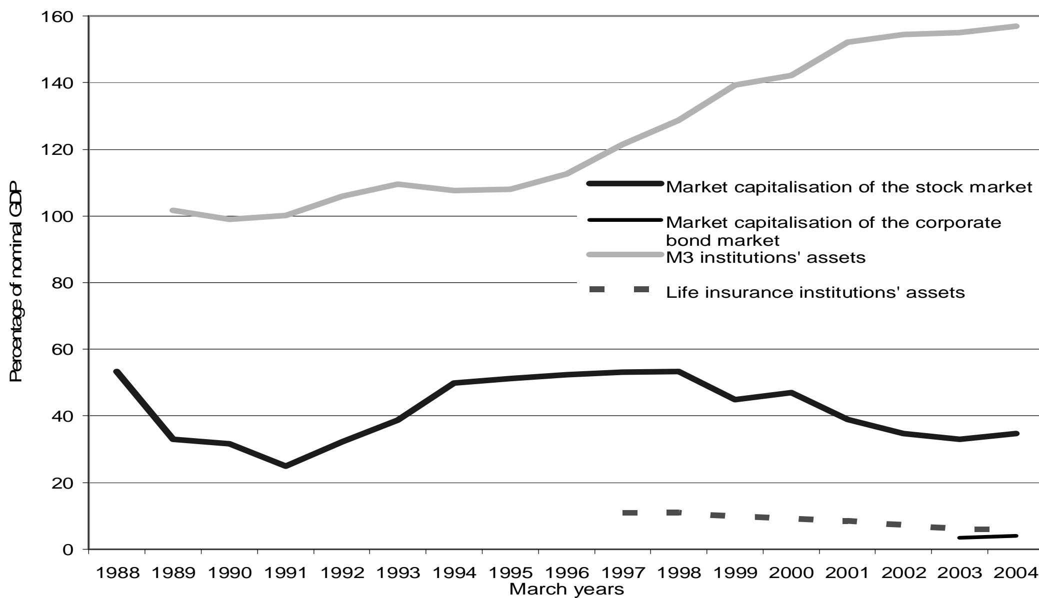

Table 1: Financial assets by institution type, year end 2002

	NZ[1] (percent of total)	**Australia**[2] (percent of total)
Banks	74%	49%
Managed Funds	16%	23%
Insurance	5%	13%
Finance Companies	3%	8%
Building Societies	1%	1%
Credit Unions	insignificant	1%
Other	1%	6%

4. New Zealand's banking sector includes 16 registered banks. In December 2003, the four major banks comprised around 85% of total banking sector assets. The banks are profitable and adequately capitalised, generating aggregate after tax profits equivalent to 2.2% of GDP in 2002.

5. The private insurance sector in New Zealand remains small relative to other countries.[3] Around 80 general insurers operate in New Zealand, with 20 of them accounting for 95% of total insurance written.[4] The sector has enjoyed stable growth of premiums of around 2.75% per annum over the past five years and remains profitable despite declining investment income. About 25 life insurers operate, with the five largest accounting for 80% of the market. However, the assets under management of the life insurance sector have been gradually falling over the past five years.

6. Although this review focuses on banking and insurance, other financial institutions are also important for providing competitive pressure, a second tier of financing for some firms and a greater choice of investment.

1.2 Government regulation of the financial sector

7. At the broadest level, government involvement in the financial sector is concerned with the smooth functioning of commerce. Much of the regulation is generic to all parts of the economy, such as ensuring that the legal system supports trade through establishing property rights (e.g., contract and commercial law), establishing legal and enforcement mechanisms and competition law. The government also has various social objectives for intervention in the financial sector. These issues are beyond the scope of this report.

8. In relation to the financial sector, consumers find it particularly costly to obtain and evaluate information on the risks of investing and to monitor firms. This situation can lead to consumers making poor choices and financial firms taking on larger risks than they would if consumers were able to monitor their operations. This can give rise to particular risks in the financial sector as problems at one institution can spread to other institutions or the economy at large. Failure of one institution may lead to a loss of confidence in the financial system and the large-scale withdrawal of funds from other financial institutions. Moreover, failures of large financial institutions, or several institutions, will have implications beyond the immediate set of investors affected e.g., if a disruption in the payments system resulted in firms and households being unable to transact. Some financial institutions are more

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[1] Financial Stability Report, RBNZ.
[2] Reserve Bank of Australia (RBA).
[3] Premiums per capita of NZ$1740, 28th in the world in 2001.
[4] The ownership of New Zealand insurers is outlined in Appendix Six.

vulnerable than others due to the nature of the business that they undertake e.g., banks must repay many deposits on demand, making them more susceptible to runs. All these outcomes can result in an inefficient allocation of capital, instability loss of confidence in the financial system and hence a high cost of funds for New Zealand firms.

9. While these features may provide a prima facie case for regulation, the costs of government intervention need to be born in mind. Regulatory rules are only beneficial to the economy as a whole when the benefits of the regulation outweigh the costs. Further, in making choices as to the best way to regulate, it is important to seek to use the least costly regulatory tools.

10. Regulation imposes direct administrative and compliance costs. If not designed appropriately, regulation leads to economic costs through the distortion of market signals. It can also stand in the way of competition and beneficial innovation, either directly by restricting activities or institutions, or indirectly by deterring participation in the market.

11. Perhaps the most significant area of risk for government in regulating the financial sector is that it may be seen as a de facto guarantor of institutions or for consumers, even when no explicit guarantees are offered. This can lead to a situation where investors inadequately monitor the institutions that they are involved with and financial institutions undertake riskier activities than they would otherwise.[5] However, inadequate regulation may expose the government to greater pressure to provide fiscal support in the event of the failure of a major financial institution. When a bank fails, the government will almost always have a role. Having resolution options available is therefore important for managing expectations.

12. Bearing these costs and benefits in mind, we consider that the government has a role to play in regulating the financial sector for both financial stability and consumer protection reasons. Moreover, in practice, these roles overlap. In regulating to promote financial stability, the government can help to minimise the large and widespread costs that can result from the financial system not functioning effectively. In regulating to ensure adequate consumer protection, the government helps to ensure that consumers can make choices that are in their best interests and adequately monitor firms into which they invest.

1.3 The performance of the financial system

Efficiency and the provision of financial services within the banking sector

13. The level of development, innovation and service delivery in New Zealand's banking sector is broadly similar to that of banking systems in Australia, Canada and the UK.[6] To a significant degree, the financial services offered incorporate the beneficial effects of technology and computing power. These have allowed a variety of new delivery mechanisms to be developed and improvements in the quality of customer services to be made. A number of indicators support this: high

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[5] This is no mere theoretical concept: the "double or quits" or "bet the bank" mentality was a key feature of the Savings and Loan crisis in the USA, which was the biggest government bailout in recent history.

[6] Work in this area was supported by a report commissioned from the NZIER (appendix eleven).

ATM usage by international standards; high EFTPOS usage; and rapid and deep penetration of internet banking. Although relatively high by international standards, customer satisfaction lags behind levels recorded for the US and UK but is higher than in Australia.

14. The nature of the services provided by banks appears to be conducive to competitive behaviour. This includes a relatively high level of product homogeneity, easy access to market information and relatively low implied switching costs. In addition, no significant barriers to entry in the New Zealand banking sector are currently present. The traditionally cited barriers – economies of scale, access to resources and/or networks, regulatory requirements and reputation – do not appear to be onerous. Moreover, considerable entry into, and exit out of, the sector since 1986 implies a degree of contestability.

15. A number of reasons can be put forward for why bank rates of return on capital have been sustained at high levels for a number of years in such an apparently competitive market. These include:

- the rents generated by early investment in innovative technology and systems. However, many in the industry believe these are coming to a natural end;
- tighter credit allocation processes leading to very low levels of impairment compared to other developed countries; and
- the savings accumulated by cost cutting over a number of years. Once again, some in the industry believe that this process has come to an end as natural minimum levels of staffing have been reached etc.

This implies that in the future the high rates of return are likely to be competed away unless new barriers to competition appear. These could result from changes in technology, industry behaviour and even regulation e.g., a policy that made it difficult for some foreign banks to enter the market.

Box 1: Foreign investment and hollowing out in New Zealand's banking sector[7]

The New Zealand banking system is often referred to as foreign owned. While this is true for most banking assets, issues relating to the customers, tax, laws and potential fiscal burden in the event of a bank failure are domestic issues. The ownership of the assets does not displace the rights, benefits and responsibilities that these issues entail for New Zealand.

Although New Zealand's banks and insurance companies have always been substantially foreign owned, foreign investment has played a greater role in the development of New Zealand's banking sector since deregulation in 1987. Around 98% of banking sector assets are now foreign owned relative to just over 60% prior to deregulation. Foreign ownership has, on the whole, provided benefits in terms of the cost and quality of services offered in New Zealand through the transfer of technology and expertise. Foreign ownership has also bolstered the creditworthiness of New Zealand's major financial institutions by providing them with strong and reputable owners.

[7] Work in this area was supported by a report commissioned from Burleigh Evatt on hollowing out (appendix ten).

However, a high degree of foreign ownership of banks also poses some unique challenges and can have implications for growth and economic development. Over recent years, a significant transfer of high-level and entrepreneurial decision-making to Australia has taken place as well as some outsourcing of processing functions. Relocation of decision making has been achieved through transfer of reporting lines, application in New Zealand of Australian business models, policies and performance metrics and requirements to align information technology architecture. Some centralisation of processing functions has also taken place. The scale of this transfer varies between banks, depending on their particular business strategies.

The economic impacts of this hollowing out are difficult to identify and measure. However, hollowing out does have the potential to affect the way in which credit is allocated in New Zealand. The setting of high-level business policy in Australia, and the resultant dilution of senior management in New Zealand, may result in banks' policies not being fully appropriate for New Zealand conditions. This could make decisions by banks less predictable, certain sectors of the economy may be inadequately serviced or policy may be inappropriate for the stage of the economic cycle e.g., if mortgage-lending standards are tightened in Australia due to house price concerns, such policies are more likely to flow onto the New Zealand economy, regardless of the state of New Zealand house prices. Another potential impact of relocating functionality to another country is the greater difficulty in protecting New Zealand's ability to tax bank profits derived from New Zealand operations.

Conversely, the centralisation of some functions may improve the quality of risk management policies due to greater expertise and the ability to take advantage of the diversification benefits from a larger economic unit. Centralisation also has natural limits, as customers will become dissatisfied if policies do not fit local conditions well. When that happens, banks' commercial priorities are likely to shift to protecting the customer base and market share. Some evidence of this taking place already exists. However, with limited senior management capacity in New Zealand, banks may take some time to fully respond.

Seamlessness of the trans-Tasman market

16. The high level of interdependency between the Australian and New Zealand financial systems has not necessarily translated into a purely seamless trans-Tasman market for the provision of banking services.[8] Information technology platforms in Australia and New Zealand have developed quite differently, credit histories are often not recognised, it is difficult to make same day cross-border payments and banking relationships are not always transferable. However, our consultations suggest that internal bank systems and a lack of sufficient demand by customers appear to be the key reasons for banks not offering a seamless service, rather than regulation.

17. A number of mechanisms exist to facilitate cost-effective cross-border transactions:

- credit cards can be used in either country;
- large corporations have access to foreign currency accounts, set-off arrangements and wholesale foreign exchange;

[8] Work in this area was supported by a report commissioned from Burleigh Evatt on barriers to a seamless market (appendix ten).

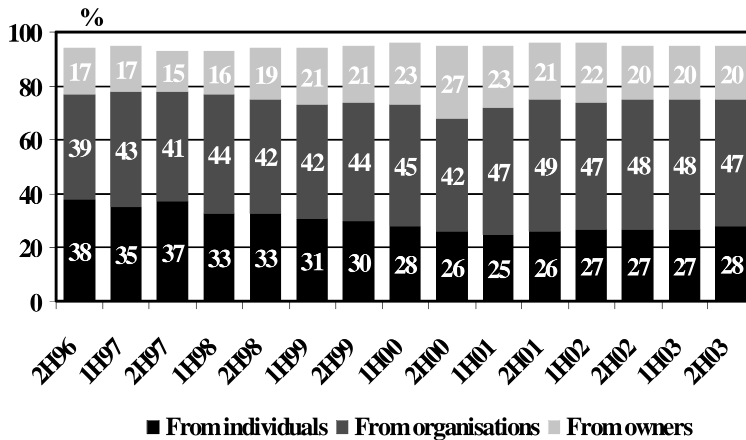
- for large corporations, there is some co-ordination of relationship management teams across the Tasman; and
- small and medium-sized enterprises trading with Australia have access to trade finance, foreign currency accounts and foreign currency risk management products.

18. In practice, there is little evidence that access to finance is a significant barrier to New Zealand firms wishing to expand in to the Australian market.[9] Moreover, only a small group of companies are likely to be potentially affected – namely those that wish to operate in, rather than trade with, both countries. Such companies are likely to face some of the same problems as companies wishing to operate across states in Australia as there are also regulatory differences between Australian states.

Stability

19. New Zealand's financial system is stable and functioning effectively, although potential vulnerabilities remain. This stability reflects a favourable macroeconomic environment, sound financial institutions, and well-functioning financial markets. This assessment was endorsed by the International Monetary Fund. However, the IMF also warned that New Zealand's reliance on foreign funding, typically intermediated through the banking system, had the potential to engender vulnerabilities. In the face of stress, the cost of this funding could increase sharply or the quantity could reduce to a level insufficient to support banks' balance sheets. In addition, some rating agencies have pointed to the dependence on wholesale funding as a potential source of risk, as such funding is considered to be more volatile than retail deposits.

Figure 2: Bank funding composition



20. New Zealand's financial system also faces some risks in common with those faced by other developed economies at present. One is increased household leverage that could potentially strain some households' finances if interest rates were to increase significantly or income growth was to slow markedly. Also, rapid corrections of global imbalances, e.g., the large US current account deficit, could be associated with sharp and destabilising adjustments to interest and exchange rates. More generally, episodes of financial instability have often had their origins in long economic expansions as these can lead to unsustainable optimism and

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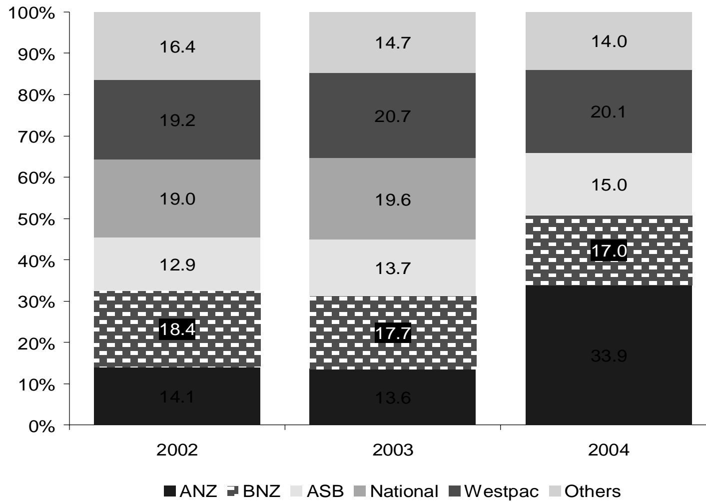
9 LECG, New Zealand - Australia Economic Interdependence, report prepared for MED, 2004.

downplaying of risk e.g., in the US securities markets at the time of the 1990s technology boom.

21. However, our current assessment is that the New Zealand banking system is financially robust, with banks holding well-diversified portfolios and being well hedged against exchange rate movements. Stress tests undertaken by the RBNZ indicate resilience, consistent with the sector's adequate level of capital and good profitability. Significant exchange rate swings and house price declines could be absorbed by all big banks. Dynamic stress test scenarios involving major shocks to agriculture and external funding costs suggest more persistent strains on bank profits, but do not raise serious financial stability concerns.

22. Nonetheless, a high degree and concentration of foreign ownership, and the resultant increase in concentration of New Zealand's banking system does pose some challenges. The four major banks are each systemically important in their own right. That is, they are now each of a size, and play such a central role in the New Zealand financial system, that closure in the event of failure would have significant adverse effects on the wider financial system and economy.

Figure 3: Bank market share[10]



23. At present, we do not see any single institution outside of the banking sector posing a similar systemic risk to the financial system and economy. The insurance sector is much smaller, less vulnerable to unexpected withdrawal of funds and does not intermediate payments. The risk of an insurance failure causing harm to the rest of the economy, outside of those directly exposed, is less likely in New Zealand than for a bank. However, the failure of a number of institutions in one particular sector could pose risks to the wider economy. Moreover, the failure of a single financial institution heavily exposed to a particular region or business sector could have quite significant consequences for that region or sector. Alternatively, systemic issues can arise because certain industries lose the ability to off lay risks to underwriters e.g., some specific sectors were affected by the failure of HIH Insurance Limited in Australia.

24. New Zealand's insurance sector has a high degree of foreign ownership, which could adversely impact on New Zealand policyholders if a foreign insurer failed. In addition, inter-linkages between financial institutions mean that an assessment of

10 In 2004, National Bank's assets are included in ANZ's total. CBA's assets include those of ASB.

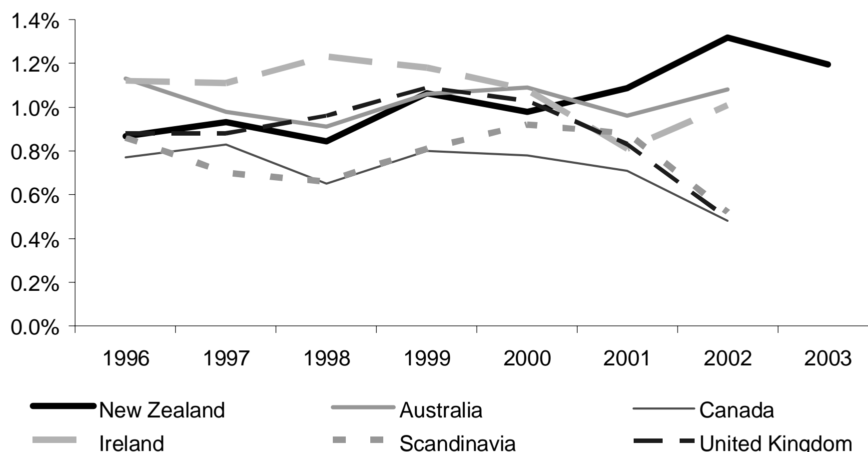
stability cannot consider different types of institutions purely in isolation e.g., some banks hold exposures to insurance and non-bank institutions, which could impact on the profitability of the banking institution. However, the RBNZ requires that locally incorporated banks separate the non-banking components of their business from their banking components by using a holding company structure.

Reputation

25. A financial system's reputation rests on two main attributes: its soundness and its efficiency. The reputation of the financial system impacts on the willingness of foreign and domestic investors to lend to the system, and will ultimately influence the prices and quantities at which New Zealand can access foreign and domestic savings.

26. New Zealand's banking system is perceived by external commentators as profitable, sound, efficient and well regulated. It generates attractive risk-adjusted returns and is adequately capitalised. The regulatory framework that applies to the system is largely compliant with international standards such as the Basel Concordat and the Basel Core Principles for Effective Banking Supervision. The credit ratings given to New Zealand banks are relatively high by international standards, although premised on a high level of ongoing capital support from their parent companies. Bank financial strength ratings, which exclude the impact of external support, are generally lower than their Australian counterparts. This reflects the less diversified portfolio of the New Zealand entity.[11] Credit rating agencies are not only interested in the likely parent commitment but also the regulatory environment that banks operate in. Recently, Moody's has indicated that it sees no immediate ratings pressure on the banks from the RBNZ's moves to enhance their crisis management capability.[12]

Figure 4: Comparison of banks' return on assets



Source: New Zealand Institute of Economic Research

27. The reputation of New Zealand's insurance industry benefits from strong foreign parents. However, its regulation is light handed, outdated in parts and inconsistent with international principles. Further, it does not recognise that many of the key insurance companies operate in a trans-Tasman environment. These regulatory

[11] See appendix five for New Zealand's bank financial strength ratings relative to other countries.
[12] Moody's Investors Service Ltd, Banking System Outlook: New Zealand, October 2004.

weaknesses have the potential to discourage consumers from purchasing investment-style life insurance products, although there is no evidence of this to date. These points notwithstanding, as reputational effects in the insurance industry are probably less significant than in the banking area, it seems unlikely that New Zealand's insurance regime is damaging the reputation of the financial system as a whole.

1.4 Key future trends most likely to affect the financial system

28. Banking in New Zealand has undergone a substantial transformation over the last 20 years. Notable developments have been the extent and sophistication of technological innovation, an increased focus on risk management, large-scale reduction of risks in the payment system, internal cost cutting, competition, price adjustments to reduce cross-subsidisation, and a number of mergers and takeovers. Some of these developments may well have run their course, but technological innovation and competition are likely to continue for the foreseeable future. In time, competition may lead to a reduction in the high levels of profitability currently enjoyed by the banks. The increased use of technology by banks has been a key enabler of more sophisticated risk management, but it also implies that the failure of technology has become a greater potential source of risk. Indeed, it may be that key technology providers will become systemically-important institutions in the future.

29. Structurally, New Zealand has not experienced the trend towards forming large financial conglomerates that cover banking, insurance and securities businesses to the same degree as other countries. This reduces the need for a specific supervisory framework for conglomerates. However, some pressure may emerge to develop a fuller framework for regulating such entities if the level of conglomeration in New Zealand increases over time.

30. For the time being, New Zealand's financial structure is influenced by the Australian restrictions on large bank ownership. Further significant concentration of the New Zealand market is unlikely unless the Australian authorities relax the "four-pillars" policy, and/or allow foreign takeovers of their large banks.[13] If this happens, the implications for competition and concentration in New Zealand could be very significant. This possibility reinforces the need to have a policy framework in place that can deal with systemically-important banks owned by countries other than Australia.

31. Demographic transition, the Government's savings initiatives and the likely changes to the taxation of investment income may increase the incentive to save and invest in New Zealand. While the impact on aggregate savings is uncertain, it may have implications for financial market development.

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[13] Under the Australian four-pillars policy (which is policy not legislation) none of the four largest Australian banks are able to merge. Even without this, the “big four” are unlikely to merge under Australian competition law. However, it may be that at some point in the future, competition considerations are set aside to ensure that Australian banks are able to obtain the critical mass needed to compete with global banks.

2 DOMESTIC POLICY IMPLICATIONS

2.1 Current arrangements

32. The three key regulators of the New Zealand financial sector are the Reserve Bank of New Zealand (RBNZ); the Ministry of Economic Development (MED), which includes the Registrar of Companies and the Insurance and Superannuation Unit; and the Securities Commission. These regulators, along with others in the financial sector, regularly meet to discuss relevant developments and issues.[14] The Commerce Commission is responsible for competition and fair trading issues, which are not discussed here.

33. The RBNZ has the statutory responsibility of supervising registered banks. It does this for the purposes of maintaining the soundness and efficiency of the financial system, and avoiding significant damage to the financial system that could be caused by the failure of a registered bank. It has a wider role in relation to providing liquidity and being the lender of last resort (LoLR) to the financial system. It also has an operational and oversight role in the payments system. The RBNZ does not supervise bank-affiliated insurance business but, as already discussed, does impose restrictions on the banks' exposure to that business.

34. The RBNZ has some discretion in determining how it carries out its role. It focuses on the financial health of the banks. Compared with international norms, New Zealand has traditionally placed comparatively more emphasis on market and self discipline through disclosure and director responsibility and has placed less emphasis on detailed prudential supervision. However, other countries are now placing more emphasis on disclosure and governance and the RBNZ is working to enhance its supervisory capacity and crisis management preparedness.

35. Regulation undertaken by MED has more of an explicit consumer-protection focus than that undertaken by the RBNZ. MED is responsible for insurance policy. The insurance sector is considerably less regulated than the banking sector[15] and focuses on disclosure instead of the intensive prudential supervision that many other countries have. General insurers must inform consumers of their rating, lodge a deposit and comply with reporting requirements. Life insurers are governed by the Life Insurance Act 1908. It provides for financial reporting and deposits but not ratings. MED reviews the financial statements for both general and life insurers, but there is no prudential supervision by a government agency and no obligation to comply with the usual capital adequacy requirements applied internationally.

36. MED is also responsible for policy relating to other financial institutions with the Securities Commission carrying out regulatory functions in the securities law area and the business services branch of MED undertaking a range of regulatory functions in relation to financial institutions. The Securities Act provides for disclosure on a product basis and this forms the basis of regulation for managed funds, superannuation funds and finance companies. Building societies and credit unions that offer securities are also subject to the Securities Act, but some

[14] The powers of each regulator are outlined in appendix one.

[15] For details of the supervisory arrangements by financial institution type, see appendix two.

institution-specific legislation also governs their operation. Banks are only required to provide an investment statement and not a prospectus as the main disclosure requirements for banks are provided by the Reserve Bank Act. In insurance, only those products that have an investment element are covered by the Securities Act.

37. In addition to the regulatory roles performed by the Securities Commission and MED, persons who offer debt securities or securities via collective investment schemes are supervised by trustee companies and statutory supervisors. They ensure that the terms of the trust deed or offer of securities have not been breached. In case of a breach, trustee companies and statutory supervisors can seek a range of remedies from the Court.

2.2 How regulation should be undertaken

38. In practice, the regulatory objectives of promoting financial stability and ensuring adequate consumer protection overlap to a considerable degree. Both are aimed at improving economic efficiency through providing appropriate certainty and protection to financial sector participants and dealing effectively with market failures or externalities. By reducing the likelihood of an institutional failure, regulation primarily aimed at promoting financial stability also offers some protection to the consumers of financial products. Similarly, if regulation assists consumers in making more informed decisions, then fundamentally weak and/or non-viable institutions are less likely to survive, enhancing the longer-term stability of the financial system.

Financial Stability

39. Financial stability is important for the development of the financial system and the rest of the economy. The government has a role in promoting financial stability in order to minimise the risk and cost of widespread financial disruption. Financial instability can occur as a result of:

- solvent institutions experiencing liquidity problems;
- the failure of one institution spilling over to others or affecting the payments system;
- the failure of a parent institution spilling over to its subsidiary or branch;
- the failure of one institution spilling over to the economy at large;
- the simultaneous failure of a number of institutions due to adverse economic conditions or their own imprudence; or
- the failure of the payments system.

40. Efficiency considerations must be borne in mind in promoting financial stability. At one extreme, the government could regulate such that no financial institution ever failed. From an efficiency perspective, this approach is difficult to justify as the occasional failure of smaller institutions is unlikely to do much damage to the wider financial system and/or economy. Moreover, it could place major constraints on some institutions, create significant moral hazard problems and ultimately stymie growth. At the other extreme, regulators could focus simply on designing the interconnections between institutions (e.g., payments and settlements systems) and the tools and processes for managing problems in institutions in such a way that they reduce the risk of problems being transmitted between institutions. However, this does not address the issue of investors having insufficient

information to adequately monitor institutions.

41. In terms of financial stability, we consider that the appropriate balance is achieved by focussing the most intensive regulation on ensuring the soundness of institutions for which financial problems or failure would result in large costs to other parts of the financial system or wider economy, whilst also pursuing risk reduction in payment and settlement systems and maintaining a broad overview of the financial system. As already discussed, banks are the only financial institutions that could individually pose a major threat to financial stability in New Zealand. This supports the concept of regulating banks more intensively than other financial institutions, as is currently the case in New Zealand. However, it is important that the regulatory system is also capable of detecting, monitoring and acting on potential risks that could emerge from outside of the banking sector.

Consumer protection

42. Consumer-protection regulation is concerned with assisting consumers in making informed decisions and having the ability to monitor institutions into which they invest. Where information or expertise inadequacies cannot be overcome or consumers have little bargaining power, government can provide regulation or a suitable supervisory body to act on their behalf. This may be appropriate in situations where the creditworthiness of the institution offering the product is difficult or costly to assess, and/or when the consequences of default for consumers are very significant. Consumer-protection regulation thus requires both a provider and product focus.

43. As with financial stability, the benefits of consumer-protection regulation need to be balanced against the costs. Costs include compliance, moral hazard risks and the crowding out of market mechanisms that could develop to deal with these issues e.g., reputational effects, credit ratings, standardised contracts, industry self-regulation and self reporting. Further, an appropriate balance needs to be struck between regulation and financial education. Financial education can make consumers more aware of the risks they face, help them to manage these risks and equip them with the knowledge required to appropriately choose and monitor the institutions and products in which they invest. There are nonetheless limits to the ability of consumers to protect themselves, particularly when they are party to a long-term contract from which it is costly to withdraw or where a product is so complex that education cannot reduce information asymmetries.

44. Consumer protection is a key objective of regulation for the institutions that dominate New Zealand's non-bank financial sector. Sound regulation in the non-bank financial sector is important for facilitating the development of a domestic financial industry. In particular, the financial system and the legal and regulatory frameworks that support it must be sufficiently well developed for niche financial service providers to emerge and fill any gaps left by the larger financial institutions or financial markets e.g., in the event of a hollowing out of the banking sector. Such providers also have an important role to play in exposing New Zealand's dominant banking sector to effective competition.

45. Some concerns regarding regulation in the non-bank financial sector have been raised and MED is initiating a number of reviews to determine whether regulation

in this sector is adequate – some of which are already being carried out.[16] This will include assessing the quality of information available to regulators and whether greater prudential regulation (i.e., greater focus on risk management practices) may be required to complement the existing disclosure-based regime. This assessment requires balancing the need for public confidence in these institutions, without generating perceptions of an implicit guarantee. It also requires ensuring that regulation does not constrain the business they can undertake to such an extent that their development is impaired.

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48. Officials will also seek to ensure that a consistent consumer protection approach is adopted across financial markets. As part of this, officials will need to assess the adequacy of small depositor protection, including for banks. The wholesale market accounts for a larger proportion of the funding of New Zealand's financial system than small depositors and has an information advantage over small depositors. As such, it can run first if problem develops, leaving small depositors unambiguously worse off. In addition, in the absence of restrictions on organisational form, the interests of New Zealand depositors in trans-Tasman banks would be subordinated by the Australian depositor preference arrangement.[17]

49. Given that the regulation of the non-bank financial sector is being reviewed at present, the regulatory tools applying to the sector are not further discussed in this report.

2.3 Domestic institutional arrangements

50. The role of maintaining an overview of financial stability rests with the central bank in most countries including Australia and the UK. In New Zealand, the RBNZ's central statutory role is to regulate and supervise banks, with a view to promoting the soundness and efficiency of the financial system. It has a number of functions and powers with which to achieve this, and undertakes activities that are broadly understood to be for financial stability purposes e.g., designation of payment systems, LoLR. However, no widely accepted understanding of what financial stability means in practice exists and there are few international precedents to follow.[18] Treasury intends looking into this issue during 2005, undertaking some initial analysis of whether responsibility for financial system stability needs to be clarified and more explicit accountability assigned.

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[16] These reviews are outlined in appendix four.

[17] Australian depositor preference means that Australian depositors have a priority claim on the assets of the Australian bank in a winding up.

[18] Oosterloo, S. and de Haan , J., Central Banks and Financial Stability: A Survey, Journal of Financial Stability 1 (2004).

51. In recent years, many countries have spilt the role of promoting overall financial stability and the prudential supervision of individual banks and grouped the prudential regulation of all financial institutions under one umbrella organisation e.g., Australia, has combined its prudential supervision of financial institutions together under APRA and its company, consumer protection and markets' regulator under the Australian Securities and Investments Commission (ASIC). The RBA maintains responsibility for financial stability, liquidity provision and regulation of the payment system via the Payment System Board. The UK has consolidated all financial sector regulation in a single agency (mega regulator), while leaving the Bank of England with a number of financial stability responsibility. The Irish have consolidated wider prudential supervision in the central bank. The "mega-regulator" approach followed by the UK has been adopted by around 20 countries to date. The model in which the central bank is responsible for both financial stability and regulating banks is more common worldwide than the mega-regulator, Australian or Irish approach.

52. The key reason given by countries for re-grouping financial sector regulation has been to improve the economies of scale and scope in regulation, in particular to deal with financial conglomerates and financial institutions offering similar financial products. Such re-grouping also helps to reduce potential information exchange problems between the regulators. Splitting the financial stability and regulatory roles of the central bank is seen as allowing the regulator to pursue other goals, such as investor protection, and to monitor institutions that are not a risk to financial stability. However, it is unclear how effective this split will be in the longer term given the links between financial stability and prudential supervision.

53. The desirability of a more consolidated approach to prudential supervision rests in part on the structure of the financial system and policy objectives. Different financial institutions – credit unions, finance companies, banks, insurance companies etc – are currently regulated in quite different ways in New Zealand. This implies that the scale economies from a more consolidated approach are likely to be small. Moreover, insurance companies and other non-bank financial institutions are not systemically important in the same way that large banks are in New Zealand. In light of this, and given the current effective coordination between the New Zealand regulators and the regulatory and administrative costs of integration, we do not appear to face any compelling reasons to adopt a more consolidated model for prudential regulation at present or to regulate banking and insurance under the same umbrella.

54. However, this could change if the structure of the economy or policy objectives changes. If the reviews of the non-bank financial sector that will be undertaken by the MED result in recommendations for more prudential regulation or more comprehensive supervision, a reconsideration of whether the domestic institutions that regulate the financial sector should be consolidated or regrouped will be required. While MED will lead these reviews, it will consult closely with the Reserve Bank and Treasury.

55. A possible concern with the current model is that it may not adequately detect the emergence of potential systemic risks outside of the banking system. These risks may emerge due to rapid growth in a particular sector, adverse market conditions exacerbating problems in a particular sector or difficulties relating to a set of

institutions that, in aggregate, could pose risks to the rest of the financial system.

56. In the absence of a single regulator, effective coordination of financial sector regulation is important to ensure that all institutions are adequately and appropriately regulated and supervised and that the roles of each regulator are clear. Effective coordination in New Zealand is facilitated by the geographical proximity of the financial regulators, the establishment of the Financial Regulators' Coordination Group that meets informally once per quarter to share information and the implementation of memorandum of understandings between some of the regulators. The IMF found in its Financial Sector Assessment Programme (FSAP) that "*overall, the main government regulatory agencies, MED, Securities Commission and the RBNZ, seem well coordinated and maintain close contacts that enable them to monitor issues relating to cross linkages between NBFIs and banks*".

57. We consider that it is important to ensure that these systems remain sufficiently flexible to deal with any risks to financial stability that may emerge in the future. We see a role for the RBNZ, in conjunction with other regulators where appropriate, in assessing which financial institutions could pose risks to the financial system and having powers and/or responsibilities in such a case. The RBNZ has begun publishing a *Financial Stability Report*, which assesses the health of the wider financial system. In our view, this report should continue to be produced on a regular basis. We also consider that it may be useful for MED and the Securities Commission to regularly meet with the RBNZ and be invited to contribute to this report.

2.4 TOOLS FOR REGULATING THE BANKING SECTOR[19]

58. A number of techniques can be used to regulate and/or supervise banks. Most countries, including New Zealand, use all of them, but there are considerable variations in the balance and intensity of use of different tools. In order to determine the most appropriate balance, we need to consider to what extent market failure can be reduced through policies that encourage market or self discipline and to what extent additional regulatory requirements and monitoring is needed (regulatory discipline). However, all registered banks are required to maintain and publish a credit rating, which assists in providing market discipline and an independent view of each bank's creditworthiness.

59. The key sources of market discipline in New Zealand are the wholesale market, shareholders and small depositors. The wholesale market provides most of the market discipline, partly because it comprises the bulk of the total funding of the banking sector. It is also in a better position than small depositors to evaluate the solvency of banks and exert discipline but, as a result, is also likely to be inherently more volatile than deposit funding. Small depositors are unlikely themselves to have a large amount of information on the bank or sufficient time, resources or expertise to provide effective monitoring.

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[19] The Law Commission's report on life insurance is under consideration by MED, and some changes to the way in which both life and general insurers are regulated is expected. We therefore considered it premature to assess within this review the best tools for regulating the insurance sector or how the current regulation stacks up. As a result, this section and the next focuses on banking sector regulation.

60. Another way to ensure that banks manage their risks appropriately is self discipline through good corporate governance. Within New Zealand, this is generally achieved through director attestations, ensuring sufficient shareholder interest in New Zealand institutions, requirements relating to board compositions and a requirement that directors act in the interests of their company. Our consultations with senior banking representatives have confirmed that these measures have improved risk management in banks. However, self discipline is likely to be less effective as problems within an institution start to emerge.

61. Although an approach that focuses on market discipline when banks are healthy may be appropriate, increasing regulatory intervention is appropriate as risks emerge. Such an approach allows supervisors to target resources at problem areas and minimise the costs of regulation, as regulatory tools impose higher economic and compliance costs than other forms of discipline.

2.5 How current regulation stacks up

62. The RBNZ has a reputation for applying only limited supervisory intervention. This reflects the rhetoric that has accompanied the New Zealand economic reforms over the last two decades, but has also raised concerns among some commentators that the current RBNZ model may be inadequate in a crisis situation. In practice, the approach of the RBNZ does indeed place less reliance on regulatory and supervisory mechanisms (regulatory discipline) than on disclosure and corporate governance (leveraging of market and self discipline). However, it is significant that:

- the *powers* of the RBNZ are closer to international norms than its *practices* i.e., while the RBNZ's emphasis is on market and self-discipline, it has significant regulatory powers available to it that it does apply; and
- internationally, while the practices of the RBNZ put it towards the low intervention end of the continuum, the practice of the RBNZ is moving some way towards a more conventional approach e.g., the RBNZ is investing in enhancing its crisis management capability. Nonetheless, it remains committed to being a low-cost regulator, with an explicit focus on efficiency. As such, the degree of regulatory intervention remains, and is likely to remain, relatively limited.

63. Overall, in our assessment, the current banking supervision regime appears to be effective and efficient in meeting its statutory requirements. There are work programmes underway at the RBNZ to enhance and update its supervisory practice that will improve the effectiveness of regulation further.[20] The following section assesses the main tools for regulation in New Zealand's banking sector. Section three takes into account issues that arise due to the high level of foreign ownership in New Zealand's banking sector. In coming to the conclusion that regulation is effective and efficient, both this section and the following one on trans-Tasman arrangements have regard to whether regulation:

- fosters an appropriate level of competition, innovation and neutrality across the financial system;

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[20] Appendix three contains a summary of the IMF's FSAP recommendations and actions being taken in response.

- does not impede the development of a seamless trans-Tasman market for the provision of financial services;
- provides the right incentives for institutions to act prudently of their own accord;
- allows economies of scale and scope to be captured;
- minimises the regulatory costs on banks and insurance companies (compliance and operational);
- provides an appropriate degree of protection for depositors, investors, and consumers of financial services;
- is consistent with and supportive of tax policy as it applies to banks and insurance companies;
- ensures adequate legal and operational capacity to manage a financial crisis; and
- supports New Zealand's international financial reputation.

Entry standards

64. In New Zealand, the registration of a bank can only occur if a number of statutory criteria are met. All bank applicants are required to meet a range of substantive qualitative hurdles relating to risk management, quality of directors and senior management, governance and parent oversight (where applicable). These requirements provide some assurance that only high-quality entities will be registered as banks. While the minimum capital requirement of $15m is relatively small by international standards (in Australia the requirement is $A50m), it reflects a balance between requiring prospective bank owners to demonstrate commitment and maintaining a reasonable entry threat to support competition.

65. The effect of bank registration is to bring the institutions under the prudential framework of the RBNZ. That is, in order to be called a bank, an institution must be registered. However, it is possible that a systemically-important bank-like institution could emerge that does not fall under the RBNZ's jurisdiction. It will be important to monitor this area to ensure that the RBNZ has appropriate powers available to it in anticipation of such an institution emerging rather than in reaction to such an event.

Prudential standards

66. Prudential standards are the rules that are applied to regulate institutions to limit their risk taking, with the aim of reducing the probability that they will fail. These rules generally include quantitative limits that are imposed on various types of risk. The requirement for registered banks to hold adequate capital in relation to the risks they face provides a buffer should losses occur and reinforces the incentive for the parent to manage and monitor the risk taken by the New Zealand bank. The RBNZ applies relatively fewer prudential limits on banks than other international regulators, and its regulations interact well with more prescriptive home-country regulations. No evidence suggests that this has resulted in a higher-risk banking industry.

Disclosure standards

67. The disclosure regime is based on comprehensive quarterly disclosures by registered banks of their financial condition and risks. It is one of the principal vehicles through which market and self discipline operate, particularly in the absence of New Zealand banks having publicly listed shares and hence generally

not being subject to separate equity market disclosure requirements. It is also relied on heavily (but by no means exclusively) by the RBNZ for monitoring banks.

68. New Zealand's disclosure regime is by international standards quite comprehensive and timely. Moreover, a number of parties make use of the disclosure statement in assessing banks including other banks, rating agencies and some investment advisers and financial analysts. The RBNZ also monitors banks and the broader financial system via a number of other means. These include financial market intelligence, banks' liquidity and settlement positions, spreads on bank funding and analysis of a wide range of macro financial data. These additional sources of information help to ensure that the RBNZ is better informed about banks' activities and potential risks.

69. The IMF concluded that it would be appropriate to review the contents of disclosure statements and supplement them with focused prudential information directly for the supervisor.[21] They considered current statements to be insufficiently timely and comprehensive to be used effectively by wholesale parties for assessing creditworthiness or for some supervisory judgements. A number of areas where additional information could be beneficial were identified including liquidity exposures, market risks, credit risks and large exposures.

70. The RBNZ has already made some amendments to the disclosure regime and these will take effect from early 2005. These will facilitate the early adoption of international accounting standards, modify the large exposure and connected exposure requirements and make some additional tidy-up changes. Further changes are planned for 2006, following a proposed broad-ranging review taking into account relevant domestic and international developments and also Basel II disclosure requirements. The proposed review will likely include an assessment of user perspectives on the disclosure regime, the adequacy of the range and quality of information being disclosed, compliance costs, the frequency and timeliness of disclosure, and issues of possible trans-Tasman harmonisation.

71. Significant differences exist between the Australian and New Zealand public disclosure requirements for banks. While the major Australian banks are listed companies and hence have an obligation to disclose any information that could have a material effect on the bank's share price in real time, they are not subject to as detailed prudential and financial reporting requirements as prescribed by the RBNZ. As part of work to align disclosure with Basel II and the new accounting standards, the RBNZ will need to work closely with APRA to ensure unnecessary inconsistencies are avoided. The RBNZ has already seconded a senior staff member to APRA to work with the Australian authorities on the policy development of Basel II.

Governance standards

72. A cornerstone of New Zealand's approach to bank supervision is that the primary responsibility for managing a bank, and the risks that it faces, should lie with the local board, and management of the bank itself. Banks and their directors have significant duties under general law in this respect. The RBNZ has built on this platform in a number of ways, including a requirement for bank directors to attest

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[21] FSAP summary report, paragraphs 24 and 47.

to the accuracy of the disclosure statements and that their bank's risk management systems are adequate and are being properly applied.

73. Anecdotal evidence suggests that director attestations have a positive effect on risk management and board engagement in banks. However, for a range of reasons, the attestations should not be solely relied upon for assurance that banks are managing risks appropriately. In the absence of relevant test cases, how director attestations sit within the context of relevant company law and their enforceability against directors is uncertain.

74. Other policies might be desirable as mechanisms to reinforce director attestations in promoting sound risk management practices. In the view of the IMF, two areas warrant particular attention – credit policies and market risks. The IMF indicated that selective use by the RBNZ of on-site examinations or independent reviews would strengthen risk management practices in banks and better equip the RBNZ to understand, assess and respond to banks' risk management capacity. The RBNZ is planning to use its powers under section 95 of the Reserve Bank Act[22] to require banks to undergo periodic third-party reviews of aspects of their financial and accounting systems, risk management systems, internal control or governance arrangements. The framework for these reviews is being developed and will be implemented in 2005.

75. In addition, the RBNZ is reviewing governance arrangements for banks, including the role of bank boards and independent directors. A discussion paper is planned for 2005 that may consider possible options for further enhancing bank self discipline. It will focus on the role of bank boards (especially boards of wholly-own bank subsidiaries), independent directors, board oversight of risk management and audit and governance structures within banks.

Compliance, monitoring and enforcement powers.

76. If the information readily available to the RBNZ indicates risks may be emerging, the RBNZ has a die range of information gathering and enforcement powers available. It may require banks to provide additional information, require information be externally audited, appoint an investigator to review specified aspects of a bank's operations and, ultimately, employ crisis management procedures.

3 Regulatory Control in a Trans-Tasman Context

77. Due to greater globalisation of financial markets, the cross-border provision of financial services is increasing worldwide. As a result, regional blocs, such as the European Union and Scandinavia, are pursuing more integrated prudential regulatory regimes, particularly with respect to banking. Given the high degree of integration that already exists between the Australian and New Zealand banking sectors at a commercial level, considering possible ways forward for closer integration of trans-Tasman prudential regulation is warranted. This section examines various options from more coordination and cooperation through to a joint regulator with the powers to act and enforce rules in both countries.

[22] This section allows the RBNZ to require a registered bank to supply a report on the financial and accounting systems and controls of the registered bank.

3.1 Overview of current trans-Tasman relationship for banking and insurance regulation

Banks

78. The home/host model for supervising cross-border banks was first established in the 1975 Basel Concordat and has been subsequently revised and extended using the same basic principles. The Concordat assumes that effective cooperation between host and home authorities is a central prerequisite for the supervision of banks' international operations and develops two principles: (i) no foreign bank should escape supervision; and (ii) supervision should be adequate.

79. Current regulatory arrangements governing trans-Tasman banks are consistent with the Basel Concordat. The home supervisor is responsible for supervising the activities of the global banking group. In practice, this means that APRA's prudential standards apply on a consolidated basis and thus can be incorporated as part of group policies into the systems of Australian banks in New Zealand. In addition, APRA occasionally undertakes on-site supervision in New Zealand.

80. The RBNZ has a general responsibility to supervise the operations of the foreign bank domiciled in its jurisdiction as well as the banks for which it is the home regulator. However, the degree of control the RBNZ has depends on whether the bank is a subsidiary or a branch. Control is multi-faceted and includes legal, operational and technical dimensions. In a crisis, the RBNZ can act more independently if the entity is a subsidiary, as the bank's operations could be more easily separated from the parent and the bank has a separate legal personality in New Zealand.

81. While there are clear similarities between the basic supervisory frameworks in Australia and New Zealand, some material differences in the current objectives, style, substance, and detail of banking regulation in the two countries exist. With regard to objectives, the key goal in New Zealand is systemic stability, whereas in Australia APRA's primary duty under the Banking Act is to protect depositors. Moreover, in liquidation, the Australian Banking Act provides that the assets of a bank in Australia will be used to meet its deposit liabilities in Australia in priority to all other claims. With regard to style, substance and detail, APRA's approach is generally regarded as considerably more detailed, prescriptive, intrusive and "hands-on" than New Zealand's.

Insurance

82. Trans-Tasman insurers must comply with both Australian and New Zealand supervisory requirements. However, New Zealand's approach to insurance focuses on disclosure rather than intensive prudential supervision, as in Australia. Although trans-Tasman insurers must comply with two sets of regulation, New Zealand's requirements are not onerous. Insurers have to lodge two sets of financial statements.

83. New Zealand policy holders benefit from indirect prudential supervision by APRA of Australian-based insurance companies operating in New Zealand, but their interests may not always be fully protected. The Australian requirements should

mean that a company APRA allows to operate will be financially sound and that there will be early warning of any financial difficulties. However, it is conceivable that New Zealand policyholders may have lower priority and access to assets in an insolvency situation. Moreover, regulators' actions may, at times, conflict when both countries are acting in their own best interests.

84. The recent removal of some of the New Zealand assets of Tower to Australia illustrates that where one country has prudential supervision and another has not, the country with prudential supervision will have the stronger hand in controlling the flow of assets between the two countries. It also highlights the need for closer communication between APRA and New Zealand regulators: . **[Information withheld under section 6 of the OIA 1982 – prejudice New Zealand's international relations]** Although the MED cooperates with overseas regulators, particularly APRA when appropriate, there is considerable scope to expand this cooperation and the exchange of information.

3.3 The options for greater regulatory integration

85. Closer integration can be achieved in a number of ways, from better coordination through to a single regulator model. How far we move down the route of integration will ultimately depend on how we can secure the potential benefits of integration at least cost. The options discussed in this paper are not mutually exclusive and can be considered as steps along a spectrum. They are:

    (A) the enhanced home/host model;
    (B) the enhanced home/host model plus a joint committee structure to formalise policy harmonisation, information sharing and crisis management coordination; and
    (C) a joint regulator for prudential regulation, supervision and crisis management.

86. The joint regulator model considered in this report is not the APRA-as-supervisor model proposed by Australian officials during 2004. The APRA-as-supervisor model involved APRA supervising all systemically-important trans-Tasman banks. While the joint model discussed in this report is also a single regulator model, it applies to all banks (and could be extended to other financial institutions) and is premised on an equal say for New Zealand over issues relating to New Zealand banks. If this premise does not hold, then the model is effectively an APRA-as-supervisor model.

87. This section outlines the three models for closer regulatory integration proposed in this report. The following section provides a framework for assessing the costs and benefits of these forms of integration.

(A) Enhanced home-host supervision

88. On 25 August 2004, Cabinet Policy Committee requested the RBNZ to develop an enhanced home/host model for banking in conjunction with APRA. The RBNZ is working at implementing this model, and has approached APRA outlining the key issues it would like to progress.[23] The main features of this model are:

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[23] This letter is attached in appendix seven

- greater sharing of supervisory information, including coordination with APRA regarding third-party reviews of risks and systems;
- coordinating regulatory requirements where possible to reduce compliance costs on trans-Tasman banks; and
- better preparedness for bank crises including clarification of roles, responsibilities, powers and arrangements regarding crisis management and consideration of cross-border issues related to the lender of last resort function.

89. With respect to insurance, the Law Commission has just tabled its report on a Review of Life Insurance Act 1908 in parliament. The Minister of Commerce now has until the end of May to review and report back to Parliament on the report and, within this context, will need to consider the development of an enhanced home/host model for the regulation of insurance. This should include careful consideration of the model adopted for banking and whether similar arrangements would work for insurance. **[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]**

(B) Joint committee structure

90. Option B extends option A to include the establishment of a trans-Tasman coordination committee as a forum through which trans-Tasman coordination could be advanced. The committee could comprise senior officials from APRA, RBNZ and RBA. Where any of the issues considered by the committee 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 be operationally focussed, share information about developments in supervision and regulation and may work together on policy development where appropriate. It could also coordinate responses to financial crises involving banks that are common to both countries and systemic shocks that affect both countries. Sub groups of lower level officials would be assigned specific tasks to help the committee in reaching views on particular matters.

91. The Committee would meet on a regular basis to build familiarity and a genuine dialogue between key institutions. It could also convene periodically to review trans-Tasman crisis response preparedness and the state of the two countries' financial systems. In addition, the committee would be called together at an early stage in the development or imminent development of a financial crisis affecting both countries.

92. This 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. It would also be structured in a way that recognised that bank ownership – and hence home-country supervision – can change, and thus avoid locking in arrangements that might later prove to be unworkable or inappropriate. Key issues that would need to be resolved include whether there should be a requirement for the committee to report to relevant Australian and New Zealand Ministers or domestic financial regulator groups about their work programmes and how the MoU, required to set up the committee, could be made most effective.

(C) The joint regulator model

93. The final model considered is a joint regulator model. The basic concept is a single authority responsible for regulation, supervision and crisis management. Whereas in option B, Australian and New Zealand would opt in to working together where appropriate, under a joint regulator each country would be bound to do so. As such, this model raises issues that extend beyond the framework governing financial sector regulation e.g., legal, fiscal and governance considerations.

94. In order for a joint body to be a workable institution there would need to be:

- agreement between the governments on the appropriate objectives of regulation and regulatory approach e.g., whether the principal goal is systemic stability or consumer protection, the appropriate coverage of regulation and the appropriate supervisory approach. This is required so that the agent is subject to the correct incentives and can be held accountable;
- agency independence regarding regulation, supervision, enforcement and crisis management in order to manage any potential conflicts between national interests;
- agreement between governments as to appropriate governance arrangements and level of their involvement; and
- agreement between governments on rules and protocols regarding government decision rights in crisis management and mechanisms to resolve potential conflicts of interest.

95. In practical terms, this means that New Zealand's minimum requirements of a joint banking regulator would be:

- the same regulatory scope in Australia and New Zealand;
- a ministerial council to coordinate the policy and regulatory framework;
- equal voice for Australia and New Zealand on the Council;
- a high level of operational independence;
- an agreement that crisis management options are developed that minimise the need for fiscal support;
- maintenance of separate lender of last resort functionality;
- clarity on tax sharing;
- exemption of smaller retail banks from Australian local incorporation requirements (or a change to those requirements);
- exemption for some smaller non-bank financial institutions; and
- removal of Australian depositor preference.

These minimum requirements are explained in more detail below. If these requirements could not be secured and maintained, it is unlikely that the regulator would be a genuinely joint institution.

Alignment of policy objectives and regulatory approach

96. Agreement would need to be reached on the joint regulator's objectives. Ultimately, this is likely to mean a more explicit focus for New Zealand on consumer protection and, as a result, a change in the way in which supervision is undertaken. Under this model, one institution would undertake supervision in both countries. Some increase in the overall level of supervision for Australian-owned

banks is likely, but non-Australian banks operating in New Zealand would be subject to considerably more supervision than is presently the case e.g., Kiwibank.

97. Australian depositor preference would need to be removed as it would subordinate New Zealand depositors and the wholesale market generally in a winding up situation. Australia has indicated a willingness to extend depositor preference to New Zealand but not to remove it. Such an extension would be insufficient to fully address New Zealand's concerns as the wholesale market would still be subordinate and, consequently, may be unwilling to lend in a crisis situation or only do so at prohibitive rates.

98. The regulatory scope of a joint regulator would ideally need to be the same in both Australia and New Zealand. The RBNZ supervises banks only, whereas APRA oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies and most members of the superannuation industry.

Operational independence, governance and accountability

99. A joint regulator would need to have a governance structure that allows each country's interests to be taken into account in the formulation and development of prudential policy. This may be more challenging than for other trans-Tasman institutions. Other joint agencies (e.g., the proposed Joint Therapeutics Goods Agency and Food Standards Australia New Zealand) developed have been predicated on:

- a greater alignment of national interests and similar policy approaches;
- the policy issues being judgements of a more scientific/technical nature, which facilitated less ministerial control and more operational independence; and
- large administrative or capability benefits due to a lack of resources in New Zealand to adequately regulate the sector.

100. To ensure that both countries maintain a voice in banking regulation and supervision, separate institutional arrangements would need to be established, such as a Ministerial Council and policy secretariat, to coordinate the policy and regulatory framework in which the agency would operate. The Ministerial Council would have oversight and accountability for the high-level policy framework. It would comprise Ministers from each country, briefed by the relevant government agencies in each country. It would be important for New Zealand to have equal voice on the Council for New Zealand specific issues, or a right of veto.

101. A joint regulator would require a high level of operational independence to effectively manage any potential conflicts of national interest. At present, APRA can be subject to greater Ministerial direction in relation to its day-to-day operations and in relation to the policies it pursues than the RBNZ. Moreover, ministerial controls have been increased as a result of the failure of HIH. However, APRA can invoke its emergency powers independently. The RBNZ, while relatively independent in its day-to-day operations, requires Ministerial consent in order to exercise powers such as giving directions to banks in crisis situations and an order in council is required to invoke statutory management.

Crisis Management

102. Under a joint regulator, only one agency would be responsible for crisis management. As the financial implications for both countries of a crisis are likely to be high, the tools developed to resolve crises must be fair to both countries.

103. A starting presumption should be that the joint regulator develops trans-Tasman failure management options that minimise, if not obviate, the need for fiscal support. This would help to ensure that no financial institution is assumed to have an implicit government guarantee. One means of achieving this would be if the joint regulator established a suite of options for dealing with a bank failure prior to any crisis emerging and was given the authority to exercise these powers independently.

104. In the event that fiscal costs were considered unavoidable in resolving the failure of a trans-Tasman bank, the question of which government should bear the cost would inevitably arise. **[Information withheld under section 9(2)d of the OIA 1982 – avoid prejudice to the substantial economic interests of New Zealand.]**

105. As is the case with any non-central bank supervisory authority, the joint regulator would not have the responsibility, or the capability, for providing LoLR services. The RBA would be the LoLR for Australian dollar obligations, while the RBNZ would be the LoLR for New Zealand dollar obligations. Each central bank would determine its own policies for making LoLR operational, albeit with close coordination. Co-ordination would be most important in the area of providing bank-specific liquidity, and would only take place if there were no doubts over the bank's capital adequacy and market sources had been exhausted. Each central bank would also retain the right to provide liquidity to the financial market as a whole via open market operations when greater liquidity is needed e.g., technical payment system failure, Y2K.

Other considerations

106. A joint regulatory body raises issues extending beyond the nature of the institution to the performance of the wider economy. These can impact on our assessment of the desirability of such an institution. Some of these issues have significant crossover with other areas of the wider single economic market agenda (SEM).

107. Identifying income that should be subject to New Zealand tax is particularly difficult in the case of banks. Their assets and liabilities are fungible and may move across borders rapidly. Banks are highly leveraged and operate at low margins, so small adjustments in measuring gross income or expenses can lead to large changes in income subject to tax. Currently, Australian entities have an incentive to report income in Australia, in order to take advantage of imputation credits for Australian shareholders that are available for Australian but not New Zealand income tax paid.

108. New Zealand's current banking supervision regime was not designed to protect the tax base. Nonetheless, various elements, including local incorporation, outsourcing restrictions and rules governing the conduct of business, have the effect of helping to anchor banking business to New Zealand by maintaining a recognisable local bank that includes the business links that have traditionally been conducted in New Zealand. This local bank is subject to New Zealand tax law, albeit with some

difficulty. However, if, for example, a bank were allowed to shift to a branch operation in New Zealand then Australian banks would have greater capacity to structure their business to locate much of what is currently their New Zealand balance-sheet and income to Australia. This could result in an erosion of the New Zealand tax base and some tax-driven movement of functionality across the Tasman.

109. Aligning with Australia's local incorporation rules could have an impact on the competitiveness of New Zealand banks. In Australia, all foreign banks that accept retail deposits, including non-systemically important banks, are required to locally incorporate. Extending this requirement to New Zealand is likely to reduce the activity of foreign banks in New Zealand and, in turn, reduce the competitiveness of the New Zealand market. However, it is difficult to gauge the magnitude of this effect. To the extent that foreign banks operating in New Zealand were primarily interested in the Australasian market rather than New Zealand per se, then the level of banking activity in New Zealand may not be seriously affected. However, over the longer run, it may restrict the level of business integration New Zealand can have with countries outside of Australia.

110. In the insurance sector, adopting a more Australian-style of regulation would mean that non-Australian overseas insurers operating in New Zealand would be subject to a more intrusive regulatory regime. This may act as a disincentive for some companies to provide insurance in New Zealand if they have to comply with two regimes with high capital adequacy and solvency requirements, thereby lessening competition. Amendments to insurance regulation in New Zealand stemming from the reviews underway, while likely to result in greater regulation of the sector, are still unlikely to be as heavy handed as in Australia.

111. Other major areas of regulation that could affect competitive neutrality are relatively low risk. The Australian and New Zealand competition laws are well aligned. Similarly, the restrictions applied to banks on lines of business are also broadly aligned – both Australia and New Zealand authorities have policies in place to separate core banking business from insurance and other material lines of non-financial business.

112. Entry standards for New Zealand and Australian banks are very similar except for the minimum capital requirements ($NZ15m and $A50m respectively). To ensure a level playing field within the trans-Tasman banking market, a single threshold would be needed. Any reduction in the Australian threshold would probably be seen by Australian authorities as compromising consumer protection and the reputation of the banking system. Increasing the New Zealand threshold would raise the hurdle for small institutions to become registered banks and compete more strongly in that market, thus reducing the competitive pressure that they are able to exert on banks.[24] However, it is likely that at present this pressure exists not because of the threat of NBFIs registering as banks, but simply as they provide an alternative source of banking services.

3.2 The costs and benefits of greater regulatory integration

[24] At present, there are only two NBFIs in New Zealand with net assets around $A50m.

113. From an economic perspective, reasons cited for closer integration of trans-Tasman prudential regulation and supervision include helping to reduce banks' compliance costs, facilitating the development of a seamless trans-Tasman market for the provision of financial services and improving crisis management capabilities and trans-Tasman coordination more generally. However, a number of countervailing forces also exist that may limit the extent of desirable integration. These include the potential costs of not tailoring policy to local conditions or preferences (including efficiency costs) and the protection of New Zealand investors and depositors. There may also be an impact on regulatory effectiveness of greater centralisation of decision-making power away from New Zealand. The issues we consider in the next section are:

- the costs of regulation versus the effectiveness of regulation;
- the impact of regulation on the development of a seamless market; and
- the effectiveness of crisis management.

The costs and effectiveness of regulation

114. When the level of commercial integration in a sector is high, as is the case in the trans-Tasman banking sector, regulatory integration can help to ensure that costs of complying with two sets of regulation is not onerous. However, some forms of integration also entail costs from regulation not being able to reflect differences in local conditions, preferences and institutional structures. This can result in regulation not being best practice in one or both economies and is most problematic when decisions are difficult to reverse e.g., if the policy framework is firmly entrenched.

115. At present, the RBNZ's less interventionist supervisory regime interacts reasonably well with the more intrusive approach adopted by APRA and other foreign regulators, minimising the potential for duplication. With the RBNZ enhancing its supervisory capabilities, robust information sharing arrangements will be necessary to ensure that duplication and compliance costs continue to be kept to a minimum. For example, the RBNZ is looking at ways to harmonise its approach to implementing the new Basel II capital standards with Australia. The same issues may arise in the insurance sector if, as a result of the reviews of insurance underway, an increase in the intensity of supervision in New Zealand occurs.

116. Although greater convergence in the Australian and New Zealand supervisory regimes for banks and other financial institutions is likely over time, some material differences are likely to remain in the objectives, style, substance and detail of banking regulation that reflect differences in policy preferences and local conditions. An Australian-style regime would impose additional costs on New Zealand's banking sector (particularly for those non Australian-owned banks not already partly subject to APRA supervision) and it is unclear that there would be any material gain in effectiveness – a view endorsed by senior members of New Zealand's banking community during our consultation process (see box 2). We consider that regulation aimed at promoting a stable financial system, if administered effectively, goes some way towards protecting consumers from unexpected financial losses, without imposing undue costs on the institutions themselves. Encouraging consumers to bear some responsibility for managing their own risks also helps to minimise the regulatory burden on banks.

117. Economic differences between Australia and New Zealand give rise to differences in local conditions for banking and insurance. Differences in the nature of banks' assets and liabilities mean that not all rules applying in Australia are needed in New Zealand. Asymmetric shocks occur and are best addressed by regulators and financial institutions alike taking country-specific responses e.g., house price bubbles. Moreover, the average size of major financial institutions in New Zealand is smaller than in Australia, and is likely to remain so, which impacts on the extent of prudential requirements that can be imposed without undermining the competitiveness of the sector.

118. If the scope of the joint regulator extended beyond banks, some smaller institutions would find it difficult to comply with Australian-style prudential requirements. Although the demise of weak institutions would not be of great concern, some smaller insurers provide services for niche markets and their removal may mean that aspects of the New Zealand market are not adequately catered for. It would also reduce competition and innovation. To prevent such institutions from going out of business, these companies (particularly in the insurance sector) may require exemption from the control and rules of the joint regulator, thus reducing the benefits of a joint institution.

119. In sum, we consider that integration premised on one set of rules for both New Zealand and Australia could impose significant economic costs on New Zealand. Moreover, most compliance cost savings could be secured through robust information sharing agreements and better coordination.

Box 2: Consultation with senior members of New Zealand's banking system

The Treasury and RBNZ had meetings with 14 senior participants in the New Zealand banking system. These included CEOs, Directors, and senior management of banks, the CEO of a credit union and other industry experts. Many of the participants have direct contact with the Australian authorities and parents, either as members of Australian bank Boards, through APRA consultations or group management.

The consultations broadly followed the structure of the Terms of Reference for this review. The feedback from participants was remarkably consistent.

Participants generally thought that the financial system was efficient, with a good provision of financial services. Where more specialised services were needed – for larger corporates – these were provided by parents at reasonable cost, although the financial market for the largest New Zealand companies is already the international market. At the retail and small business levels, the perception was that the market is efficient, with a number of participants pointing to the low fees and margins (by international and historical standards) and fierce competition in the mortgage market as good examples. A majority commented that New Zealand banks are world best in some areas (particularly IT), and often ahead of parents.

Few thought that the lack of a seamless market was related to prudential regulation. In any case, this was not considered a priority issue for the banks, given the lack of commercial demand for such a service. If it was, it would be resolved within the banking group.

There were some concerns about the hollowing out of functionality, including of senior management, knowledge and experience. However, some commentators noted that

market discipline would address this problem if service quality started to suffer. Others viewed hollowing out as a wider issue for New Zealand, as it reduced the pool (and quality) of available talent that could move to other jobs and directorships outside banking, and this would affect future economic growth. Most participants stressed the importance of local knowledge and decision-making capabilities.

In general, participants were comfortable with the direction the RBNZ is heading with regards to its regulatory and supervisory activities, although some cautioned about going too far to the heavy-handed end of the spectrum. Some felt that maintaining a New Zealand regulator, focussed on New Zealand specific issues, was important. Others suggested improvements, such as the RBNZ getting closer to the senior management of banks.

Most participants expressed unease about the regulation of the non-bank financial sector, and the risks that a relatively poorly informed public faced when investing in the sector. However, these concerns were not driven by specific information. Many considered that some degree of shakeout in the sector was inevitable.

There were widespread concerns that APRA had become too heavy handed in its approach, in particular following the failure of HIH Insurance Limited. Compliance costs in Australia were considered high and climbing. As a result, there was little support for APRA-style regulation in New Zealand, and hence a fair degree of scepticism about the benefits of a joint regulator. All participants thought it unlikely that Australia would move towards New Zealand-style regulations and that a joint institution would effectively operate under APRA's rules and supervisory approach. Most thought that the current situation of separate regulators in Australia and New Zealand was not unduly costly and the best approach was to improve cooperation and communication between the regulators. Some indicated that they found the policy arguments in favour of joint regulation difficult to substantiate and that Australian support for this approach was largely motivated by commercial considerations.

The development of a seamless market

120. Some commentators have claimed that regulation and, in particular, RBNZ policies on outsourcing and local incorporation[25] have stymied the development of a seamless market in financial services. However, feedback from our consultations with bank senior management, directors and an independently commissioned report indicates that prudential regulation is not a significant barrier to banks offering a seamless service. In addition to differences in internal bank systems between Australia and New Zealand, more significant barriers include:

- different pricing of loans in the two countries due to differences in the business cycle and hence monetary policy;
- complexities in enforcing loans (and the security offered with them) outside of the jurisdiction in which they are granted;
- customer relationships being country based and reliant on face-to-face contact; and
- the need to exchange currency.

[25] The RBNZ requires that all systemically-important banks operating in New Zealand are locally incorporated. Systemically-important banks are defined as those whose New Zealand liabilities, net of amounts due to related parties, exceed $10 billion. Details of the local incorporation policy can be found in the *Banking Supervision Handbook, Statement of Principles: Bank Registration and Supervision*.

Differences in commercial law, economic structure and taxation may also indirectly discourage the provision of integrated banking services. These differences deter firms in New Zealand and Australia from establishing production and distribution activity in both countries, thus reducing demand for a seamless trans-Tasman banking services.

121. Banks are already putting processes in place that will facilitate more effective information sharing between Australian parent banks and their New Zealand entities and thus a more seamless provision of services.[26] Most already offer this service to their larger trans-Tasman clients. Some also have initiatives underway to extend this service to their smaller clients. Until they face stronger commercial incentives to do so, banks are unlikely to fully integrate their IT platforms.

122. In reality, a strong relationship between organisational form and business structure is not apparent. Westpac, currently a branch, has its own treasury in New Zealand and raises its own funds – a feature expected more of a subsidiary. In contrast, BNZ, a subsidiary, has a substantial portion of its fundraising functions performed by its parent out of Australia. The cost of raising funds and managing liquidity does not appear to vary between those banks operating as branches or subsidiaries in New Zealand. Moreover, it is unclear that the centralisation of banking functions away from New Zealand has resulted in any marked efficiency gains.

123. In assessing the overall efficiency gains of imposing fewer restrictions on organisational form – a possible outcome of some forms of integration – consideration should also be given to the potential consequences for financial stability. New Zealand regulation interacts wells with home-country regulation as long as the local board and management are comfortable that home-country regulation is supportive of the New Zealand bank. Restrictions on corporate form bring greater legal certainty and the benefits of a local board acting in the interests of the New Zealand bank. Moreover, outsourcing policies help to safeguard New Zealand's interests in a failure situation by providing the board of directors of the registered bank with the legal and practical capability to control the management and operation of the New Zealand banking group's assets, liabilities and systems on a stand alone basis.

124. These types of policies also stem the hollowing out of decision-making capability and functionality. This can be important if the centralisation of power and functionality adversely impacts on customer satisfaction, the allocation of credit and the provision of other financial services. However, if these problems do emerge, commercial incentives should also help to ameliorate them over time.

125. Overall, we consider that the maintenance of separate regulatory capacity is not acting as an impediment to the development of a seamless market. Moreover, foregoing this capacity could have implications for regulatory effectiveness and the longer-term stability of New Zealand's financial system.

Crisis management

126. For a country with a high degree of foreign ownership of its banking assets, cross-border coordination is an important element of effective crisis management.

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[26] New Zealand Trade and Enterprise is working with some of the major banks in Australia to facilitate this service.

However, in the absence of effective trans-Tasman coordination, crisis management could pose a considerable financial risk to New Zealand.

127. Ideally, in the event of problems with the New Zealand operations of a trans-Tasman bank, the capital support from the Australian parent would be sufficient to ensure that no regulatory intervention is required. If this support was insufficient, or the problems were more widespread than just the New Zealand operations, then some degree of coordination between the Australian and New Zealand regulators would be required to ensure that the actions of one regulator did not undermine those of the other. The types of conflict between the Australian and New Zealand legal systems that could create tensions or reduce the effectiveness of regulation in a trans-Tasman failure situation include:

- New Zealand depositors being disadvantaged in the case of failure of a branch due to Australian depositor preference;
- each country imposing remedial measures that may have implications for the other economy without getting agreement from the other regulator;
- difficulties for New Zealand in taking remedial action quickly, as troubles originating locally may require reorganisation and resolution at the global level;
- New Zealand having less information about the Australian operations of bank than local operations, impacting on New Zealand's ability to anticipate problems;
- differences in insolvency laws resulting in a trans-Tasman organisation being subject to conflicting duties or differing priority rules applying in insolvency. Where New Zealand law "governs the transaction" the entity should comply with New Zealand law. However, in practice directors located in Australia may opt to comply with Australian law; and
- the outcome of a failure situation being less predictable given two jurisdiction will be managing the crisis.

128. Some of these tensions also exist for insurance. In addition:

- in relation to non-life branch insurance, Australian legislation explicitly favours Australian policyholders and an insurer in difficulties could repatriate assets before liquidation, resulting in Australian policy holders being paid out first;
- in relation to life branch insurance, New Zealand legislation provides that insurers must hold separate statutory funds in New Zealand. However, the reality is that companies can resort to dishonest tactics to move funds into Australia before liquidation; and
- even when a New Zealand insurance company is a wholly-owned subsidiary, its directors have a duty to act in the best interests of the holding company rather than the New Zealand company. This could allow them to siphon assets to Australia e.g., via unsecured loans to an Australian parent in financial difficulties.

129. These issues have economic costs as they can make speedy resolution of a crisis difficult and make the outcome of insolvency more uncertain. Further, these issues can result in claimants taking actions in the jurisdiction most favourable to them. The RBNZ already has some policies in place intended to minimise the potential economic costs arising from such conflicts of interest e.g., local incorporation means that the Australian parent company's only stake in its New Zealand operations is its shareholding, thereby reducing the Australian banks claim on New Zealand deposits if Australian depositor preference is invoked. RBNZ rules also explicitly disallow directors to act in the interests of the holding company rather than the New Zealand bank.

130. Moving to a joint regulator model could resolve some of the tensions discussed above by ensuring that both New Zealand and Australian officials have access to the same information, making reorganisation of the global entity easier and reducing the number of parties managing a crisis. With just one regulator, there would be no risk of separate regulators taking competing actions that could ultimately undermine the effectiveness of any crisis resolution proceedings. A joint regulator approach might also provide New Zealand with greater leverage to enforce its own interests in Australia e.g., in the event of an Australian-specific shock that affected the Australian operations of the bank.

131. However, differences in regulation and the potential asymmetry of powers between Australia and New Zealand, e.g., legal and negotiating powers, also make the ability to act unilaterally a valuable attribute in crisis management. For example, if a common shock hit both the New Zealand and Australian operations of a trans-Tasman bank, it may be in the bank's best interests to sort out its Australian operation first. As a result, independent intervention on the part of the New Zealand regulators would likely be required in order to safeguard New Zealand's interests i.e., to keep the bank open in New Zealand while a process for crisis resolution is established A joint regulator approach may also lead to a less timely resolution of a crisis in the country where the operations of the failed institution account for a smaller proportion of the institution's global operations, yet may be a very important part of that country's financial system e.g., if a bank is systemically important in New Zealand but not in Australia.

Governance and accountability arrangements

132. Setting up new institutions raises both governance and accountability issues. Our experience with trans-Tasman institutions is limited, but agreeing legislative processes has been problematic in establishing the Joint Therapeutics Agency. Given the high cost of banking failures, integration that did not provide New Zealand with an adequate voice over New Zealand-specific issues could have significant consequences for financial stability. Moreover, unlike other areas of regulation, New Zealand and Australia's interests are most likely to diverge in a crisis situation when timely and decisive action is most required.

133. […….] Australia has recently gone through a major review of financial sector regulation and, as a result, is unlikely to want to move too far from its current model.[27] [………]**[Information withheld under section 9(2)j of the OIA 1982 – Enable a Minister of the Crown or any Department or organisation holding the information to carry on, without prejudice or disadvantage, negotiations]**

3.4 Overall assessment of options

134. Weighing up these costs and benefits, option B (the joint committee structure) is our preferred approach for closer integration. We consider that it offers most of the benefits of a joint institution, but at a considerably smaller cost to the financial system. That is, a joint committee could effectively deal with many of the key cross-border regulatory issues affecting trans-Tasman financial institutions without risking compromising national interests. To the extent that a joint committee

[27] APRA was established on 1 July 1998, following a large-scale review process.

structure formalises working arrangement between the RBNZ, APRA and RBA, the momentum for greater harmonisation, information sharing and coordination should be maintained. Closer working relationships should also be forged, which would allow for more effective resolution of a trans-Tasman banking failure – one of the key benefits of greater integration. While each regulator would retain the ability to make an independent decision if agreement on the most appropriate way to resolve a crisis could not be reached, the existence of such a committee would indicate a strong commitment to finding a mutually agreeable solution.

135. Option B encapsulates option A, (the enhanced home/host model) – the key drawback of which is that it is not a formal structure. As such, under option A, there may be less commitment to carrying the work forward than under a more formalised structure. In addition to providing a formal structure through which greater integration can be achieved, option B offers the similar benefits to option A. That is:

- each country is free to place the degree of emphasis on consumer protection and prudential supervision that they consider appropriate;
- it aims to minimise the costs of regulation;
- it retains the ability to maintain a level playing field, and therefore attract major banks from outside Australia, and to react to shifts in the home country's policies and laws if they are not in New Zealand's best interests;
- it allows New Zealand to take actions that protect New Zealand depositors and policy holders in the event of failure of a trans-Tasman institution;
- it does not commit New Zealand to a policy that may be difficult to reverse, and maintains a voice for both countries in policy decisions;
- it allows Australian and New Zealand regulatory bodies to retain a different scope of operations; and
- it facilitates more effective crisis management, as a result of greater access to information, and more certainty as to how individual regulators will act.

As such, option B also complies well with the assessment criteria set out in section 2.5.

136. We recommend against moving to option C (the joint regulator model) at this time as we continue to question both its merits and feasibility. On balance, the economic benefits are likely to be small and the potential costs large. In a worst case scenario, the establishment of such an institution may have an adverse impact on financial market development and the stability of our financial system. In particular, we have concerns about:

- adopting a regulatory and supervisory regime that is not best practice for New Zealand and involves higher compliance costs;
- the impact of potentially greater hollowing out of the New Zealand financial system on regulatory effectiveness and longer-term financial stability;
- the inability to tailor regulation and supervision to New Zealand-specific circumstances, particularly when averting or resolving a crisis; and
- the feasibility of establishing governance and accountability arrangements that adequately protect New Zealand's interests.

We are unaware of any group of developed countries that have moved to a joint prudential regulator, perhaps indicating the practical challenges in developing such arrangements and uncertainty as to the net benefits.

137. On balance, adopting option B would make it easier to reassess the desirability of a joint trans-Tasman regulator in the future. However, greater convergence of national interests is likely to be required before a joint institution becomes a truly viable option.