ARTICLES

The evolution of prudential supervision in New Zealand

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This article reviews how the Reserve Bank’s prudential supervision activities have evolved over the last five years. During this period, three major impacts on prudential supervision have been the global financial crisis (GFC), the collapse of nearly 50 finance companies and the Canterbury earthquakes. The article discusses the implementation of the new prudential regimes for the Non-Bank Deposit Taking (NBDT) and insurance sectors, both of which have been established following the government’s Review of Financial Products and Providers (2006). It also highlights how the GFC in particular has led to a rebalancing in prudential supervision. While self- and market discipline remain key pillars of prudential supervision, there is now greater emphasis on regulatory discipline, including tighter regulatory standards and a more active engagement between the Reserve Bank and the regulated entities.

1 Introduction

The scope and nature of the Reserve Bank’s regulatory and supervisory activities have grown and changed significantly in the last five years. One outcome of the Review of Financial Products and Providers (a review led by the Ministry of Economic Development during the middle years of the last decade) was a decision to introduce prudential regulation for the NBDT and insurance sectors. Given the Reserve Bank’s existing mandate for prudential supervision of banks, the government decided that it should become the single prudential regulator for New Zealand and take on responsibility for those two other sectors. Over the same period, New Zealand’s financial system faced three extraordinary and largely unrelated challenges: an unprecedented Global Financial Crisis (GFC); the numerous finance company failures; and the Canterbury earthquakes.

The Reserve Bank responded to its broader mandate and these challenges by expanding and adapting its prudential supervision capabilities. The Prudential Supervision Department (PSD) was created on 1 November 2007. The department is responsible for the microprudential regulation of banks, payment and settlement systems (PASS), insurance companies and NBDTs, and for supervision of all but NBDTs. It is also responsible for supervising the compliance of entities in all those sectors with their obligations under the Anti Money Laundering and Countering the Financing of Terrorism Act 2009 (“AML supervision”). Macroprudential issues, which have gained renewed attention since the GFC, are covered separately.

PASS oversight is a critical area of responsibility for the Reserve Bank. Payment systems are often referred to as the “plumbing” of the financial system – in the sense that they perform the vital function of facilitating all financial flows, but whose importance is often overlooked until things go wrong. This importance has been much better recognised internationally since the GFC. Because PASS oversight is by its nature very different from supervision of institutions, and because the legal framework under which we exercise our responsibilities in New Zealand is rather different, this article does not cover it. We intend that it be the subject of a separate stand-alone Bulletin article in the near future.

This article looks at how PSD has accommodated its new responsibilities for NBDTs and insurers, how we have responded to the major events and how our overall supervisory approach has evolved.

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1 We are grateful to the following Reserve Bank colleagues for their valuable comments: Margaret Griffin, Ian Harrison, Bernard Hodgetts, Michael Reddell, Grant Spencer and Andy Wood.


3 This article is limited to a discussion of prudential supervision. The Reserve Bank’s approach to anti money laundering and countering the financing of terrorism supervision will be the subject of a separate, forthcoming article.

2 The fundamentals of prudential supervision

Prudential supervision is about the regulation and monitoring of financial institutions and infrastructure, in order to enhance the soundness and efficiency of the financial system. This is primarily done by responding to market imperfections which, left alone, would lead to welfare losses.

The most compelling reasons for regulating and supervising financial institutions are to prevent the failure of one institution from affecting the financial system and the economy more widely (spillovers and negative externalities), and to offset the negative consequences of players not bearing the full cost of their actions when things go wrong (moral hazard). Information asymmetries, as will be shown later, provide a further reason for intervention.

A good example of the potential for wider economic spillover effects is the special role of the banking sector and its connections to the real economy. Banks’ position at the heart of the payments infrastructure and their key role as credit providers mean that any disruption quickly spills over and damages the real economy. Equally, the protection provided by insurance is an important element in the financial security of individuals and companies in New Zealand, and in the economy’s ability to function efficiently. Failure of a major insurer would have a significant impact on the financial system, the economy and on individuals affected.

The interconnectedness of financial institutions can also result in the failure of one player quickly affecting others. This applies particularly in the banking sector, and can occur either because other institutions are directly or indirectly exposed to a failed bank or because of a loss of confidence amongst banks in each other’s ability to meet future obligations when they fall due, thus triggering a liquidity freeze as evidenced at the start of the GFC. Moreover, the public may lose trust in the banking system and a bank run may ensue. Although the Reserve Bank’s role of lender of last resort means that it has an effective response to any bank runs, these situations can easily spill over to the real economy; for example, in the form of a credit crunch. A key objective of prudential regulation and supervision is to reduce these risks.

Moral hazard occurs when those making decisions do not take account of the full cost of getting it wrong. The importance of the financial system to the overall functioning of the economy can accentuate moral hazard by reinforcing expectations of government support in the event of difficulties. Market participants know this and may assume that government support would be made available in a crisis. This can lead to excessive risk taking, thus – paradoxically and worryingly – increasing the probability of financial crises.

Due to their smaller sizes and the lower levels of interconnectedness, the insurance and NBDT sectors are not of the same systemic importance as the banking sector. However, the moral hazard, negative externality and spillover arguments apply to varying degrees across the board. It is the spillover effect to the wider financial and economic system in particular that prudential regulation seeks to address.

Consumer protection, the attainment of predefined social goals and constraining market power are also often cited as rationales for public intervention – but prudential supervision is not generally the best tool for addressing these issues and they do not form the basis for prudential supervision in New Zealand. Rather, they are addressed by a variety of other ministries and agencies, such as the Ministry of Consumer Affairs, the Commerce Commission and the Financial Markets Authority, which regulate other aspects of the activities of financial institutions.

Legal bases

Sections 68 and 157A of the Reserve Bank Act 1989 require the Reserve Bank to carry out its supervision of banks and NBDTs (respectively) for the purposes of promoting the maintenance of a sound and efficient financial system; and avoiding significant damage to the financial system that could result from the failure of a registered bank or NBDT.

This role is mirrored in the insurance context. Section 3 of the Insurance (Prudential Supervision) Act 2010 provides that the Reserve Bank promotes the maintenance of a sound and efficient insurance sector and promotes public confidence in the insurance sector.

The Reserve Bank’s philosophy and approach towards prudential supervision

The legal bases underpinning prudential supervision clearly imply that the Reserve Bank’s supervisory role concerns the financial system and the insurance sector respectively but not (directly at least) individual financial institutions.

This, of course, also influences the Reserve Bank’s philosophy as regards prudential supervision, which in New Zealand is comparatively light-handed. It is not about completely eliminating risk, but rather aims to ensure that risk is well understood by market participants, including depositors and policyholders. Primary responsibility for managing an institution rests with its board and senior managers; and for making investment decisions with those who have, or may have, a claim on that institution (depositors, investors and policyholders). The fact that New Zealand does not have a permanent deposit insurance scheme is commensurate with this philosophical approach.

That said, it should be noted that although the Reserve Bank’s legislative purpose is system-wide in nature, we are very mindful of the damage that individual institutional failure, or especially a series of related failures, such as was seen with the finance company sector, can do to system-focused objectives. So, although the Reserve Bank would be prepared to allow individual firms to fail and does not provide any absolute “protection” to depositors or policyholders, we seek – via the application of rules and requirements discussed below – to reduce the probability of institutional failure across all three industries.

Figure 1
Three pillars of prudential regulation and supervision

![Three pillar approach]

Three pillar approach

The Reserve Bank’s approach towards prudential supervision relies on the well-established ‘three pillars’ of supervision: self discipline, market discipline, and regulatory discipline.

Self discipline

Self discipline refers to a firm’s internal risk management and governance systems, responsibility for which rests primarily with a firm’s board and senior managers. The Reserve Bank seeks to embed and enhance self discipline via a number of channels: for example through governance requirements and guidance that support independent scrutiny by the Board of Directors or an equivalent body. The Reserve Bank also has powers to object to the appointment of directors and senior managers who may not meet a “fit and proper” test.

Market discipline

Market discipline is about the role of financial market participants in monitoring the risk profile, and the financial performance and position, of financial institutions, and in influencing their behaviour (especially risk-related behaviour). Investors and policyholders can exercise market discipline through the price they demand for supplying funds or through their choice of product provider. A core element of the Reserve Bank’s approach is to help overcome information asymmetries, i.e., situations where

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For a fuller discussion of market discipline see Mortlock, G ‘Strengthening market disciplines in the financial sector’, Reserve Bank of New Zealand Bulletin, 65 (3). September 2002
one party has better information than the other and is in a position to use that to its economic advantage. Consumers or investors, for example, might not be in a position to adequately assess a company’s risk without the company disclosing information in an accessible way.

Information asymmetries are not just damaging in a consumer protection sense but they can also lead to a misallocation of resources and exacerbate cyclicalities in the financial system and the wider economy. Finance companies’ overextending lending to property development companies is a good example. Mandatory disclosure requirements aim to overcome these information asymmetries and ensure that investors have the information they require to make informed decisions and exercise market discipline. There are tough disclosure requirements for firms in all three sectors. One common feature – for all but the smallest NBDTs and insurers – is the requirement to have and disclose a credit rating.7

**Regulatory discipline**

In addition to taking measures to enhance self and market discipline, the Reserve Bank also places emphasis on regulatory discipline. This involves certain rules and mandatory requirements in specific areas, such as minimum capital and liquidity requirements. A number of general requirements exist in all three sectors, for example risk management and governance rules, but their stringency might differ, reflecting our risk-based approach. Rules for banks tend to be tougher than those for other sectors. Two of the bank specific requirements are: a requirement for banks above a certain size to be locally incorporated and limits on the amount of outsourcing they can do.

Institutions in all three industries are subject to minimum capital (solvency, in the case of insurance) requirements. Capital adequacy serves two main purposes: to provide financial institutions with a buffer so that they can withstand losses from plausible but low probability events, and to ensure that those who own a bank, NBDT or insurance company have a reasonable amount of ‘skin in the game’ and an incentive to make sure the business is well run and does not take on undue risk. Banks and NBDTs are also subject to liquidity requirements.

Again, capital and liquidity standards are calibrated to reflect systemic risk. Bank and NBDT capital standards are calibrated to deliver equivalent outcomes, while insurance has a somewhat lower capital requirement. However, capital standards also reflect exposure risk. In all sectors, more risky assets carry a higher risk weighting and thus capital charge.

These regulatory requirements supplement financial institutions’ own risk frameworks and market discipline to support the soundness of the financial system. The requirements ensure that all entities in each sector are subject to minimum rules that support regulatory competitive neutrality while taking account of differences in risk.

New Zealand’s approach towards prudential supervision aligns with the Basel and the International Association of Insurance Supervisors’ (IAIS) core principles.8 This approach is well established in the banking sector and now being introduced to the insurance and NBDT sectors. The decision to extend the Reserve Bank’s prudential powers to these two sectors was taken prior to the GFC and the collapse of the numerous finance companies. However, it is those two events and the Canterbury earthquakes that have presented the three major challenges for prudential supervision these past five years.

3 Developments over the last five years

Three challenges: GFC, finance companies and Canterbury earthquakes:

**GFC impact**

The GFC impacted on prudential supervision in two main ways: one directly and the other more indirectly.

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7 See the Reserve Bank’s factsheet on credit ratings available at http://www.rbnz.govt.nz/finstab/nbdt/3857993.html

8 The Basel and IAIS core principles are set by the respective international standard-setting bodies and contain essential elements for effective banking and insurance supervision. They are available at: http://www.bis.org/publ/bcbs129.htm and http://www.iaisweb.org/view/element_brief.cfm?src=1/94.pdf
Once the full impact of the GFC was felt in New Zealand, it led to immediate intervention by the Reserve Bank and government. In the banking and NBDT sectors, a liquidity freeze in the interbank lending market and the nervousness with which market participants tried to assess institutions’ riskiness required unprecedented intervention.

**Banks**

Although New Zealand banks, including the big four and their Australian parents, weathered the GFC reasonably well in comparison to many of their foreign counterparts, they had become heavily dependent on international wholesale lending markets for their funding. And with a high proportion of that funding borrowed on a short term basis, the drying up of wholesale funding soon began to affect them. The Reserve Bank and government intervened swiftly with various measures to support system liquidity and confidence.

The Reserve Bank implemented a suite of emergency liquidity measures, including a widening of the definition of collateral it accepted for its overnight lending facility and the term auction facility (TAF). Under the TAF banks could borrow funds from the Reserve Bank for terms of up to one year against eligible collateral. In order to calm markets and investor sentiment, the government, with the involvement of the Reserve Bank, announced a temporary deposit guarantee for eligible institutions.

The GFC exposed some vulnerabilities of regulatory regimes around the world and laid bare the intricacies of dealing with financial institutions and financial markets that are globally interwoven. The impact on prudential supervision has been more indirect and happened largely through a tightening and strengthening of regulatory standards at the national and international levels.

**Domestic response**

At home, the Reserve Bank accelerated the development and implementation of policies for the banking sector, some of which had already been in the pipeline. The precarious situation that many banks around the world found themselves in, and the case of Lehman in particular, demonstrated the difficulties of dealing with a failing financial institution in an orderly manner without the need for government bailouts. In New Zealand, a policy on resolving a failed institution, called Open Bank Resolution (OBR), was accelerated. OBR will allow a distressed bank to be kept open for business, providing continuity of core banking functions and thus limiting the contagion effects on the rest of the financial system, while placing the costs of the failure primarily on the bank’s shareholders and creditors rather than taxpayers. As well as protecting the taxpayer’s interests, OBR should reduce the risk of moral hazard by ensuring that authorities are in a position to impose losses on owners and creditors without closing the bank.  

The onset of the GFC also brought into sharp relief the downsides of a banking system characterised by relatively low levels of liquid assets and a heavy reliance on short-term offshore funding markets. The drying up of funding from those markets confirmed that the previous disclosure-based liquidity regime was in need of strengthening. A new liquidity policy for locally incorporated banks came into effect in April 2010. The main elements of this policy are three liquidity ratios, rules and guidance on banks’ liquidity management processes and reporting obligations to the Reserve Bank as well as public disclosure of key information. The disclosure requirements aim to enhance market discipline. A one-week and one-month mismatch ratio aims to ensure that banks can meet their obligations in case of a short-term liquidity stress. A core funding ratio requires banks to source more of their funding from long-term wholesale markets and retail deposits. It effectively reduces the amount of funding that needs to be rolled over in the short-term. The Reserve Bank is currently in the process of extending the liquidity policy to branches of overseas incorporated banks.

In many instances, the Reserve Bank was in a position to react to the GFC more quickly than prudential regulators in other jurisdictions. Our system focus was helpful and meant that some policies, such as OBR, were...
already at a relatively advanced stage of development. Looking ahead we will continue to reassess our prudential policy framework in the context of international regulatory developments. Our aim is to remain in broad alignment with international regulatory norms, while modifying policies to allow for specific New Zealand conditions.

**Response at the international level**

At the international level, there has been a range of responses, including changes to compensation practices, a reshape of accounting rules, enhanced disclosure and resolution regimes, better risk management practices and new legislation such as Dodd-Frank in the US. A large part of the international response falls under the umbrella of the Financial Stability Board (FSB), the forum for the national regulatory authorities of the world’s financial centres and international financial institutions, and the Basel Committee on Banking Supervision, which has overseen reforms of the regulatory framework for the banking sector, also commonly referred to as Basel III. The main elements of Basel III involve higher capital adequacy requirements, tougher liquidity requirements and policies for dealing with distressed systemically important banks. With regard to liquidity and bank resolution, these changes are broadly consistent with policies already in place or in the process of being implemented in New Zealand. The Reserve Bank is currently consulting on its proposed implementation of the Basel III capital adequacy standards.

**NBDT sector and failure of finance companies**

Over 2008-2010, the Reserve Bank became responsible for prudential regulation of the NBDT sector. Trustees continue in their role as front-line supervisors. The NBDT sector has been marred by the collapse of close to 50 finance companies since the middle of the last decade. The failures occurred largely for domestic reasons to do with inadequate risk management, including overexposure to certain sectors and related party lending, and supervision. In hindsight, the heavy reliance on disclosure to market participants (i.e., market discipline) did not work as intended. A key failing was the poor quality of the information available to investors. These NBDT failures, while not themselves of systemic importance to the financial system, devastated the savings of many New Zealanders and the trust investors had placed in the sector. Reforming the sector’s regulatory framework is aimed at alleviating these regulatory failings and can make a significant contribution to re-establishing confidence in the sector. The Reserve Bank is contributing by improving standards in prudential regulation, while the Financial Markets Authority (FMA), established in 2011, is raising the standards for market conduct.

The decision to strengthen prudential regulation in this sector came out of the Review of Financial Products and Providers and was taken in December 2005, but the preconditions for the subsequent wave of failures were already in place. For the Reserve Bank, it has meant increasing our knowledge of this sector and introducing a new regulatory regime. The bulk of this regulatory regime was introduced in 2010. Similar to the prudential regulation of banks, it covers requirements on capital, liquidity, related party exposures, credit ratings and governance and risk management. These requirements are tailored to the needs of the NBDT sector, reflecting their generally smaller size compared to banks. Smaller NBDTs are exempt from certain requirements, for example, the requirement to have a credit rating.

A second NBDT Bill, currently in the legislative process, is intended to extend the Reserve Bank’s regulatory powers to areas such as fit and proper requirements for directors and senior managers, licensing of NBDTs and controls on ownership changes. It also introduces a framework for managing NBDT failures.

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11 For more information on the FSB, see: http://www.financialstabilityboard.org/index.htm
12 See also F. Barker and N. Javier, ‘Regulating non-bank deposit takers’, Reserve Bank of New Zealand Bulletin 73 (4), December 2010
13 More detail on each of these requirements can be found at: http://www.rbnz.govt.nz/finstab/nbdt/requirements/3857992.html
**Insurance sector**

The Insurance (Prudential Supervision) Act 2010 established the Reserve Bank as the prudential regulator and supervisor of the insurance sector. While the insurance sector did not suffer the failures of the NBDT sector, it too had been loosely regulated and was identified by the Review of Financial Products and Providers as a sector in need of enhanced regulation and supervision. The Reserve Bank has had to build up its knowledge of this sector. Since 2010 a number of regulations and standards have been introduced, covering, amongst others, governance, disclosure and solvency. A licensing regime has been put in place and insurers are currently going through the process of obtaining their licences. As with banks and NBDTs, it is a risk-based approach, with some smaller insurers exempt from some of the requirements, and with our resources applied more intensively to the larger players.

**Canterbury earthquakes**

The earthquakes had, and continue to have, a material impact on financial institutions, especially the non-life insurance sector. A key task in the subsequent weeks and months was to establish the size of the claims and how insurance companies would cope with those claims, usually with significant recourse to reinsurance. While the damage estimates are now clearer, the still ongoing aftershocks and difficulties in accurately assessing the damage mean that these estimates remain subject to revision.

Although the foreign parents of some New Zealand insurers provided useful support in some instances, a small number of insurers ran into serious difficulties as a result of the scale of the disaster relative to their reinsurance cover and capital positions. AMI encountered significant problems due to its heavy exposure to Christchurch, roughly one-third of its total business, and required a government underwrite to provide it with sufficient time to replenish its capital base. The Reserve Bank was heavily involved in finding a solution to AMI’s problems.

One response, which was already signalled before the February 2011 earthquake, was to set tougher requirements for insurers that offer catastrophe cover. There was an absence of consistent, mandatory solvency standards in New Zealand prior to the introduction of the new prudential regime, and the Reserve Bank considers that the new standards will put insurers in a stronger position to cope with future catastrophe events.

The adequacy of reinsurance and capital resources becomes vital for the country at a time of serious natural disaster. This means that the capital and/or reinsurance requirements on non-life insurers must be set at a level that gives the required degree of comfort that insurers are in a position to withstand any similar future event.

Recent events have almost certainly increased moral hazard in the market. That is, insurers and policyholders may believe that government intervention will occur in the future if there is a catastrophe. This further supports the need for robust solvency requirements in respect of earthquake risk.

4  **Impact on supervisory approach**

The challenges outlined in the previous section have had a significant effect on prudential supervision in New Zealand. The GFC presented new regulatory challenges in what had until then been the Reserve Bank’s core area of prudential supervision, the banking system. While the Reserve Bank was well placed to respond to those challenges, as evidenced by having been at the forefront of strengthening liquidity requirements and developing the OBR failure framework for banks, work still needs to be done. We are, for example, currently consulting on further strengthening our prudential standards in line with Basel III.

The general trend since the GFC has been towards tighter regulation. In terms of our three-pillar approach, there has been a shift towards more emphasis on regulatory discipline. But this does not mean that prudential regulation systems around the world are being completely overhauled. For the most part, this strengthening of regulatory standards takes place by amending existing
rules and regulations. Basel III, for example, builds on Basel II. Our regulatory response at home is no different. We have amended, and are amending, existing regulatory standards to strengthen inter alia liquidity and capital provisions and to further facilitate market discipline.

Thus, the Reserve Bank still favours a light-handed approach by international comparison, but with a rebalancing of regulatory discipline alongside the well-established canons of market and self-discipline, allied with a significantly more active approach to institutional engagement and information provision. Disclosure reporting by financial institutions continues to be a core element of this approach. The strengthening of capital-adequacy requirements and the introduction of liquidity ratios in the banking sector do represent a stronger emphasis on regulatory discipline. And the insurance and NBDT sectors are moving from a loosely regulated regime, as mentioned above, to one with higher regulatory standards. Whereas a decade ago the Reserve Bank might have relied more on self- and market discipline, and less on regulatory discipline, the regimes that are now being introduced in these two sectors reflect this rebalancing in emphasis, also in terms of direct engagement between the Reserve Bank and financial institutions. The frequency and substance of the Reserve Bank’s engagement with banks has already been stepped up. This increased level of engagement with banks also translates to the Reserve Bank’s interactions with insurance companies. However, regular on-site inspections, which were already a key feature in many other jurisdictions before the GFC, will continue to play a minor role to be used in exceptional circumstances only.

The stronger emphasis on regulatory discipline increases the need for robust and thorough analytical underpinnings of the rules and regulations the Reserve Bank imposes on the financial system. Analytical capabilities have been enhanced and new policies are routinely accompanied by regulatory impact analysis which, where possible and sensible, includes quantitative analysis of the policy’s costs and benefits. More than before, consultation documents encourage affected parties to supply the Reserve Bank with concrete cost and benefit information to facilitate the use of cost-benefit analysis.

A risk-based and outcome-focused approach

Prudential regulation and supervision in New Zealand will continue to be risk-based and outcome focused, whether that is in the banking, NBDT or insurance sector. Being risk-based and outcome-focused means that the Reserve Bank is concerned about getting to the best outcome to meet its legislative objectives. The Reserve Bank sets common minimum standards but does not apply a simple one-size-fits-all to regulated institutions either within or across sectors. A simple example is that the capital rules are different for NBDTs, banks and insurers. Another is governance requirements. The Reserve Bank’s robust governance requirements for banks are enshrined in their conditions of registration and reflect the systemic importance of that sector, while in the NBDT sector there is scope for exemptions from governance requirements for eligible NBDTs, and in the insurance sector, where the variability of size and nature across the sector is enormous governance requirement, they have the status of guidance.

5 Conclusion

The last five years have been an eventful period for prudential supervision thanks to the domestic and global developments described in this article. The Reserve Bank’s prudential regime in the banking sector has met these challenges well. We have not faced the bank failures that a number of countries around the world have had to deal with. The regulatory and supervisory approach based on self discipline, market discipline and regulatory discipline has served us well. This approach is now being rolled out to the NBDT and insurance sectors. It is expected that this will reduce the likelihood of a repeat of the problems encountered by the NBDT sector under the previous regime.

However, any regime has to continue to evolve and to adapt to new circumstances, and ours is no exception. Where necessary, we have tightened up standards and
implemented new policies. Looking ahead in banking, Basel III will have an impact on prudential regulation in New Zealand, in particular through a strengthening of capital adequacy requirements. Domestically, large banks are also being required to pre-position for OBR. In the NBDT and insurance sectors we will press on with the implementation of a high-quality prudential regime and fine tune existing requirements.

6 References