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By email stocktake@rbnz.govt.nz

Dear Ashley, Jeremy and Rachel

Regulatory Stocktake Consultation

This letter is my submission on the Reserve Bank's regulatory stocktake consultation document. I wish to comment on only two aspects of the document; those which deal with the fit and proper tests, and the issues around disclosure requirements and private information. In both cases, I have written blog posts on these issues and they should be read as part of this submission:

- On the fit and proper issues, http://croakingcassandra.com/2015/04/23/fit-and-proper-people/, and
- On disclosure requirements http://croakingcassandra.com/2015/08/05/disclosure-requirements-some-anomalous-laws/

Fit and proper

In general, I don't think your consultative document made any serious attempt to explain, or evaluate, how the fit and proper requirements promote the soundness and efficiency of the financial system in New Zealand. Without that sort of work (either included in the documents, or with links to it), it is difficult for you know, or for outsiders to comment, on which, if any, marginal changes might be appropriate.

Under the current Reserve Bank Act, the Bank must have regard to the suitability of directors and senior managers in determining whether to register a bank in the first place. But ongoing conditions of registration for established banks, in this and other areas, are a matter of choice for the Bank.

"Fit and proper" requirements are certainly common internationally. But New Zealand citizens should reasonably ask "to what end, and with what evidence that the requirements make a useful difference?"

The Reserve Bank's prudential regulatory powers have to be used to promote the soundness and efficiency of the financial system (sec 68 of the Act). The focus of the suitability ("fit and proper") tests is presumably on the soundness limb of that provision. If so, prior Reserve Bank "non-objection" must be expected to reduce the threat to the soundness of the financial system (not just the individual institution, but the system itself). But how might it do that? The Reserve Bank says it focuses on integrity, skills and experience.

At the (deliberately absurd) extreme, if the Reserve Bank were blessed with the divine quality of omniscience, you could see into the soul of each potential appointee, and discern accurately how those individuals would respond to the sorts of threats, risks, shocks ,and opportunities they would face while serving with a New Zealand registered bank. No one prone to deceive under stress, to breach internal risk limits, or to take "excessive" risk would get appointed. That sort of insight would be very helpful. But you cannot be offering that standard in your monitoring.

Instead, your documents suggest a backward-looking focus – checking out past appointments, past criminal convictions, and the like. All of which is fine, but all of that information is known (or knowable) to those at registered bank concerned who are making the appointment. And most of the stuff that is really interesting, and telling, is likely to be about character. That isn't knowable in advance, and certainly not by Reserve Bank officials. What expertise do Reserve Bank economists and lawyers have in second-guessing the judgement of the banks themselves in making such appointments? And what incentive do they have to get it right? The model looks like one that favours the appointment of grey colourless accountants and lawyers, who have not yet blotted their copybooks – perhaps never having taken any risk – with a bias against anyone who has learned banking, and what it is to lose shareholders' money, the hard way.

Banking regulators worry about the risks to depositors and taxpayers if widespread or large banking failures occur. But the first people to lose money as a result of mistakes, misjudgements, or worse are usually the shareholders in the bank concerned. They might reasonably be assumed to have more at stake from bad appointments of directors or senior managers than central bank regulatory officials do. After all, New Zealand has in place pretty demanding bank capital requirements.

No doubt there will be people (and perhaps there already have been) who were employed by failed finance companies coming up for Reserve Bank approval in the next few years. In some cases, those people will have had no responsibility for the failure, and in others there may have been some culpability. But business failures happen, and they aren't always a bad thing (indeed, unlike some systems, our banking regulatory system is explicitly designed not to avoid all failures). Why is the Reserve Bank better placed than the registered bank concerned to reach a judgement on whether any previous involvement with a failed finance company should disqualify someone from a future senior position in a bank (or other regulated financial institution)?

In a similar vein, I wonder if the Reserve Bank has done any sort of retrospective exercise and asked itself how likely it is that, with the information available at the time, it would have rejected any (or any reasonable number) of those responsible for the 1980s failures of the DFC and the BNZ. Done in a suitably sceptical way, it would be an interesting exercise

I'm not suggesting there be no rules at all. My two specific proposals would be as follows:

- conviction for an offence involving dishonesty in the previous 10 years should be an automatic basis for disqualification from such senior positions. It wouldn't be a perfect test, but it is certain and predictable, and probably better than a "we don't like the cut of your jib" sort of discretionary judgement exercised by regulatory officials. And it doesn't hold the false promise of regulators being able to sift out in advance people who might, in the wrong circumstances, later be partly responsible for a bank failure.
- a requirement that a summary CV for each director and key officer be shown on the registered bank's website. Those summary CVs might be required to list all previous employers or directorships, and any previous criminal convictions and formal regulatory actions against the individual.

By contrast the current fit and proper tests seem to be an additional compliance cost, for no obvious (or demonstrated) public policy benefit in safeguarding or promoting the soundness of the New Zealand financial system.

On the specific questions you pose in respect of the fit and proper tests:

- In respect of question 32, I would favour your option 2, as providing a narrower and well-defined set of types of positions being monitored/vetted.
- In respect of question 33, regarding ongoing assessment of the suitability of directors and senior officers, I do not agree that there should be any extension of the regulatory requirements. You favour a new attestation, which would seem unlikely to produce any improvement in financial system soundness (can you provide any plausible examples of people who might be left in place inappropriately without such new attestations), and which would impose a new layer of compliance costs, regulatory burdens, and legal risks. The case for additional controls in this area is simply not made in the consultative document.

Disclosure Requirements

The issues around disclosure are considerably more important than those around fit and proper tests. In fact, they go to the heart of the supervisory regime. I would, however, note that there is a simple error in paragraph 72. The statement that "because of the presence of information asymmetries some form of disclosure regime is necessary for the purposes of ensuring that banks are subject to effective market discipline". Information asymmetries do not lead automatically to a requirement for regulatory intervention (after all, information asymmetries are pervasive and exist in almost all markets), although in some circumstances regulatory requirements around disclosure may assist in reinforcing or underpinning market disclosures. In the absence of any disclosure (voluntary or compulsory), the level of activity in a particular market would be much lower than otherwise. The market response to that threat is to provide information and signals in a variety of ways.

As you know, twenty years ago the Reserve Bank moved to a system of prudential regulation of banks that was designed to rely heavily on public disclosure of key information on a regular basis. The proposition underpinning the disclosure framework was that investors (depositors, bond-holders) and others transacting with a bank should have all the information that the Reserve Bank had about a regulated bank. That seemed only fair and reasonable – after all, it was investors' money that was at stake, not the Reserve Bank's. And if the Reserve Bank had private information that was not disclosed to depositors/investors that could, in the event of a subsequent failure, open the Reserve Bank up to charges (political and rhetorical, even if not legal) that it should have acted earlier, and thus prevented the losses investors/depositors subsequently experienced. Private information might have supported the argument for government bailouts if things went wrong.

A lot of effort went in to devising the disclosure regime. Because so much weight was put on disclosure requirements, the law was written in a way that exposed those responsible for bank disclosure documents to significant penalties (including potential imprisonment) for breaches of the requirements. The prospect of such steep penalties certainly altered incentives, and behaviour. Banks may, or may not, have become safer as a result, but directors have certainly gone to considerable lengths to minimise their own risks.

In the last decade, however, as you note in the consultative document, the Reserve Bank has backed away from heavy reliance on the public disclosure aspect of the regulatory regime for banks. That in part reflected the events of the international crisis of 2008/09, which led to a much greater focus on timely liquidity and funding data - more timely than could ever be captured in the existing disclosure statement model.

The disclosure requirements have themselves been watered down, and there are now proposals for further reductions. This tendency seems unfortunate (and despite the inevitable complaints from banks about compliance costs). If anything, the focus globally in recent decades has been on more and more disclosure. Perhaps more concerning is the explicit shift the Reserve Bank has made to collecting private information about banks' day-to-day activities and risks, information which is not available to investors and depositors. The Reserve Bank has been keen to promote the idea of its OBR tool being used in the event of a bank failure, so it remains the case that the regime is designed to be about depositors/investors being primarily at risk of losing money, not the Crown. And yet the Crown uses statutory powers to acquire information about these regulated institutions which depositors do not typically have access to.

There is, as a result, a growing gap - and a major inconsistency - in the system. The disclosure requirements were presumably designed to reflect the information the Reserve Bank thought was required, by depositors/creditors and by it, to shed light on the soundness of particular institutions and, by extension, of the system as a whole. And yet, in the consultative document, the Bank now says that "we continue to check disclosure statements for compliance purposes, but our use of disclosure statements for supervisory purposes is considerably less, and is declining over time. If the disclosure documents contain useful information it should be useful to supervisors and to depositors/creditors. If it is not useful to supervisors, it suggests that the wrong information is being put in the hands of creditors/depositors. If so, that should be remedied.

In the consultative document, the Reserve Bank canvasses the possibility of further reducing the amount of information made public, while potentially further increasing the amount of private information the Reserve Bank itself obtains from banks. That seems a wrong-headed approach, and quite inconsistent with the desire to promote (a) market discipline and (b) an expectation that government bailouts are not the option of first resort if a bank runs into difficulty. If the Reserve Bank has revealing private information not available to depositors, and the Bank subsequently fails, why would a reasonable small depositor not argue with some force that the responsibility for her loss of money rested, proximately, with the Reserve Bank? Such arguments, correct or not in some narrow economic sense, will strengthen the (already high) likelihood of government bailouts.

My alternative proposal is to reshape disclosure requirements so that depositors and creditors are given the same information that the Reserve Bank considers necessary for it to be able to monitor the health, and emerging risks, in individual banks.

In other words, scrap the existing disclosure requirements completely (which would, no doubt, materially reduce compliance costs), and require instead that all regulatory returns that banks provide to the Reserve Bank be published on the relevant bank's website within, say, an hour of the information being sent to the Reserve Bank. If the private information is valuable to the Reserve Bank it would also be valuable (at least in principle) to depositors/creditors and those in the private sector monitoring banks on their behalf. It is, after all , the money of the depositors and creditors that is at stake, not that of the government or the Reserve Bank. And private readers have rather more incentive to use the information well than officials at the Reserve Bank do (however able or well-intentioned the latter may be).

Moving in the direction discussed just above would, of course, represent a substantial change in approach. Timely statistical returns of the sort banks supply to the Reserve Bank can't first go through a full audit sign-off and director attestation, but the Reserve Bank itself - by its own revealed preferences - clearly thinks that in terms of knowing what is going on on a timely basis, those protections are less important than getting timely information. If things are very timely there will almost inevitably be the occasional error, but that is not an argument against the idea. After all, even Statistics New Zealand (perhaps even the Reserve Bank) occasionally finds mistakes in its data. The concern shouldn't be errors - people are human and will err - but about the risk of being deceived. But adequate protections against deliberate attempts to deceive either the Reserve Bank or creditors (by deliberately supplying erroneous or misleading information) surely either already exist in statute or common law, or could be legislated separately. And the fact that the Reserve Bank's own analysts would be reliant on the same data that were going public would provide an additional layer of comfort - since the Bank is readily able to ask, and require answers to, probing follow-up questions.

If we were to go down this route, I would have no particular problem with an additional requirement to keep something like the current disclosure statements on a six-monthly basis (attestations and all), as some sort of compilation document, although it is difficult to be sure quite what would be gained by such a document. There might be more of a case for reinstating a (web only) Key Information Summary, which would not replace the timely data, but would provide a reasonable reference point for the ordinary lay depositor.

I am also not suggesting an absolutist approach to this issue. I have no problem with the answers to ad hoc inquiries by the Reserve Bank of an individual bank not being published. And in times when an individual institution may be approaching crisis, there probably inevitably needs to be a degree of confidentiality around the handling of that detailed information involved in crisis management (although such material should probably still be discoverable after the event). Indeed, protecting that sort of information was a part of the justification for the (now abused) section 105 secrecy provisions in the Reserve Bank Act. There is no foolproof dividing line, but I would suggest as a starting point that any statistical returns which are (a) regular, and (b) required of all (or a significant subset of) banks should be subject to my immediate disclosure rule. And perhaps the Reserve Bank Board could offer an attestation in its Annual Report that it has satisfied itself that staff and management are operating the system in a way that ensures all regular supervisory information is being made available to depositors and other creditors.

Yours faithfully

Michael Reddell