Resilience as a pathway to Prosperity

A speech delivered to FSC24 Conference in Auckland on 5 September 2024
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With special thanks to Chris Hunt, Patrick Carvalho and Kerry Watt

Reserve Bank of New Zealand
Te Pūtea Matua

Introduction

E nga mana, e nga reo. E nga karanga maha o te wa.

Tihei mauri ora!

(To all authorities, all voices, to the many chiefs gathered here. Behold the breath of life!)

E nga rangatira

Karanga mai

Mihi mai

Whakatau mai

Tena koutou katoa

(Thank you to the leadership of the Financial Services Council Conference who have called us here; who have welcomed us here; who have looked after us here. Thank you very much)

I want to acknowledge the recent passing of The Māori King, Kiingi Tuheitia Pootatau Te Wherowhero VII. Kiingi Tuheitia has been instrumental in advocating for Māori in uniting people through kotahitanga and will be sorely missed. I also want to thank him for his collaboration with Te Pūtea Matua on the history of Māori banking. I send my aroha to his whānau during this time.

It is a pleasure to speak to you today at the annual Financial Services Council Conference.

This is my third time joining you since becoming Deputy Governor and General Manager of Financial Stability. Thank you for continuing to invite me back! It is always a pleasure to discuss with you what's next for the Reserve Bank of New Zealand, Te Pūtea Matua.

The theme of this year's conference is Consumer Resilience and Prosperity.

Today I'd like to pick up this theme by discussing the role of the Reserve Bank as a central bank and prudential regulator, and how we think about financial stability.

In particular, I'll talk about three things.

- First, how we focus on the resilience of the financial system as a pathway to enabling a productive and sustainable economy, and ultimately prosperity and wellbeing.
- Second, how we do this while also having regard to other important enabling features of the financial system, including competition, innovation, efficiency and inclusion.
- Third, how this all comes together in our Strategic Themes, mirroring those of the Council of Financial Regulators (CoFR)[1].

[1] Council of Financial Regulators. (n.d.). *Kaunihera Kaiwhakarite Ahumoni*. Council of Financial Regulators. https://www.cofr.govt.nz/

We do this all in the context of being part of the international financial system, where trust and confidence is built by following international best practice as a modern prudential regulator.[2]

The rationale of public policy in the financial system

Central banks have been in the business of financial stability for centuries.

Maintaining financial stability was one of the key motivations for the establishment of the Riksbank in Sweden as the first central bank in 1642, and the Bank of England shortly after. At the Reserve Bank of New Zealand, we've been in the business of financial stability since we were founded 90 years ago, and more formally as a prudential regulator since the 1980s.

It is important to step back and briefly remind ourselves why a public policy institution, such as Te Pūtea Matua, is tasked with the responsibility for ensuring financial stability. The role of the financial system is to enable saving and spending to be managed over time and through different states of the world. The financial system plays a crucial role in allocating economic resources and managing risks. Businesses, households and communities rely on a well-functioning financial system to live their lives and engage in society.

A sound and well-functioning financial system—encompassing markets, institutions, and payment systems—serves as a public good, much like physical infrastructures such as transport, energy, water, and communications, which benefit society broadly beyond individual users

At the same time, we know that financial systems can be inherently fragile and vulnerable.

Financial risks are not always adequately identified, priced, or allocated to those best placed to manage them. This is illustrated by plenty of examples through history of herd behaviour and irrational exuberance. In addition, the financial system is highly interconnected, meaning a failure in one part can quickly spread and endanger the wider system as a whole.

The Global Financial Crisis (GFC) occurred 17 years ago. For some of you in this room, the impact might feel distant or unfamiliar, while those of us who experienced it firsthand may find our memories fading. It is important to remember that the costs of financial instability can be felt far beyond the management, shareholders or customers of individual financial institutions. Again, history is littered with examples of financial crises that have caused widespread damage to the broader economy and society.

The fiscal cost of cleaning up a financial crisis is substantial. Global studies estimate that the fiscal burden can range from 5-10% of GDP. For the New Zealand context, this translates to about $20-40bn. And that's before you count the costs of lost economic activity and the costs to society of prolonged high unemployment. It is easy to lose sight of the human impact behind these figures – people's jobs, incomes, savings and retirement funds are all at stake. This is why our key financial stability legislation for banks is called the Deposit Takers Act – its primary goal is to protect depositors, who are individuals like you and me.

[2] Hawkesby, C. (2022, September 22). *Our transformation as a prudential regulator*. Reserve Bank of New Zealand. https://www.rbnz.govt.nz/hub/publications/speech/2022/speech2022-09-22

Defining financial stability

What do we mean by "financial stability"?

It's not enough to say that financial stability is the absence of financial instability.

Even in the absence of a financial crisis, we know from experience that large imbalances and vulnerabilities can develop during periods of apparent calm, sowing the seeds of bigger troubles further down the track.

Equating stability with the absence of instability is a bit like saying that peace is the absence of war. Again, this is too simple. In practice, we know that enduring peace and prosperity involves many preconditions, like strong relationships with neighbouring countries, common rules, treaties and trade agreements, acceptance of international law, and much more.

To understand what financial stability means for New Zealand, we need to start by looking at the pieces of legislation that underpin the Reserve Bank's responsibility for financial stability.[3] More specifically, the Purposes, Objectives and Principles we need to follow along the way (see appendix A).

This is an exercise that many central banks and prudential regulators overseas have undertaken over the years, distilling their legislation, frameworks and approaches down into a succinct definition of what financial stability means to them (see Appendix B).

Recently we've undertaken a similar thought exercise, in part in response to our new legislative underpinnings, to build a common understanding of our role and approach to decision-making on financial stability and practically setting prudential policy.

I'd like to share some of that thinking with you today.

- *A stable financial system is one where resilient financial markets, institutions and infrastructures enable a productive and sustainable economy, and ultimately prosperity and wellbeing.*

In my view, this simple way to describe financial stability has several desirable features.

1. *Outcome focused.* This definition is outcome-focused, aligning with our overarching statutory purpose in the Reserve Bank Act (2021) to "promote the prosperity and well-being of all New Zealanders and contribute to a sustainable and productive economy".

2. *Pre-condition.* It acknowledges that a resilient financial system is a precondition to achieving the broader desired outcomes for New Zealand. Our principal contribution to achieving these outcomes is through the provision of a resilient system.

3. *Dynamic.* The concept suggests resilience is dynamic, meaning that a stable financial system should not only absorb shocks but also anticipate, prepare for, recover from, and learn from

[3] RBNZ Act (2021), the Deposit Takers Act (2023), the Banking (Prudential Supervision) Act 1989, the Non-bank Deposit Takers Act (2013), the Insurance (Prudential Supervision) Act (2010), and the Financial Market Infrastructures Act (2021).

them. Furthermore, our approach needs to serve both the current financial system, and how it might evolve in the future.

4. *Enabling*. Finally, this definition acknowledges that a truly resilient financial system must perform its functions effectively and reliably. Such a system ensures that people can save their money, handle everyday transactions, access credit for both consumption and investment and insure against risks. But it must also do so efficiently and in an inclusive manner in part driven by competition and innovation. I will return to these concepts in a minute, but meeting these conditions will foster public trust and confidence in the system and the economy as a whole.

While this definition for financial stability has been put together in a New Zealand context, it bears a striking resemblance to the efforts of prudential regulators in other countries.

That shouldn't come as a surprise, as we all operate collectively as part of the international financial system. At the Bank for International Settlements (BIS) in Basel global standards are set for prudential regulators. And the International Monetary Fund (IMF) review the capability and capacity of countries to meet these standards and approaches through their 10 yearly Financial System Assessment Programmes (FSAPs). Within these organisations and globally there is recognition that financial stability is not an end in itself but one of the best tools for supporting growth and prosperity.

The Financial Stability Frontier

While a resilient financial system needs to be at the centre of our efforts as a prudential regulator, our definition importantly recognises that resilience alone will not enable a pathway to prosperity and wellbeing. While stability is a necessary precondition, other important enablers include having a financial system that is:

- competitive,
- innovative,
- efficient[4] and
- inclusive.

These all directly or indirectly feature in our legislation and the Financial Policy Remit from the Minister of Finance (Appendix C). So, while resilience is our primary objective and underpins our contribution to financial stability, we must also consider these other factors whenever we make financial policy decisions.

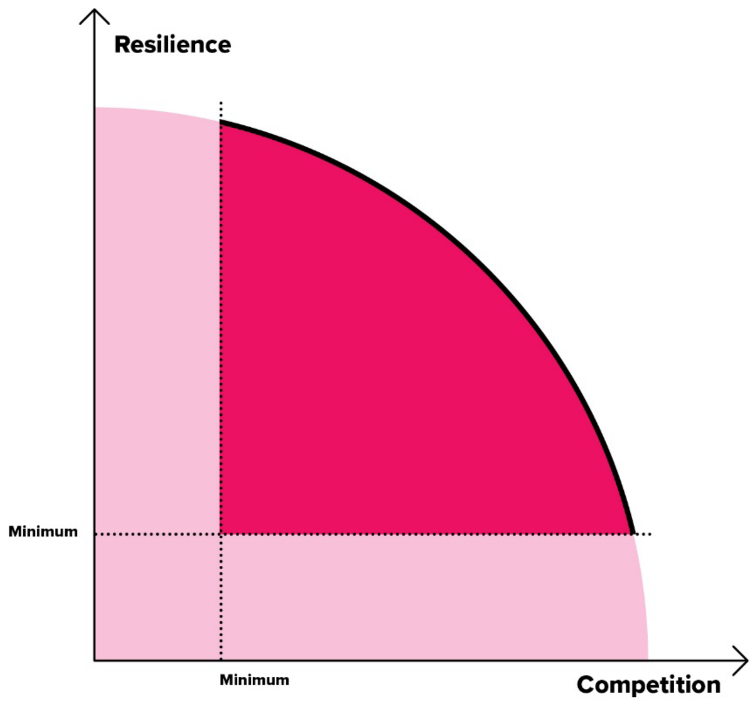
Sometimes a policy decision that improves the resilience of the financial system may also improve competition, innovation, efficiency or inclusion. At other times, there may be a trade-off between resilience and these other factors, especially over the short-term.

[4] Reserve Bank of New Zealand. (2011). Understanding financial system efficiency in New Zealand. *Reserve Bank of New Zealand Bulletin, 74*(2), 1-10. https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Bulletins/2011/2011jun74-2.pdf

Today, I want to introduce the concept of a 'Financial Stability Frontier' to demonstrate how we weigh up financial policy choices and how they affect these important enablers of the financial system.[5]

For illustrative purposes, I'll just keep it to just two dimensions of weighing up the resilience of the financial system with the amount of competition in the financial system. However, this is a concept that could equally be illustrated weighing up resilience with any one of innovation, efficiency or inclusion.

Figure 1. Financial Stability Frontier



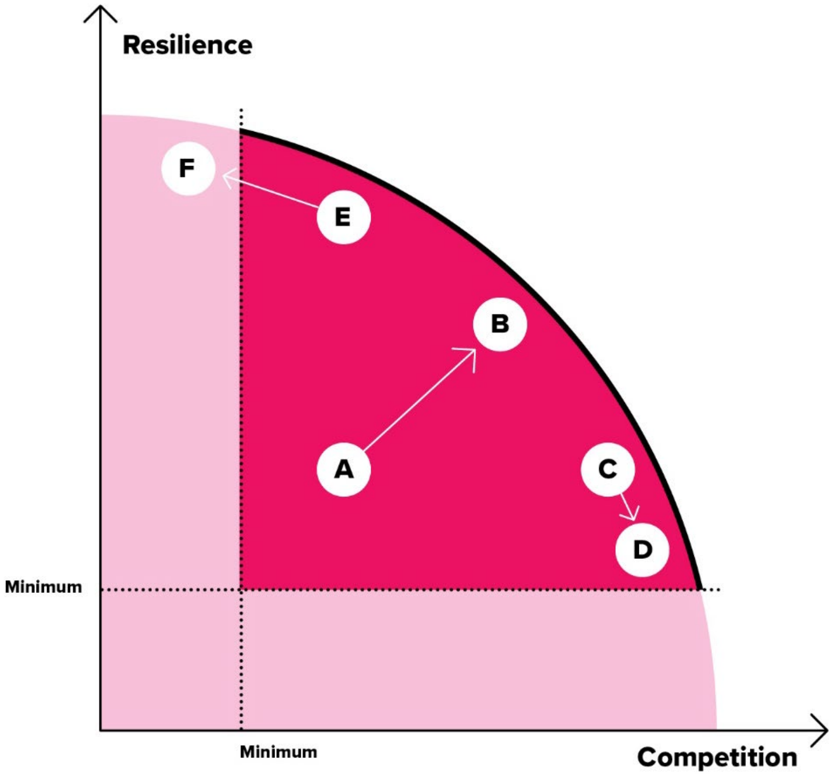
Let me step you through the idea.

- On the Financial Stability Frontier, resilience and competition are shown on the Y axis (vertical) and X axis (horizontal) respectively.
- Both resilience and competition are enablers of a productive and sustainable economy, and so we prefer to have both factors. In other words, outcomes in the top right-hand side of the diagram are better and outcomes at the bottom left-hand side are worse.
- The shaded area represents all the possible combinations of resilience and competition that can come about from our choices of financial policy settings.

[5] Students of economics will recognise its parallels with a Production Possibility Frontier, but don't let that be a barrier to others

- The dotted lines represent the minimal levels of acceptable resilience and competition respectively. Below these levels are not acceptable setting for our financial policy decisions (these can be thought of as something akin to risks appetites).
- The thick dark line represents the Financial Stability Frontier, which are the limits of what our financial policy can achieve. When on the Financial Stability Frontier, gaining either more resilience or more competition involves a trade-off of accepting a lower amount of the other.

Figure 2. Financial Stability Frontier



The Financial Stability Frontier diagram then helps illustrate how different financial policy setting weigh up against each other. For example,

- Moving from point A to point B is a situation where our financial policy improves resilience and competition. There is no trade off from this policy choice.
- Moving from point C to point D involves giving up a lot of resilience in the financial system for a small amount of additional competition, which may be considered an unattractive trade-off to accept.
- Moving from point E to point F involves gaining a small amount of additional resilience in the financial system but results in an unacceptably low amount of competition.

While this is a conceptual framework, it is a powerful discipline to be transparent and communicate how our financial policy decisions affect the important enablers of the financial system, and how we have weighed up these considerations. It's a process that is more art than science. However, talking to my counterparts in foreign central banks and prudential regulators, this is a framework that we all carry around in our heads.

Furthermore, our public consultations are designed to gather evidence and information on these dimensions, to support our analysis of the costs and benefits, and to share this in regulatory impact statements. All of this contributes ultimately to sound and transparent policymaking consistent with our mandate.

To bring this more to life, I want to touch on some practical examples.

- *Capital Review*. In 2019 we concluded the review of prudential capital requirements for banks. A key feature of this review was to lift capital requirements to strengthen the resilience of the financial system. At the same time, we amended a number of capital rules to reduce the gap between capital requirements for large banks and other banks. As a result, the Capital Review both increased resilience and took steps to improve the landscape for competiton.
- *Mutual capital instruments*. One unresolved issue from the Capital Review was a request for a capital instrument for mutual banks which could qualify as tier 1 capital (without this, mutual banks are limited in their options to raise tier 1 capital due to their mutual structure). Last year we decided to establish new mutual capital instrument rules which will help provide new capital raising options for these banks. Again, this will help to support both resilience and competition.
- *Māori Access to Capital.* Following the Māori Economy Report (2018)[6], we have been working with the banking industry and other government agencies to remove barriers to access capital, especially around the treatment of collectively owned land. Through deepening their understanding of our prudential frameworks, financial institutions have been able to develop more innovative ways to manage the risk of lending against Māori land. As a result, we have been able to achieve a similar amount of resilience in the financial system, while enhancing innovation and expanding inclusion in the financial system.
- *Macroprudential tools*. Earlier this year we activated a new macroprudential tool, Debt-to-Income (DTI) restrictions, as a guardrail to reduce boom-bust cycles in mortgage lending and asset prices. Having both DTI restrictions and the existing Loan-to-Value (LVR) restrictions meant that we could better focus each tool on the risk it was designed to manage. Activating the DTI tool enabled us to ease the LVR settings, resulting in more efficient use of these tools while retaining a similar amount of system resilience.
- *Deposit Takers Act*. Finally, we are currently consulting on prudential standards under the new Deposit Takers Act, including how to apply the new Proportionality Framework. Under the Proportionality Framework, we can set different prudential requirements for different groups of deposit takers determined by their size and nature of business. This provides us with scope to ensure these different groups have a minimum level of resilience appropriate for their characteristics, while have also having regard for how our decisions can influence competition, innovation, efficiency and inclusion. A practical example is that we are consulting on the

[6] Reserve Bank of New Zealand. (2018). *Te Ōhanga Māori – The Māori economy 2018*. Reserve Bank of New Zealand. https://www.rbnz.govt.nz/hub/research/additional-research/te-ohanga-maori---the-maori-economy-2018

minimum amount of capital to hold as a deposit taker, which is a potential barrier to new entrants.

Our strategic themes 2030

Those are just a few examples from our role as a prudential regulator.

However, many of these same principles apply more broadly to our role as a central bank, particularly as we seek to adapt to our changing economy and society. This work includes enhancing the cash system, exploring the launch of a central bank digital currency (CBDC), and considering whether to open access to settlement accounts more widely to non-bank deposit takers and other Fintechs.

Of course, these enabling characteristics of the financial system do not exist in isolation of each other. For example, a competitive and efficient financial system cannot exist in a sustainable way in the absence of resilience. These features of a well-functioning financial system all interact and enable each other over a long-term horizon.

Reflecting this, in pursuing our operational objectives as a central bank and prudential regulator, our strategic themes highlight these areas of focus, as we look to the future and our contribution to a productive and sustainable economy. As outlined in our Statement of Intent[7], our strategic themes are:

- Promoting trust and confidence,
- Improving resilience,
- Strengthening efficiency and competition,
- Increasing participation in the financial system,
- Leveraging data, information and technology,
- Putting people front and centre.

[7] Reserve Bank of New Zealand. (2024). *Statement of intent 2024–2028*. Reserve Bank of New Zealand. https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/publications/statements-of-intent/statement-of-intent-2024---2028.pdf

Figure 3. Our operational objectives and strategic themes

In New Zealand, our regulators of the financial system come together as the Council of Financial Regulators (CoFR), each with distinct and connected responsibilities.

These strategic themes mirror those of our colleagues on CoFR. Our outcomes focused and enabling definition of financial stability requires us to work closely with our regulatory counterparts. The Financial Markets Authority for conduct, the Commerce Commission for competition, and the Reserve Bank for financial stability.

Strikingly, in our engagements with Boards and executive teams of regulated entities, these strategic themes resonate with what they too are seeking to achieve. It is a reminder that we are all in this together. It is a reminder that when we lift up from the day-to-day challenges in the financial services industry, we all want a financial system that ultimately contributes to the prosperity of all New Zealanders.

Conclusion

Thank you again for the invitation to speak with you today at the annual Financial Services Council Conference.

And congratulations for the choice of Consumer Resilience and Prosperity as one of your themes. It is a theme that is close to my heart as a central banker and prudential regulator.

For you, the resilience of your customers, the consumers of New Zealand, is a pathway to their prosperity. For the Reserve Bank, resilience of the financial system is a pathway to enabling a productive and sustainable economy, and ultimately the prosperity of all New Zealanders.

Standing here today, I am reminded that achieving all this is a collective effort. For all New Zealanders to thrive, we must work together. I look forward to your engagement and insights.

I am also reminded of a whakatauki;

Nō reira

Nau te rourou, naku te rourou, ka ora ai te iwi.

With our contribution, and your contribution, the people will prosper.

Tēnā koutou, tēnā koutou, tēnā tatou katoa.

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Appendices

Appendix A - The Purposes, Objectives and Principles we need to follow along our way

Reserve Bank of New Zealand Act 2021

Purposes

The purposes of this Act are to—

(a) provide for the continuation of the Reserve Bank of New Zealand; and

(b) promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy.

Bank's objectives

1. The Bank's main objectives are—

Economic objective

   a. the economic objective of achieving and maintaining stability in the general level of prices over the medium term; and

Financial stability objective

   b. the financial stability objective of protecting and promoting the stability of New Zealand's financial system; and

Central bank objective

   c. otherwise acting as New Zealand's central bank in a way that furthers the purposes of this Act.

Deposit Takers Act 2023

Purposes

1. The main purpose of this Act is to promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy by protecting and promoting the stability of the financial system.
2. To that end, this Act has the following additional purposes:
   a. to promote the safety and soundness of each deposit taker:
   b. to promote public confidence in the financial system:

c. to the extent not inconsistent with subsection (1) and paragraphs (a), (b), and (d), to support New Zealanders having reasonable access to financial products and services provided by the deposit-taking sector:

d. to avoid or mitigate the adverse effects of the following risks:

ii. risks to the stability of the financial system:

iii. risks from the financial system that may damage the broader economy.

Insurance (Prudential Supervision) Act 2010

Purposes

1. The purposes of this Act are to—

    a. promote the maintenance of a sound and efficient insurance sector; and

    b. promote public confidence in the insurance sector.

2. Those purposes are achieved by—

    a. establishing a system for licensing insurers; and

    b. imposing prudential requirements on insurers; and

    c. providing for the supervision by the Reserve Bank of New Zealand (the Bank) of compliance with those requirements; and

    d. conferring certain powers on the Bank to act in respect of insurers in financial distress or other difficulties.

Financial Market Infrastructures Act 2021

Purposes

1. The purposes of this Act are to—

    a. promote the maintenance of a sound and efficient financial system (including by responding to threats to the stability of, or confidence in, the whole or a significant part of the financial system); and

    b. avoid significant damage to the financial system that could result from problems with an FMI, an operator of an FMI, or a participant of an FMI that threaten the stability of, or confidence in, the whole or a significant part of the financial system; and

    c. promote the confident and informed participation of businesses, investors, and consumers in the financial markets; and

    d. promote and facilitate the development of fair, efficient, and transparent financial markets.

2. Those purposes are to be achieved by—

    a. establishing a system for designating systemically important FMIs and FMIs that apply for designation; and

    b. imposing regulatory requirements on designated FMIs; and

    c. providing for the supervision of compliance with those requirements by the Reserve Bank of New Zealand and the Financial Markets Authority (acting as the regulator); and

    d. conferring certain powers on the regulator to gather information; and

    e. conferring certain powers on the regulator to act in respect of distressed FMIs.

3. *See* also section 77 (which sets out the purposes for which the regulator's powers under Part 4 may be exercised).

Appendix B – Definitions of Financial Stability across the world

- Bank of Korea
  - "Financial stability can be defined as 'a condition in which the financial system is not unstable'. It can also mean a condition in which the three components of the financial system—financial institutions, financial markets, and financial infrastructure—are stable."
- Europe Central Bank (ECB)
  - "Financial stability can be defined as a condition in which the financial system—which comprises financial intermediaries, markets, and market infrastructures—is capable of withstanding shocks and the unravelling of financial imbalances."
- Federal Reserve
  - "A financial system is considered stable when its markets and institutions—including banks, savings and loans, and other financial product and service providers—are resilient and able to function even following a bad shock."
- Bank of England (in line with the UK Prudential Regulation Authority)
  - "A stable financial system is one that has sufficient resilience to be able to facilitate and supply vital services by financial institutions, markets and market infrastructure to households and businesses, in a manner that absorbs rather than amplifies shocks."
- Reserve Bank of Australia (in line with the Australia's Council of Financial Regulators)
  - "A stable financial system is one in which financial intermediaries, markets and market infrastructure facilitate the smooth flow of funds between savers and investors and, by doing so, help promote growth in economic activity."
- Swiss National Bank
  - "Financial stability is a key prerequisite for the functioning of a national economy and for the effective implementation of monetary policy. A stable financial system can be defined as a system whose individual components—financial intermediaries and the financial market infrastructure—fulfil their respective functions and prove resistant to potential shocks."
- Bank of Japan
  - "Financial system stability refers to a state in which the financial system functions properly, and participants, such as firms and individuals, have confidence in the system."
- Deutsch Bundesbank
  - "A stable financial system fulfils its central macroeconomic functions smoothly and at all times. This embraces, in particular, the efficient allocation of financial resources and risks as well as the provision of an efficient and secure financial infrastructure."
- Monetary Authority of Singapore

  - "MAS seeks [financial stability] to reduce the risk and impact of a failure. … Promoting a stable system…requires MAS to meet the other five objectives [safe and sound financial intermediaries; safe and efficient financial infrastructure; fair, efficient and transparent organised markets; transparent and fair-dealing intermediaries and offerors; and well-informed and empowered consumers.]"
- World Bank
  - "A stable financial system is capable of efficiently allocating resources, assessing, and managing financial risks, maintaining employment levels close to the economy's natural rate, and eliminating relative price movements of real or financial assets that will affect monetary stability or employment levels."
- The IMF (Working Paper No. 2004/187)
  - "A financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events."

Appendix C - Financial Policy Remit from the Minister of Finance 2022

Financial Policy Remit

Purpose

This Financial Policy Remit is issued by the Minister of Finance under section 203 of the Reserve Bank of New Zealand Act 2021 (the Act).

The Financial Policy Remit provides for matters that are desirable for the Reserve Bank to have regard to in relation to one or more of the following, in accordance with section 204(1) of the Act

- Achieving the financial stability objective
- Acting in a way that furthers the objectives or purposes of the prudential legislation
- Acting as a prudential regulator and supervisor under the prudential legislation.

The Reserve Bank Board must have regard to the Financial Policy Remit when acting in relation to prudential strategic intentions and standards, as set out in section 49 of the Act.

Matters specified in accordance with section 204(1)

Protecting and promoting financial stability can have implications for the Government's broader policy objectives and the wider economy. It is desirable for the Reserve Bank to have regard to the following matters.

The Government's desired outcomes for the financial system

It is desirable to have a financial system that is strong, efficient and inclusive, with a low incidence of failure of entities regulated by the Reserve Bank.

Within the appetite of a low incidence of failure, a competitive financial system should be encouraged so as to best ensure ongoing financial efficiency and inclusion. In this respect, the Reserve Bank should have regard to the benefits of:

- imposing regulatory and supervisory costs that are proportionate to the expected risks and benefits to the financial system and society;
- encouraging new investment and financial innovation that raise the productive potential of the economy; and
- encouraging the allocation of financial resources in a way that maximises the sustainable long-term growth of the New Zealand economy.

If a regulated entity does fail, the Reserve Bank is expected to manage the failure in a manner that minimises the costs of failure and disruption to the broader economy, and prioritises protections for vulnerable consumers, depositors and public funds.

Other Government policy priorities

The Minister also considers it is desirable for the Reserve Bank to have regard to the following matters.

<u>Housing</u>

The Government has a policy objective to support more sustainable house prices, including by dampening investor demand, which would improve affordability for first home buyers. This is part of the broader Government Policy Statement on Housing and Urban Development, which provides a vision that everyone in Aotearoa New Zealand lives in a home and within a community that meets their needs and aspirations.

<u>Climate change</u>

The Government has a priority of building resilience and facilitating adaptation of New Zealand's economy, society and environment to climate change. It is important that the financial system continues to play an appropriate role in supporting community wellbeing and resilience as it responds to that transition and increases in underlying risks as a result of climate change.

<u>Financial inclusion</u>

The Government has a priority of improving financial inclusion and maintaining financial sector diversity, including supporting access to finance and financial services for those who are less well-served by traditional institutions, including rural communities, disabled persons, low-income individuals, and small businesses.

<u>Cyber resilience</u>

The Government has a priority of improving New Zealand's cyber resilience, with a vision that New Zealand is confident and secure in the digital world. In light of evolving cyber risks, it is important that the public and private sector work closely together to achieve this objective.

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