Asian Shadow Financial Regulatory Committee

Lessons from the New Zealand Model of Market-Based Financial Regulation

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The New Zealand model of market-based financial regulation is widely regarded as an innovative approach to financial regulation. The underlying philosophy of this model relies on three pillars of discipline:

(i) self-discipline by banks in the management of their risks, primarily by reinforcing the role of directors in taking ultimate responsibility for the performance of banks;
(ii) market discipline based on a policy of disclosure in tandem with a policy of not bailing out failed institutions; and
(iii) a regulatory discipline that is focused on financial stability rather than depositor protection and implemented with adequate capital requirements and less intrusive supervisory requirements.

In a market-based regulatory approach, depositors and other creditors are not insulated from bank losses. They thus have an incentive to monitor banks, and banks are required to disclose relevant information about their financial and operating conditions. Ideally, for market discipline based on full information disclosure to work, there should be neither explicit nor implicit deposit insurance. Strengthened internal governance of banks and minimum supervisory requirements also represent desirable ingredients of market-based financial regulation.

In New Zealand, considerable emphasis has been placed on self-discipline by banks in risk management, primarily by holding directors personally liable for the performance of banks under their stewardship. The responsibility of directors is widely recognized to have led to much improved corporate governance practice of banks even before the introduction of the U.S. Sarbanes-Oxley Act of 2002. Banks have become more conservative in their risk taking and this has reduced systemic risk in the financial system. Disclosure of a bank's condition has allowed banks to better monitor each other, enhancing competition and efficiency through peer pressure. Disclosure-based regulation has allowed market regulators to take an arm's length approach to bank regulation, which has reduced the costs of compliance and enforcement. Moreover, it has contributed to the lowering of entry barriers to the banking industry, and consequently, leveled the playing field. More information disclosure and lower entry barriers contrast sharply with practices in many Asian countries, where authorities are reluctant to reveal sensitive information about a bank's condition to the public for fear that this might induce bank runs, and to fully open the banking industry to foreign players for fear that this might result in the significant presence of foreign banks.

Although market-based regulation is intellectually appealing, the New Zealand model may not be fully applicable in other countries. This is mainly because having no protection for small depositors is politically infeasible in many countries in Asia. Nonetheless, market discipline on a limited extent could be promoted by explicitly making large depositors and other creditors open to bank losses, which currently is not the case in many Asian countries.

In conclusion, the New Zealand model of market-based financial regulation has positive aspects that can be considered by other countries in Asia. In particular, self-discipline in corporate governance by making directors take ultimate responsibility for the risk management as well an information disclosure is invaluable and should be adopted. Disclosure-based market discipline exerted by large depositors and other creditors could also be promoted. For self-discipline and market discipline to be effective, however, a well-functioning institutional infrastructure, such as the legal and accounting systems, credit rating and securities analysis, media, etc., must be in place. Asian countries lacking such an infrastructure thus need to put more effort to attain it.