SPEECH

Corporate governance in the financial sector

An address by Dr Alan Bollard, Governor, Reserve Bank of New Zealand to the annual meeting of the Institute of Directors in New Zealand, Christchurch on 7 April 2003

Corporate governance is now a topic of considerable interest to a large and expanding cross-section of the community. It is obviously of fundamental importance to this audience, given that most of you are company directors. It is also of interest to the Reserve Bank, in its capacity as supervisor of the banking system. In this speech, I will discuss a number of themes relating to corporate governance, with particular emphasis on the important role it plays in promoting a sound financial system.

Until fairly recently, corporate governance was not a topic that attracted much public attention. It was a topic reserved for discussion in the Board room or in academic environments. However, recent events, such as the Enron scandal and other corporate governance failures, have put corporate governance on the front pages of our main newspapers. Although none of us welcomes this kind of adverse publicity, it has nonetheless had beneficial effects. In particular, it has highlighted the important role that corporate governance plays in a modern economy and the consequences of getting it wrong. And it has strengthened the incentives for directors and policy-makers alike to reassess the structures needed to produce high quality corporate governance.

In this address, I present a central banker's perspectives on a number of corporate governance issues. In particular, I will:

- comment on the role that corporate governance plays in the financial system and wider economy, and why it is important for economic growth and financial stability;
- highlight what I would regard as the key elements of sound corporate governance; and
- discuss the role that corporate governance plays in the Reserve Bank's approach to banking supervision.

Before traversing these subjects, I think it would be useful to begin by defining what I mean by corporate governance. In this address, I am deliberately using the term quite broadly to encompass the systems and structures that a corporate entity has in place to oversee its affairs. This involves a number of elements, including a clear understanding by directors of their company's strategic objectives, structures to ensure that the objectives are being met, systems to ensure the effective management of risks, and the mechanisms to ensure that the company's obligations are identified and discharged. Although corporate governance involves many systems and structures, the heart of it lies in the boardroom - a point I hardly need to stress with this audience.

It is self evident that sound corporate governance is essential to the wellbeing of an individual company and its stakeholders, particularly its shareholders and creditors. We need only remind ourselves of the many companies, both at home and abroad, whose financial difficulties and, in some cases, ultimate demise have been substantially attributable to weak corporate governance. But sound corporate governance is not just a vital factor at the level of the individual corporation. It is also a critical ingredient in maintaining a sound financial system and a robust economy. And that is why governments have taken such an interest in recent examples of corporate governance failures. It is also why banking supervisors are placing greater emphasis on the role that corporate governance can play in promoting financial stability.

In the financial system, corporate governance is one of the key factors that determine the health of the system and its ability to survive economic shocks. The health of the financial system much depends on the underlying soundness of its individual components and the connections between them - such as the banks, the non-bank financial institutions and the payment systems. In turn, their soundness largely depends on their capacity to identify, measure, monitor and control their risks.

In New Zealand, the two core components of the financial system are the registered banks - which represent the vast bulk of financial system assets - and the payment system - which processes billions of dollars of transactions each day.

Banks face a wide range of complex risks in their day-to-day business, including risks relating to credit, liquidity, exposure concentration, interest rates, exchange rates, settlement, and internal operations. The nature of banks' business - particularly the maturity mismatch between their assets and liabilities, their relatively high gearing and their reliance on creditor confidence - creates particular vulnerabilities. The consequences of mismanaging their risks can be severe indeed - not only for the individual bank, but also for the system as a whole. This reflects the fact that the failure of one bank can rapidly affect another through inter-institutional exposures and confidence effects. And any prolonged and significant disruption to the financial system can have potentially severe effects on the wider economy.

The payment system is also a critical component of the financial system. It contains the pipelines that connect the banks and other financial intermediaries. And it provides the means by which vast numbers of transactions - personal and corporate, domestic and overseas - are made each day. The payment system involves many different components, including systems for settling large, inter-bank and inter-corporate payment transactions, and systems for handling myriads of smaller transactions, such as cheques, credit cards, direct debits and EFTPOS. Each system is managed by a payment operator. Some are private companies owned by the banks, while others are under the management of the Reserve Bank. Although these operators do not face risks of the nature that banks face - such as credit risk, for example - they do have major operational risks. In particular, they need to ensure that the systems for processing payments, the back-up arrangements, and the internal governance structures are robust. A major operational failure in the payment system has the potential to cause severe disruption to the financial system and wider economy. At its worst, a major payment system failure would bring countless commercial transactions to an abrupt halt, impede the operation of business in virtually all parts of the economy and fundamentally undermine investor and business confidence.

The stakes are indeed high - hence the need for banks, other financial institutions and the payment system operators to maintain systems to enable them to identify, monitor and control their risks. And sound corporate governance is the foundation for effective risk management.

Of course, corporate governance is not just an essential ingredient for financial stability. It is also a critical feature in the longer term performance of the economy. One could be forgiven for thinking otherwise, given the emphasis placed in the news media and elsewhere on the role of government in determining a country's economic performance. We frequently read and hear commentary suggesting that the key to better economic performance lies in better government policy - be it fiscal policy, monetary policy or structural reforms. To be sure, these are all important ingredients in shaping economic performance. But I believe one of the key drivers of how well or poorly our economy performs is *where* we invest our resources and *how well* we use them. By and large, the way we allocate and use our resources is not determined by policy-makers in Wellington. It is largely determined by the investment and management decisions of hundreds of companies. In turn, the quality of these investment and management decisions substantially depends on the quality of corporate governance in each company.

Therefore, corporate governance is clearly of fundamental importance, both at the level of the individual company and for the financial system and economy as a whole. Unfortunately, to the detriment of both financial stability and economic growth, we have seen too many examples of corporate governance failures over the years, both in New Zealand and in many other countries. Indeed, it is not an exaggeration to assert that many of the financial crises seen in recent years, including in Asia, Russia and Latin America, can be attributed, in no small way, to fundamental weaknesses in corporate governance and risk management.

In particular, we know that financial distress episodes in a number of emerging economies have been caused, in part, by excessive exposure concentration, directed lending, lending to connected parties, poor credit policy and inadequate management of foreign exchange risk. To a large extent, such basic risk management failures reflect a breakdown in corporate governance. They reflect poor management of conflicts of interest, inadequate understanding in the boardroom of key banking risks, and poor oversight by boards of the mechanisms for managing their banks, such as risk management systems and internal audit arrangements. In some cases, a lack of truly independent directors on the boards of banks was also a significant factor in weakening the effectiveness of boards. And we know that these problems were compounded by poor quality financial disclosures and ineffective external audit. In some cases, the rigour of the external audit process has been impaired by a lack of auditor independence, not least as a result of some audit firms performing a range of non-audit services for their clients.

Of course, these kinds of corporate governance failures are by no means unique to the financial systems of emerging economies. We have seen similar examples of corporate governance and risk management failures contributing to financial system distress in a number of advanced economies, including much of Scandinavia in the 1980s and, of course, New Zealand and Australia in the late 1980s and early 1990s. And I hardly need to draw your attention to the much more recent high profile corporate governance failures in the United States, United Kingdom and elsewhere.

In order to address these kinds of problems, and to reduce the risk of future corporate governance failures, much activity has been underway, globally and at the domestic level. The OECD has produced a set of corporate governance principles that have become the core template for assessing countries' corporate governance arrangements. Similarly, the Basel Committee on Banking Supervision - the international standard-setting body responsible for establishing international banking supervision principles - has distilled principles for corporate governance in banks. More recently, we have had the benefit of corporate governance reviews in the United Kingdom, and many are now reflecting on the implications of the recently enacted Sarbanes-Oxley legislation in the United States. Closer to home, in Australia, there has also been considerable interest in corporate governance issues, including the role of non-executive directors. And, of course, many countries have their own national codes of good corporate governance, either developed by government or by the private sector. New Zealand is no exception, with the Institute of Directors having issued a raft of very useful guidance material to directors.

There are few absolute "rights" and "wrongs" in the field of corporate governance, but some key principles stand out. In particular, let me highlight a few basic principles to which we in the Reserve Bank attach considerable importance in a banking sector context.

- First, I would particularly stress the importance of directors having a sound understanding of their company's business, the nature of its risks and its strategic direction. This provides the foundation for the sound management of any company. It is absolutely crucial in a bank.
- Second, we firmly believe that the ultimate responsibility for ensuring that a company's risks are being properly identified, monitored and controlled lies in the boardroom.
- Third, we place considerable emphasis on the importance of having an adequate representation of non-executive and independent directors on the board, and a clear separation of the position of board chairman and chief executive officer.
- Fourth, it goes without saying - but I will say it anyway - that there is a fundamental need for directors to be scrupulous in ensuring that, individually and collectively, potential conflicts of interest are avoided or at least managed in ways that do not compromise the interests of the company.
- We also stress the importance of rigorous internal and external audit arrangements - where the external auditor has a strong measure of independence and is not conflicted by having other significant financial interests in the company.
- Finally, as the Governor of a central bank that has placed strong emphasis on disclosure by registered banks, and which sets high standards on its own financial disclosures, it will not surprise you to know that we stress the importance of regular, timely, comprehensive, meaningful and reliable financial disclosures of a company's affairs.

These kinds of principles feature strongly in the Reserve Bank's approach to the supervision of banks in New Zealand. Before going on to explain our approach, and the central role that banks' corporate governance plays in our framework, it may be useful to set the scene by highlighting the key features of the New Zealand financial system. Some of them have particularly interesting implications for corporate governance.

The New Zealand banking system is relatively unusual by international standards in a number of respects. First, unlike the financial systems of many countries, in New Zealand the banks form a very dominant part of the financial sector. Registered banks, of which there are currently 18, represent the lion's share of the total financial system, both in terms of total financial system assets and deposit liabilities. In terms of financial system stability, registered banks are by far the most important players in the financial system. And of the 18 registered banks, only about 5 banks could be regarded as systemically important, together holding more than 80% of total registered bank assets.

The New Zealand banking system is also unusual in another way - the nature of its ownership. All but two of the registered banks are foreign owned, with the two New Zealand-owned banks being very small relative to the system as a whole. The foreign-owned banks operate either as subsidiaries or as branches of foreign banks, with most of the largest banks being wholly-owned subsidiaries of Australian and British banks. As I will note later in this speech, this raises particular complications for the nature of the corporate governance arrangements in these banks and raises interesting policy questions for the Reserve Bank as guardian of the financial system.

As I have indicated, a fundamental component of New Zealand's approach to the promotion of financial stability is the emphasis it places on the importance of corporate governance as a means of encouraging banks to effectively identify, monitor and manage their business risks. This approach recognises the critical role which directors have in overseeing the stewardship of their bank. Indeed, it is worth noting that the New Zealand banking supervision framework, with its heavy emphasis on encouraging sound risk management through strong corporate governance arrangements, is somewhat unusual by international standards. In most countries, the standard approach to banking supervision involves reliance on prudential regulation of banks, where a bank's risk positions are substantially constrained by regulatory limits imposed by the supervisory authority. It also typically involves some form of on-site examination of banks by the supervisors.

In contrast, the New Zealand supervisory framework quite deliberately avoids the use of prudential regulation - except in limited areas, such as minimum capital ratios and limits on lending to related parties. And the Reserve Bank does not conduct on-site examinations of banks. Our supervisory framework is deliberately light-handed in nature, in the sense that we minimise our intrusion into the management of banks' risks and the structure of their operations. Instead, we try to foster robust "self discipline" in banks through the corporate governance and disclosure frameworks we have established. That said, I should make it clear that, although the Reserve Bank does not conduct on-site examinations of banks' loans and risk management systems, we do meet annually with the senior management teams of the banks. These meetings provide an important opportunity to discuss recent developments in the respective banks, risk management, banking industry issues and other relevant matters. The meetings keep us well informed about each of the banks and the banking industry as a whole, but fall well short of the more intrusive bank examination process typical in other countries.

We also differ from many other countries by not having deposit insurance or an explicit depositor protection objective. The statutory objectives of banking supervision in New Zealand are to promote a sound and efficient financial system and to avoid damage to the financial system resulting from a bank failure. We are not charged with protecting depositors or other bank creditors per se.

We believe the New Zealand approach is an effective way of promoting a sound financial system. We also believe it reduces the moral hazard risks associated with conventional banking supervision, and strengthens the effectiveness of market discipline on banks. The fact that the New Zealand banking system is currently one of the healthiest in the world - with high asset quality, sound risk management practices and good capitalisation - bears testimony to this. However, we are certainly not complacent, and we remain ever-watchful to detect incipient signs of financial distress, and we stand ready to intervene if necessary. Moreover, we regularly review our supervisory framework to ensure that it continues to be an effective means of promoting a sound and efficient financial system. In that context, we are currently reviewing a number of our supervision policies, with a view to further improving the existing arrangements.

Although some of you will already be au fait with the mechanisms that the Reserve Bank uses to promote strong corporate governance and risk management in banks, it is probably useful for me to briefly summarise the main features. These policies include comprehensive disclosure requirements for banks, a requirement for bank directors to attest to the veracity of their bank's disclosures and to make attestations on the management of risks, and requirements in relation to the composition of the board of directors. Let me elaborate briefly on these features:

All banks in New Zealand are required to publish comprehensive financial and risk-related disclosures on a quarterly basis, including information on a bank's and banking group's:

- capital position;
- concentration of credit exposures to individual counterparties;
- related party exposures;
- asset quality and provisioning; and
- interest rate, exchange rate and equity risks.

Each disclosure statement is required to contain a number of attestations, signed by each director. These are intended to encourage directors to focus their attention on key risks within their bank and to be satisfied that these risks are being effectively managed.

Directors of each registered bank are required to attest that the bank has systems in place to monitor and control adequately the banking group's material risks and whether those systems are being properly applied at all times. The directors are also required to attest that all prudential requirements applicable to the bank in question are being complied with, such as requirements relating to minimum capital adequacy and exposures to related parties. And the directors are required to confirm that exposures to related parties are in the best interests of the banking group.

Each bank director is required to sign their bank's disclosure statement and to certify that disclosures made are not false or misleading. If a disclosure statement is found to be false or misleading, directors are subject to potentially severe legal penalties, including substantial fines and imprisonment. In addition, directors may face unlimited personal liability for creditors' losses where creditors relied on a bank's disclosure statement that was false or misleading.

Banks incorporated in New Zealand are required to have a minimum of two independent directors, who must also be independent of any parent company or other related parties, and a non-executive chairperson. These requirements are intended to increase the board's capacity to exercise appropriate scrutiny over the performance of the management team. In addition, independent directors provide some assurance that the bank's dealings with its parent or other related parties are not in conflict with the interests of the bank in New Zealand.

Complementing these requirements, New Zealand's approach to financial sector regulation seeks to create an environment conducive to robust market disciplines. This is achieved through a number of measures, including the promotion of a relatively open, contestable banking sector, a competitively neutral approach to regulation - enabling banks and non-banks to compete on largely equal terms — and the absence of deposit insurance. In addition, the Reserve Bank's approach to responding to a bank failure stresses the importance of being able to manage a bank failure in ways that avoid the need for a government-funded bail-out, and seeks to ensure that shareholders, subordinated creditors and senior creditors, including depositors, bear their fair share of losses. All of these features are intended to strengthen the incentives for market scrutiny of banks and to further encourage the directors and managers of banks to ensure that their banks' risks — especially credit risk, market risks, exposure concentration, operational risk and liquidity - are being prudently managed.

We are confident that these measures have been successful in contributing to a sound banking system. But we have recently sent a comprehensive questionnaire to the boards of all banks to develop a greater understanding of the means by which directors satisfy themselves that their banks' disclosures are not false or misleading and that their systems for controlling risks are robust. We will be very interested to see the results of that survey and then to assess whether the existing arrangements are sufficient for the purpose of promoting a sound financial system. We are also surveying auditors to enhance our understanding of the audit processes in relation to banks and to assess the adequacy of existing audit requirements for banks.

In addition to our own assessments of these matters, we will also benefit from an external assessment of banking supervision arrangements and other elements of financial sector regulation later this year. That assessment will be conducted by a team of international experts led by the International Monetary Fund, as part of the joint IMF/World Bank Financial Sector Assessment Programme - FSAP for short. The FSAP was initiated in the aftermath of the Asian crisis, in 1999, and is designed to evaluate a country's financial system. It includes a comprehensive assessment of regulatory arrangements, including banking supervision and securities market regulation, using international standards and codes as benchmarks. It also involves stress testing the financial system to assess the system's capacity to withstand economic shocks. New Zealand will undergo an FSAP assessment later this year, and I am sure that the assessors will take a particular interest in the banking supervision framework and the emphasis we place on corporate governance and market disciplines. We await the results of the FSAP assessment with considerable interest.

Although our policies are designed to strengthen the corporate governance of banks operating in New Zealand, the foreign ownership of most of our banks introduces complications as well as advantages. As I mentioned earlier, all but two of the registered banks in New Zealand are foreign owned, operating in New Zealand either as branches or subsidiaries of overseas banks. This raises interesting issues relating to corporate governance and risk management — issues to which the Bank is currently giving further thought.

For example, in the case of banks operating as branches in New Zealand, how much reliance should we, as the supervisor of banks, or the public more generally, place on the directors of the bank in a foreign country for looking after the interests of creditors and other clients of the bank branch in New Zealand? Under existing policy, foreign banks are able to operate as branches in New Zealand unless they have substantial retail deposits or are deemed by the Reserve Bank to be systemically important. In such cases, they must operate as locally incorporated entities. Where they do operate as branches, we impose certain prudential requirements on them and require disclosure of the New Zealand branch operations, but we place considerable reliance on the directors of the foreign bank to ensure that the affairs of the bank as a whole are being prudently managed.

We recognise of course, that this approach has its limitations. In particular, we know that the directors of a bank, and the corporate governance and risk management structures within a bank, do not generally draw distinctions between the foreign branch of the bank and the rest of its operations. We are also mindful that the foreign branch of a bank is legally indistinguishable from the rest of the bank, and that assets and liabilities can move quite readily, sometimes at the push of a button, between the branch and the rest of the bank. In fair weather, that is fine. But in times of crisis, the distinction between the branch and the rest of the bank, and the legal location of assets and liabilities, may well become very important indeed.

You might think that the problem associated with branch banks could easily be solved by simply requiring banks to operate in New Zealand as locally incorporated subsidiaries. Many of the banks currently in New Zealand do just that. But even here there are corporate governance and related complications. Increasingly, both in New Zealand and elsewhere, international banks are managing their affairs as a global business, regardless of whether they operate in foreign jurisdictions as branches or subsidiaries. Core functionality, such as information technology, financial accounting and risk management, is being increasingly managed on a global level. In some cases, this is being done in a banking group's head office. In other cases, core functionality is being located in developing countries to take advantage of lower cost structures. In both cases, the legal boundaries between different parts of a banking group are becoming less relevant.

And all of that is probably just fine when things are going well. But when things do not go well — such as in a bank failure situation - the legal divisions within a banking group and the location of core functionality become very important indeed. And it is precisely this issue that we in the Reserve Bank are considering at present. In a banking system where, increasingly, the core functions of banks are being run from outside of New Zealand, we as supervisor of the banking system need to be satisfied that there are mechanisms to ensure that the interests of New Zealanders are well served - in good times and, especially, in bad. We are therefore currently assessing the feasibility and efficacy of different options for ensuring that the New Zealand operations of foreign banks are structured in ways that meet the needs of the New Zealand financial system.

Of course, this is not just an issue for the Reserve Bank. It is also an important issue for the directors of banks in New Zealand. The directors need to be satisfied that they are fulfilling their statutory responsibilities, and ensuring that sound corporate governance structures are in place, in the context of a bank whose core functions are, increasingly, being performed overseas. This involves a careful balancing act. On the one hand, directors need to ensure that the bank in New Zealand - as a separate legal entity - is meeting, and will continue to meet, its statutory and financial obligations, and is soundly managed and structured. On the other hand, they will inevitably and appropriately make those kinds of assessments in the context of the bank being part of a global banking group. The critical issue for the directors — and for the Reserve Bank - is just how much reliance should be properly placed on the parent bank and other components of the banking group when assessing the adequacy of the governance arrangements and prudential and operational soundness of the bank in New Zealand.

For example, when the directors of the New Zealand subsidiary of a foreign bank form a view on the adequacy of that bank's risk profile and management systems, how much reliance should they place on the support of the parent entity? When assessing whether the bank is adequately capitalised, how much weight should be placed on parent support? When core functionality is being moved out of the bank to other parts of the group - including IT, financial accounting, and, importantly, intellectual capital — how far should local directors go in requiring arm's length service contracts for those services, and adequate back-up arrangements in the event of parent bank failure? When assessing the nature of the local bank's exposures to other parts of the group, how far should directors go in ensuring that the exposures are in the interests of the local bank? And, in all of these matters, and many more, what is the particular role of independent directors, how many should there be on the board, and how can one be assured that they are truly independent in their thinking and their approach to their job?

These are issues that increasingly occupy our minds in the Reserve Bank. And we are considering the possible policy solutions to them. Increasingly, these kinds of questions will also be posed and answered by supervisors - and by bank directors themselves — in many countries, as banks become more global in nature. I expect that, within the next year or two, we will have made substantial progress in seeking to resolve some of these issues.