# BANKING SUPERVISION
# - AN OVERVIEW

*This speech was delivered to the ANZ Treasury Management Course earlier this year by Kerry Morrell, Chief Manager of the Banking Supervision Department of the Reserve Bank.*

My aim in this speech is to present an overview of recent developments in banking supervision. I start by drawing on New Zealand's deregulatory experience. The issues we are grappling with are much the same as those before financial market regulators in other OECD economies. But we have had to deal with them on a very tight schedule. What has happened to the banking sector in New Zealand over the last six years is a very compressed version of what has been going on in international banking circles over the past two decades.

New Zealand entered the 1980s with one of the most heavily strait-jacketed financial sectors in the industrialised world. Many finance institutions were confined by strict partitions around what business they could be in. The partitions stifled competition. The regulations virtually guaranteed bank margins and profits were made fairly effortlessly.

Moreover, large corporate failures were rare. Monetary policy looseness, industry subsidies and industry protection propped up what might otherwise have been ailing industries. The government was often,in fact, residual financial risk taker.

The financial system was showing signs of stress. Meeting the fiscal cost of that residual risk bearing responsibility sent the government increasingly into debt. And the restraints imposed on the major financial institutions meant some borrowers were forced to use fringe institutions. We created the ideal conditions for dis-intermediation.

From mid-1984, and over the course of only nine months, interest rate,credit and foreign exchange controls were abolished and the exchange rate was floated.

At the same time, the government began the process of dismantling subsidies and industry protection. Businesses were, henceforth, to look after their own risk and market forces were the discipline to ensure that they did. Deregulation would open up entry to markets to strengthen competitive forces.

The finance sector was not to be left out. From early 1987 new banks were allowed to set up business - and unlike Australia we had open entry providing certain capital and behavioural standards were met. Step-by-step, the government remoulded the empowering legislation for all the different species of institutions so that they could all basically operate off the same ground rules. In public policy jargon, this was a process of levelling the playing field. There were no prescriptions about what a bank should do other than it had to be principally in the business of borrowing and lending of money or the provision of other financial services.

At the same time a new prudential supervision framework was set in place. The government decided that regulation should be kept to a minimum and that the primary incentive for prudent managment should come from the discipline of a competitive market. The Bank would be guardian of system stability - not the guardian of individual institutions or depositors. That meant a role as monitor and a role in failure management. By international standards that was a very hands-off position.

As things transpired, many in the finance sector did not fully appreciate that an important aspect of the Government's economic programme was the privatisation of risk taking. Businesses would no longer be virtually immune to failure. The restructuring programme meant there could be large swings in asset prices. Asset prices could fall.

The fall-out was pronounced. There have been failures; some capital injections have been required. As a result, we have had a big increase in bad debt provisions and weaker trading performances. Confidence in the system has probably been reduced, to some extent, both domestically and in international circles. Moreover, the sluggish economy, and the influx of new banks, do not promise an easy regeneration of profitability.

We are probably facing a flurry of merger and voluntary exit activity. Already, ANZ has absorbed Postbank. Elderbank is about to relinquish its banking license, and in the last year or so an American bank, Security Pacific, and a Canadian bank, CIBC, have both withdrawn from the market.

I believe the role of the supervisor in this situation should be to facilitate the merger of the weaker with the stronger units in order to get a stronger financial system. In that regard, I believe it is important that we do not have a system of deposit protection and that we do have good disclosure requirements. Deposit protection mutes the proper market signals which good disclosure requirements should generate.

# THE NEW PRUDENTIAL SUPERVISION FRAMEWORK

## The Parameters

The experience of the last few years suggested our supervision needed refinement. The new Reserve Bank Act effective from 1 February this year gives us the ability to constrain the potential risks to the finacial system arising from imprudent behaviour by individual banks. But the stated policy objective remains the same. It does not amount to deposit protection or a rescue package for individual institutions.

We are there to protect system stability, in part by strengthening its capacity to withstand shocks. We still believe market discipline makes the best contribution to the soundness of the system. That discipline works better with higher quality information in public circulation. Our new procedures aim to instigate that.

The new approach tips the balance of the regulatory process towards trying to avoid failures. We want to try to erect a guard rail (not a fence) around the top of the cliff rather than just providing an ambulance at the base.

In that vein, we have three fundamental options: rules and limits which curb risk exposures; and mandatory information disclosure either for enforcement purposes or to help the investor or depositer make a risk assessment; and enhanced agency specifications.

The advantage of rules and limits is that they are highly visible. Banks know where they stand. Regulators have something specific to enforce and they can be held directly responsible for that. The downside is rules can lead to inflexibility, they can be costly to comply with and uneven in their impact, despite their general application. They can also lull management and depositors into a false sense of security.

## How to Keep the Costs Down

To reduce the risk of imposing excessive compliance costs the Reserve Bank is limited to paying attention only to critical issues. Unless specifically empowered by government to look further, the new Act confines us to on-going supervision of capital adequacy, large exposures, the separation of business, and internal and audit controls. The Act empowers us to do this in terms of general principles. We are in the process of drawing up formal documents on the detail in consultation with the industry.

Institutions will have the option to chose whether they want to be supervised. That puts pressure on us to contain the cost of the system we arrive at. If it gets to the stage where institutions believe the compliance costs outweigh the benefits, they can opt out.

But having chosen to be supervised, compliance with all the rules and requirements will be mandatory.

For supervision to be effective we need most of the banking industry within our supervisory regime. We believe the benefits of being supervised are sufficiently high to ensure banks have the incentive to join the club. Therefore we should be in a position where we will be supervising the bulk of the financial system.

Most institutions will want the privilege of calling themselves banks - and only supervised institutions will be able to do that. We believe that most banks will want the risk-weighting benefits flowing from being part of the Basle Committee on Banking Supervision's capital adequacy framework. We have adapted that framework for our use. Most institutions will want access to the liquidity back-up arrangments that have been devised through the Bankers Association. These are dependent on the existence of a supervisory relationship with the Reserve Bank.

A deliberate choice was made to supervise banks only. This has drawn some criticism because of the possibility that some major institutions could go unsupervised. The decision has also been interpreted as a reversal of the previous push for a level playing field. We believe the only credible alternative to that decision would have been something like licensing the activity of financial intermediation. That is the United Kingdom approach. It could have led to a vast bureaucracy of regulators. It would have eliminated the present role of the trustee and trust deed.

## The detail so far

Our decision to take a more pro-active prudential supervision role, in fact, coincides with efforts by banking regulators to refashion a common international regulatory structure. The objectives there are to reduce the level of risk in the international financial system, to beef-up its shock absorption capacity, and to harmonise banking regulations across countries.

That international effort, co-ordinated by the Basle Committee, starts from a base of arguing that adequate bank capital is a good insurance policy ag ainst the likelihood of bank failure. It helps to focus attention on earnings and profit performance as well as asset and volume growth targets. It is a matter of routine now that a bank's ability to raise funds in wholesale markets depends on its standing defined as its capital strength and profit record.

There is no pretense that capital adequacy is the perfect indicator of bank health, nor is it sufficient to ensure continued health. It does not capture the quality of the portfolio or the concentration of risks; it is no indicator of liquidity; nor does it say anything about profitability or the quality of managment. Moreover regulators do not want to discourage innovation or encourage disintermediation with funds shifting out to non-supervised institutions.

But having agreed on the importance of a baseline shock absorber, we see definite advantages for New Zealand incorporated banks in signing up to the the new international capital adequacy rules. Moreover because many New Zealand banks are subsidiaries of foreign parents it makes sense to adopt the emerging international code rather than to devise an indigenous one. We originally tried to do that but the proposal was roundly rejected by the banks.

As time goes by, the Basle Committee is likely to come up with measures aimed at curbing specific types of risk. Their work will be something of a lighthouse to us. But we will not automatically adopt everything they may propose. We are conscious of the risk of excessive re-regulation in the guise of prudential concerns, and we will examine all of their proposals closely. In the meantime, we will proceed with our own priorities.

With capital adequacy largely under our belt, apart from some outstanding issues related to securitization and loan transfers, our attention has turned to large exposures.

Some banks will have learned the lesson of large exposures the hard way. As they got caught up in the grab for market share it is not surprising that some of them fell into the trap of being unduly exposed to certain growth sectors - like property - and the growth companies of the time.

Ceilings on exposures are commonplace in most regulatory jurisdictions. While we have monitored large exposures undertaken by New Zealand institutions since 1987 it has become clear to us that limits and ceilings on loan concentrations and exposures should apply.

The Bank is in the process of finalising rules which will limit the exposure of banks to a counterparty or a group of closely related counterparties. We have proposed that exposures to indivdual counterparties or groups of counterparties should be constrained to a maximum of 30 per cent of a bank's risk adjusted capital. This will apply to all New Zealand incorporated banks, but we propose some flexibility where risks are laid off to third parties. We anticipate that our policy should become effective on 30 September 1990.

This subject is on the agenda for a major international conference of banking supervisors being held later this year in Germany. That should lead to the setting of international standards. It is expected that our requirements will fall within the prospective allowable range.

Finding the right balance on exposures is a special headache for regulators in a small economy. In a small economy a big company could quickly run up against bank exposure limits. We don't want to end up driving the best business offshore. We don't want to sabotage the indigenous banking industry.

We also know that a certain amount of concentration is what gives a business its comparative advantage. Moreover international experience tells us that the quest to reduce exposure risks through diversification across countries and activities can also be fraught with perils.

This is not the only kind of concentration that has to be watched. The Bank's International Department has been running a system of foreign exchange exposure limits based on proceedures operated by the Bank of England. The limits apply because we were concerned about the rapidity with which losses can result from foreign currency exposures. These losses have a rapid impact on capital adequacy.

We have decided to retain these procedures but the operation will be transferred to the Banking Supervision Department.

We are in the process of setting a global dealing limit on overnight foreign exchange exposures equivalent to 40 per cent of a bank's capital. Again we propose a degree of flexibility where positions are effectively covered by a third party, such as a parent bank.

As with the large exposures and capital adequacy requirements, these limits will be monitored by quarterly returns supplied by banks. These returns are detailed and complex and require considerable effort to complete and monitor. Many detailed questions arise. The returns are subject to six monthly audit, which some argue is inadequate to give us the assurance we need. We will be reviwing our audit requirements, with a view to making them stronger. But how far can we go? Realistically, we don't think we should routinely inspect the books of banks.

On a more structural vein, we will be requiring banks to have a certain standard of internal control and accounting systems. The standards will be specified in terms of general principles. Already, we have sought and obtained from all banks, fairly detailed descriptions of their major prudential control systems. These form the basis for discussions in our consultations. We don't plan to set detailed prescriptions. We do not wish to do anything that would stifle improvements in this important area and that is a significant risk when regulators try prescriptive rules.

Recently we outlined our view on the need for rules to clearly separate out an institution's banking business from other business. We have a concern here that the stability of the system should not be undermined by supervised institutions pursuing objectives unrelated or even damaging to the well-being of their banking operations. This could happen, for instance, if an owner wants to use control or influence to get bank funding.

Some bank regulators guard against this by placing constraints on shareholding concentration or they may adopt a very conservative attitude towards approving bank shareholdings which exceed a certain proportion of a bank's voting capital. Our approach will be to encourage a well spread shareholding, but where that does not occur, to insist on a majority of independent directors and to impose controls on connected lending. This has led to an approach to banking licensing which is at variance with policies adopted in other countries, in particular, Australia. There may be risks in this approach, but we judge the risks acceptable in the interests of promoting an efficient, responsive financial sector.

A bank can also be put at risk where it has extensive non-banking interests. We will be wanting to ensure that such a bank does not become a funding vehicle for the non-banking business. We anticipate being able to do that through our registration requirement that banks must be substantially in the business of borrowing and lending money or the provision of financial services.

## What lies ahead?

We plan to put resources into refining our approach on internal control systems in the very near future. This might, for example, result in proposals for the testing or verification of system effectiveness.

As well as large exposures and foreign exchange exposure limits we also will be looking at the wisdom of imposing limits on interbank exposures. The Bank has been looking closely at developments across the Tasman and further afield in the area of settlement system risks. We are encouraged by moves in the United States and Australia to introduce improved systems to monitor interbank risks and achieve greater settlement finality.

Down the track we will have to look at the difficult area of interest rate risk. We will be helped here by work being done or co-ordinated through the Basle Committee.

One area we do not intend to pursue is that of the imposition of liquidity ratios. While liquidity management is vital we believe liquidity ratios can give spurious assurance. Liquidity is not a substitute for solvency. Furthermore liquidity ratios can be so easily manipulated. Instead, we take a broader look at each bank's liquidity management and control structures. Where an institution is in difficulty we intensify our scrutiny.

The new Act also gives us the power to impose disclosure requirements and to regulate advertising. The detail of what that will mean has yet to be worked through.

There is an enabling provision whereby banks could be removed from the prospectus requirements set by the Securities Commission. A substitute Reserve Bank framework of disclosure, consistent with supervision requirements would then take effect.

Having the Bank responsible for setting disclosure standards for banks is also helpful should we decide to extend that requirement beyond retail to wholesale and investment banks.

## CRISIS AND FAILURE MANAGEMENT

We have a crisis management facility because liquidity and solvency problems can threaten system confidence. They raise the possibility of contagion and therefore a threat to the stability of the system. It is on the basis of systemic risks that the Bank may get involved.

This procedure is not to bail out insolvent institutions.

The Bank gives regard to system liquidity at all times. The Bank stands ready to buy Reserve Bank bills (within 28 days or less to maturity) if a bank has a liquidity shortfall. The Bank also has a co-ordinating role with the Bankers' Association to activate support for a bank in temporary liquidity straits. That support will be there for a bank which is known to be solvent, but, because of pernicious rumours, finds itself unexpectedly short of funds.

If a bank is insolvent, system stabilty is threated, and the Bank judges that there is need for immediate action, including the need to preserve the position of creditors, the statutory management facility can be invoked to organise an orderly exit.

That facility was used last year to deal with the failure of the DFC. We judged that there could be serious effects on other institutions if DFC funding dried up to its clients. We were concerned about the volume of DFC's foreign exchange contracts and the damage that could be done to counterparties and foreign investor confidence.

We were also concerned about the likelihood of what might otherwise have been a disorderly liquidation. Almost all DFC borrowing was unsecured and nearly all creditors were foreign.

Generally, we were satisfied that statutory management for DFC was the right thing to do. The moratorium provisions enabled the selective trading out and subsequent transfer of off-balance sheet contracts to a major bank. The interference with creditors' rights generally only goes as far as affecting their rights to deal with their securities, not their priority ranking, except as noted below.

Reserve Bank statutory management has, as a very important guiding principle, the objective of maintaining public confidence in the operation and soundness of the financial system. The retention of the ranking of creditors is secondary to system confidence (even though disturbing the ranking of creditors would of itself have an unsettling effect on confidence in the financial system).

## CONCLUSION

The mechanics of our prudential supervision process are still evolving. Our beacon in that process will still be the principle that a well informed market leads to the best supervision. There is no intention to pedal backwards towards the government acting as the residual risk taker. We will also keep an eye on the evolution of the BIS standards and adopt those where they fit our objectives and our interests.