Revised proposals for changes to banking supervision arrangements

On 31 March this year, the Bank released a detailed set of proposals for changes to the way registered banks are supervised. The paper included draft proposals for a new public disclosure regime applicable to registered banks. The material was released to banks and other interested parties for comment.

This article outlines the background to the banking supervision proposals and summarises the main features of them.

Background

In June 1993 the Reserve Bank released a discussion paper outlining proposed changes to the way it conducts banking supervision in New Zealand. The proposals resulted from a review conducted by the Bank of its banking supervision function. That review was undertaken in order to assess whether existing supervision policies and practices are the most effective and efficient means of achieving a sound and efficient banking system. The review was conducted in the context of:

- A concern that existing supervisory practices can reduce incentives for banks to maintain prudent banking practices, by shifting responsibility to the supervisory authority.
- A desire to avoid perceptions that the Government has a role in "underwriting" individual banks or in insulating depositors from losses arising from bank failures.
- A recognition that existing supervision techniques have the potential to impose significant compliance and efficiency costs on banks, yet are not necessarily effective in promoting a sound and efficient banking system.
- A recognition that most registered banks operating in New Zealand are subsidiaries or branches of major overseas banks. In such a banking system, it was recognised that considerable reliance could be placed on the overseas parent banks to supervise their New Zealand operations, thereby reducing the extent of official supervision in New Zealand.

Objectives of Proposals
The objectives of the June 1993 proposals were:

- To ensure that policy is directed at strengthening the incentives which banks have to manage their affairs prudently.

- To ensure that the Reserve Bank's supervision policies and practices constructively reinforce those incentives, are cost effective and leave banks with the scope to be responsive to the needs of their customers.

- To maintain policies and practices which seek to minimise disruption to the financial system that may result from the failure of a bank.

- To remove the misconception that the Government underwrites the prudential soundness of individual banks.

- To maintain a banking registration and supervision system which is consistent with the maintenance of a sound and efficient banking system, and which has a high level of national and international credibility.

Main features of the June 1993 proposals
The June 1993 proposals involved a shift in emphasis from supervisory rules to placing greater reliance on market disciplines as a means of promoting a sound and efficient banking system. Reflecting this, the Bank proposed the abolition of a number of existing prudential supervision rules, including maximum limits on the amount (relative to capital) which a bank can lend to any single customer and a limit on open foreign exchange positions. It also proposed the discontinuance of prudential returns as a means by which the Bank monitors the financial condition of registered banks. The Bank signalled its intention to monitor banks primarily using information contained in the banks' publicly available disclosure statements.

The June proposals advocated a new disclosure regime for banks to replace existing prospectus requirements under the Securities Act. The new disclosure regime would require banks to release disclosure statements at quarterly intervals, with the statements being subject to full external audit six monthly. The disclosure proposals were seen as a way of reinforcing incentives for the management of banks to maintain prudent banking practices, particularly in the area of managing risks. The disclosure statements were also considered to be an effective means to equip creditors and their agents with improved information with which to monitor and compare banks, and therefore to protect their interests.

The Bank received a large number of submissions on its June 1993 paper and met with most respondents to discuss their submissions. Following this process of consultation, the Bank reformulated and further developed its banking supervision and disclosure proposals, taking into account the comments made in submissions.

On 31 March 1994, the Bank released a paper outlining a more detailed set of banking supervision and disclosure proposals for comment from interested parties. Accompanying the paper were draft Disclosure Notices. In their final form, these will be used to implement the proposed disclosure regime for banks.

The deadline for comments on the proposed policy changes is 30 June this year.

Main Features of the Revised Proposals

The main features of the revised banking supervision proposals are as follows:

- **Objectives Unchanged.** The objectives of banking supervision remain unchanged (ie to promote a sound and efficient banking system and to avoid damage to the financial system which could result from the failure or distress of a bank). Unlike some systems of banking supervision in other countries, banking supervision in New Zealand does not seek to prevent a bank from failing, or to shelter depositors from losses in the event that a bank does fail. It is considered that the absence of depositor protection or a "guarantee" that a bank will not fail should assist to reduce systemic risk by increasing the incentives which banks have to maintain prudent practices and by encouraging bank customers to monitor the performance of their bank relative to the performance of other banks.

- **Capital Requirements Retained.** The Bank does not propose to make changes to existing capital adequacy requirements for banks, other than removing the concessional risk weight relating to bank lending to primary producer boards with monopoly acquisition powers. Although the Bank considers that the disclosure regime will create sufficient incentives for banks to adhere to the Basle international minimum capital adequacy level without the need for minimum requirements, we consider that, for the time being at least, there is a net benefit for the banking system in retaining existing regulatory capital requirements, in line with most other countries. This reflects the view we have taken that retaining minimum capital requirements should not impose significant additional compliance costs on banks, but might provide some reassurance to certain overseas audiences that New Zealand's supervisory arrangements have not departed totally from international norms. The Reserve Bank intends to review the continued appropriateness of minimum capital adequacy requirements in light of experience under the new supervisory regime and the effect of payments system reforms.

- **Related Party Exposure Limit.** The Bank proposes to retain a limit on locally incorporated banks' exposures to related parties (ie shareholders and associated parties), but with some modification. This reflects a desire to limit the extent to which a bank's capital can be on-lent to a related party, given the potential for such lending to effectively decapitalise the bank in New Zealand. Under the new proposals, the limit on related party exposures will be left at the current level of 75 per cent of a bank's capital, but will be based on Tier One capital (ie essentially shareholders' equity), rather than on the broader definition of capital currently used. The effect of this proposal is to reduce the maximum dollar exposure which banks may have to related parties. In recognition that this might create initial difficulties for some banks, a transition period might be considered to enable the new limit to be phased in.

- **New Disclosure Regime.** As foreshadowed in its June 1993 paper, the Bank proposes to introduce a new public disclosure regime for all registered banks.

The new disclosure arrangements will replace existing prospectus requirements of the Securities Act and Regulations, as they apply in respect of banks' debt securities. The disclosure arrangements will be implemented using Disclosure Notices issued by the Reserve Bank under the Reserve Bank of New Zealand Act. They will cross reference to relevant Financial Reporting Standards (issued under the Financial Reporting Act 1993). In particular, the proposed disclosure regime will draw heavily on Exposure Draft No. 73 (Disclosure of Information by Financial Institutions), once issued as an approved Financial Reporting Standard by the Accounting Standards Review Board. The Exposure Draft was issued by the New Zealand Society of Accountants in April this year for comment.

The new disclosure arrangements will involve:

- **Financial and Prudential Disclosures.** The proposed disclosure notices will require comprehensive disclosure of a wide range of financial, prudential and general information. This will include: a bank's financial statements; capital adequacy information; a bank's credit rating (where it has one); information on exposure concentration and related party exposures; inter-bank exposures; information on a bank's "market risk" exposures; asset quality information; general information on the registered bank and its directorate; and information on directors' conflicts of interest.

- **Quarterly Disclosure.** It is proposed that all banks will be required to release disclosure statements quarterly (compared to six monthly prospectuses currently required under the Securities Act). In recognition of the costs associated with this proposal, the Bank has proposed that the disclosure statements made in relation to the first and third quarters of a bank's financial year be of a "short form" nature.

- **External Audit.** As indicated in the June 1993 paper, the Bank proposes that banks' disclosure statements will be audited six monthly (compared to the existing annual audit required under prospectus requirements). However, in recognition of the costs associated with this, it is now proposed that the external audit at the six month point may be of a "limited review" nature (ie a scaled down audit).

- **Key Information Summary.** The disclosure arrangements propose that banks will be required to produce a short "Key Information Summary", which would contain "key" information on a bank and would be displayed prominently in banks' branches. It is proposed that the full disclosure statements will be required to be available within two working days of a request being made.

- **Branch Disclosures.** We propose to require banks which operate in New Zealand as branches of overseas banks to make disclosures of their New Zealand operations along similar lines to those required of banks operating as subsidiaries. It is intended that the "global" financial statements of the international bank (of which the New Zealand branch is part) will also be required to be made available to creditors on request in the form in which the financial statements are published in the bank's home jurisdiction.

- **Director attestations.** An important part of the disclosure arrangements is a proposal requiring directors to sign statements in their bank's disclosure statements relating to (among other matters) whether the bank is adhering to its conditions of registration as a bank and whether the directors are satisfied that the bank has adequate risk management systems. We see these requirements as being consistent with the intention of placing greater emphasis on the role of directors in ensuring that banks maintain prudent operating practices.

- **Credit Ratings.** Where a bank has a long term credit rating applicable to New Zealand dollar obligations, we propose that it will be required to disclose the rating in its disclosure statement. Where there is no such rating, the fact that there is no rating will be required to be disclosed. It is expected that, with the disclosure statements promoting greater consumer awareness of credit ratings, banks which are not rated will consider becoming so. The proposed disclosure arrangements should also reinforce incentives for banks to maintain sound operating practices.

- **Reduced Role for Prudential Rules**. Once the new disclosure regime takes effect (and in some cases, before then), it is proposed that a number of existing prudential rules applying to banks will be removed. These include:

  - the limit on banks' lending to individual counterparties or groups of related counterparties;

  - the limit on banks' open foreign exchange positions;

  - the conditions of registration relating to changes in majority ownership and internal controls.

  In addition, guidelines issued by the Reserve Bank on banks' internal controls will be withdrawn, as will the present guidelines on exposure concentration.

- **Prudential Returns.** Once the disclosure regime is in force, the Reserve Bank will monitor banks, largely using banks' public disclosure statements. The existing prudential returns which banks file with the Reserve Bank will be discontinued. The information currently provided to the Bank by prudential returns has largely been incorporated into the proposed disclosure notices. This means that the public will generally have much the same information on banks as is available to the Reserve Bank.

- **Registration of banks.** The Bank will continue to have the role of determining applications for registration as a bank. The purpose of registration is to seek to ensure that only those financial institutions which are considered to be of good standing and are capable of carrying on their business in a prudent manner may call themselves a bank. As in the past, bank registration does not determine who may conduct banking business; it merely determines who may call themselves a bank. There is no requirement for a financial institution to be licensed or registered as a bank in order to conduct the business normally associated with a bank.

- **Role of the Reserve Bank as Banking Supervisor**. The Reserve Bank will continue to act as banking supervisor and to discharge its responsibilities under the Basle Concordat (the international agreement governing the responsibilities of "parent" and "host" supervisors). However, to some extent, there will be a change in the way the Bank discharges these responsibilities, reflecting the shift from principal reliance being placed on prudential rules to greater reliance being placed on disclosure and market disciplines. The Reserve Bank's role as banking supervisor will encompass:

  - monitoring banks' general financial condition, primarily using public disclosure statements;

  - requiring a bank to re-issue its disclosure statement where the statement is materially false or misleading (as at the date of its publication);

  - meeting with each bank's senior management annually, to discuss, among other matters, the bank's strategic direction and relevant banking system issues;

  - intervening where a bank is insolvent, is considered likely to become so, or is otherwise likely to undermine the soundness of the banking system. Such intervention would generally be aimed at seeking to avoid substantial disruption to the financial system which could arise from a bank's difficulties. The Bank has not proposed any change to its statutory powers to address a banking crisis. Those powers will continue to include: the ability to have a bank investigated; the ability to give directions to a bank (in limited circumstances); and, in extreme situations, to recommend that a bank be placed into statutory management.

- **Directors.** In keeping with the emphasis placed by the Reserve Bank on the role of a bank's directors, the Bank is proposing minimum requirements for non-executive director membership of banks' boards of directors. For banks incorporated in New Zealand it is proposed that at least two directors will need to be non-executive (but may be a non-executive director of the parent bank or other entity within the banking group, where applicable). It is also proposed that the chairperson of the bank must be non-executive (but may be an executive of the parent bank or any part of the parent banking group, where applicable). The Bank has also proposed to require banks incorporated in New Zealand not to adopt constitutions (upon re-registration under the Companies Act 1993) which enable the directors of the bank to act in the interests of a holding company (where applicable), where to do so would conflict with the interests of the local bank.

- **Ownership.** The Bank has proposed a change to the policy on bank ownership, whereby the existing condition of registration relating to changes in bank ownership will be withdrawn. (The existing condition requires a bank to obtain the approval of the Reserve Bank where a majority shareholder wishes to reduce its shareholding below 51 per cent of the total voting shares.) In its place will be a policy which will result in the Reserve Bank re-assessing a bank's standing where there is a change in the shareholding in a bank in excess of 10 percent of the total voting shares on issue. The proposed change in policy recognises that changes in significant minority shareholdings can influence a bank's standing.

- **Branches.** In the June 1993 paper the Bank had indicated that it was considering introducing a "defacto capital" requirement for banks operating in New Zealand as branches of overseas banks. This reflected a concern that the laws of some countries have the effect, in a winding up of a bank incorporated in the country in question, of subordinating the claims of creditors of the bank's overseas branches to the claims of creditors of the bank in the country of incorporation. A defacto capital requirement would be designed to provide some protection to local creditors of an international bank operating in New Zealand as a branch. On further consideration, the Bank considers that such a policy would largely defeat the benefits of operating as a branch and would probably not be as effective as local incorporation. Accordingly, the Bank now proposes that banks operating in New Zealand as branches will be required to disclosure prominently in their disclosure statements the existence (if any), and nature, of statutory or regulatory impediments to the pari passu access by creditors in New Zealand to the global assets of the international bank.

- **Breaches of capital requirements.** The June 1993 paper indicated that the Bank was considering introducing a set of pre-determined steps to address a situation where a locally incorporated bank's capital falls below the minimum required level of 8 percent of risk weighted exposures. The Bank has modified those proposals to require a bank in such a situation to submit to the Bank a plan for restoring its capital to comply with the two regulatory requirements (ie 8 percent total capital and 4 percent Tier One capital). It is proposed that the bank would be required to submit the plan to the Bank as soon as practicable after the breach of the capital requirements and that the plan would be published in the bank's disclosure statement. We would expect the plan to provide for the cessation of distributions to shareholders and for no increase to occur in the aggregate exposure of the bank to related parties until the minimum levels of capital have been restored. Where Tier One capital falls below 3 percent, we would expect the plan to provide for the bank's gross credit exposures not to be increased until its capital has been restored to at least the minimum required level.

Conclusion of Banking Supervision Review

Once the Bank has reviewed the submissions made to it on the March paper, the proposed changes to banking supervision arrangements will be finalised. It is expected that the final set of banking supervision policies will be released later this year. A revised set of disclosure proposals will probably be released later this year for a second round of comment before finalisation.

It is expected that the final form of the banking supervision and disclosure proposals will be implemented either late this year or early in 1995. The timing of implementation will largely depend on when Exposure Draft No. 73 is approved, and becomes effective, as a Financial Reporting Standard.