Review of banking supervision: Reserve Bank's policy conclusions

Banking System Department

This article outlines the Bank's review of its banking supervision arrangements and summarises the policy conclusions reached in the review.

I Introduction

In December 1994, the Reserve Bank issued a paper[1] outlining the Bank's policy conclusions with respect to banking supervision. The paper encapsulated the results of more than two years of internal review of the Reserve Bank's banking supervision role. The paper proposed a shift from detailed rules and private monitoring by the supervisor, in favour of enhanced public disclosure of financial information, and a considerable relaxation of supervisory regulation. This article sets out the background to these changes and summarises the key features of the new banking supervision arrangements. These features include:

- a new public disclosure regime for banks;
- removal of some existing prudential regulations;
- increased emphasis on the role of bank directors.

II Background

The review of banking supervision was commenced in late 1991 at the Reserve Bank's initiative. At that time, the Bank had been involved in banking supervision for approximately five years. Over that period, the Bank introduced and operated a relatively orthodox supervision policy. It involved requiring banks to comply with certain prudential requirements, including a minimum capital ratio, based on the BIS Capital Accord, and maximum limits on certain risk positions. Supervision was primarily based on quarterly information provided privately to the Reserve Bank, covering such matters as capital adequacy, the income statement, balance sheet and large exposures. The Bank supplemented this with additional information gleaned from annual consultations with the senior management of banks. The Bank did not conduct on-site examinations of banks; nor did it delegate this role to auditors or others.

1 Review of Banking Supervision: Reserve Bank's Policy Conclusions. Issued in December 1994.

Where New Zealand's banking supervision was perhaps a little unorthodox was in the objectives it sought to meet. From its inception, banking supervision was not intended to protect depositors' interests *per se*. This reflected the view taken by the Reserve Bank, that explicit depositor protection, whether in the form of deposit insurance or a statutory role to protect depositors' interests, saps incentives for creditors to exercise scrutiny over the soundness of their banks. In recognition of these difficulties, and of the important *systemic* role played by banks, banking supervision in New Zealand was, and continues to be, focused on protecting the financial system as a whole - ie on minimising dislocation to the financial system resulting from a bank distress or failure situation.

Another important feature of banking supervision in New Zealand is the Reserve Bank's approach to the registration, or licensing, of banks. Unlike the supervisory authorities in many other countries, the Bank does not license the function of banking, or even of deposit taking. Financial institutions may conduct banking business or take in deposits without having to be registered as a bank, although they must comply with disclosure and some other requirements. The only legal benefit conferred by registration as a bank is the ability to use the word "bank" in a business name.

III Objectives of the review of banking supervision

The Reserve Bank undertook its review of banking supervision for a number of reasons and with a number of objectives in mind.

Compliance costs

The Reserve Bank was concerned that conventional approaches to banking supervision can impose potentially severe compliance costs on banks. Although New Zealand's banking supervision framework is at the "light" end of the international spectrum, the Reserve Bank was concerned that supervision had the potential to impose relatively high costs on banks - not just the direct costs of complying with regulatory requirements, but also in constraining banks from meeting customer needs. The Bank wanted to explore ways of reducing such costs, so as to enhance the efficiency of the financial system.

Moral hazard

The Bank recognised that any system of registering and supervising banks carries with it a risk of moral hazard– ie that riskier banking behaviour can actually be encouraged by the presence of a supervisory framework. This can occur where the shareholders, directors and management of banks take the view that government will provide support to a bank in distress. This expectation can be reinforced where a government agency is involved in intensive day-to-day supervision of banks.

An intensive banking supervision regime can also create a risk that a bank's directors and management will focus more attention on meeting regulatory and supervisory requirements than on identifying, monitoring and managing their bank's business risks. The Reserve Bank wanted to explore ways of reducing the moral hazard problem.

Market disciplines

The Reserve Bank took the view that conventional approaches to banking supervision can reduce the incentives for creditors and their agents to scrutinise the financial soundness and performance of banks. While this problem is likely to be present regardless of the form of banking supervision, it could be expected to be more significant the greater the intensity of supervision and the greater the perception that government underwrites individual banks. The Reserve Bank sought to sharpen market disciplines on banks by increasing the incentives and scope for private sector monitoring.

Risk to the taxpayer

The Reserve Bank was aware that conventional approaches to banking supervision carry considerable risks for the taxpayer. These risks tend to be either unpriced or underpriced, even in the presence of an ostensibly fully funded deposit insurance scheme. Any form of bank registration and supervision process will inevitably give rise to pressures for government to provide support to a bank in distress - either to prevent the bank from failing or to insulate its depositors from losses in the event of failure. However, the ability to resist this pressure is dependent in part on the intensity of the supervision process. The greater the intensity of the supervisory process, the harder it tends to be for a government to resist the pressures to support a bank in distress. The Reserve Bank's review sought to find ways of enhancing the ability of government to resist these sorts of pressures.

Effectiveness of banking supervision

The Reserve Bank's review of banking supervision arrangements was also undertaken in the belief that banking supervision is not necessarily an effective or efficient means of reducing banking system risks. Much of the information available to banking supervisors tends to be too dated by the time it reaches the supervisor to enable the supervisor to adopt measures to avoid a bank failure. Moreover, it is doubtful that supervisors are any better placed than bank management to recognise early signs of financial distress. Indeed, management could be expected to be better placed to assess the appropriateness of a particular risk position, given that they usually possess more comprehensive and recent information than does the supervisor.

Certainly, the Reserve Bank's recognition of emerging financial distress in the banking system in the late 1980s and early 1990s came too late to avoid the subsequent deteriorations in banks' capital positions. The New Zealand experience in this regard would appear to be fairly typical of the experiences of a number of other countries in recent years.

Where supervision can be effective in reducing the propensity for financial distress is in the imposition of minimum capital requirements and limits on exposures to individual borrowers, among other measures. These types of measures can reduce the potential for bank failure, and accordingly, can play a useful role in keeping systemic risk to tolerable levels. But there is always a danger that such measures will be seen by banks, and the market generally, as "approved" risk positions, thereby discouraging banks from adopting more prudent risk positions. Moreover, regulatory measures imposed with the intention of reducing risk can induce greater risk taking. An example of this is the imposition of limits on exposures to individual borrowers. Such a policy can limit a bank's ability to allocate credit to high quality borrowers, thereby encouraging a migration of credit allocation to less credit-worthy borrowers.

A further difficulty with prudential regulation is that it can be applied with excessive zeal by the banking supervisor. This reflects the likelihood that banking supervisors have strong incentives to minimise the risk of bank failure. If unchecked, this can lead to a policy approach heavily weighted towards risk aversion - at the expense of allowing banks to meet their customers' needs, and to the detriment of financial system efficiency.

Change to the structure of the banking system

A further reason for reviewing banking supervision arrangements was that the structure of the banking system has undergone considerable change over recent years. When banking supervision commenced, in 1987, most of the supervised financial institutions were owned locally–four in the majority ownership of the Government. By 1992, following privatisation of the state owned banks, two of the 16 banking groups were owned locally, representing only about 10 percent of the total assets of the banking system.

The change in bank ownership suggested that a re-evaluation of supervisory policy was appropriate. This recognised that a "host" banking supervisor has a limited capacity to influence the risk profile of the banking system. The stability of the banking system is influenced more by the stability of the banking systems in which the parent banks are domiciled, than by local considerations. However, this does not suggest that there is no role for the local banking supervisor. Clearly, the local supervisor can play an important role in creating structures which encourage prudent banking practices and minimise adverse flow-on effects from disturbances in overseas banking systems.

The Reserve Bank has recast its role to make it more appropriate to the changed structure of the banking system.

IV Principal features of the new banking supervision framework

The Reserve Bank's proposed changes to banking supervision arrangements involve a shift from reliance on private monitoring of banks by the banking supervisor, to a greater emphasis on the role of market disciplines in strengthening the financial soundness of banks. This will be facilitated by a new disclosure regime for all banks operating in New Zealand. The disclosure framework will require disclosure of all significant risk dimensions of a bank, and will also place more focus on the responsibility of directors for ensuring the sound management of their bank.

The emphasis which the Reserve Bank seeks to place on market disciplines is reinforced by the proposed reduction in the extent of prudential regulation of banks. The Reserve Bank's proposals include the removal of limits on the amount banks may lend to individual borrowers, the removal of limits on banks' open foreign exchange positions, the withdrawal of Reserve Bank guidelines on internal controls and the abolition of certain conditions of registration relating to internal controls and ownership changes. The Bank considers that the new disclosure regime and the emphasis it places on directors' responsibilities should obviate the need for much of the existing prudential regulation.

The principal features of the new approach to banking supervision are as follows:

Objectives of banking supervision unchanged

The objectives of banking supervision will remain unchanged - ie the registration and supervision of banks will continue to be conducted for the purpose of promoting a sound and efficient financial system. Supervision will not seek to prevent bank failures or to insulate depositors and other creditors from losses should a bank fail. Rather, supervision will seek to ensure that the financial system, as a whole, continues to function effectively at all times.

Registration of banks

The Reserve Bank will continue to have the role of registering new banks. The registration process is designed to facilitate competition in the "banking" sector, while also seeking to ensure that only institutions of appropriate standing, with the ability to carry on business in a prudent manner, are able to use the word "bank" in their name. There is no limit on the number of banks which may be registered. The only quantitative entry requirement is that a locally incorporated bank must have capital of not less than $15 million. The Reserve Bank is generally prepared to allow a bank to operate either as a locally incorporated entity or as a branch of a foreign bank, regardless of whether it is a wholesale or retail bank.

Reserve Bank's banking supervision role.

Under the new arrangements, the Reserve Bank will continue to have responsibility for maintaining the soundness of New Zealand's banking system. It will seek to achieve this by:

- *Setting the disclosure rules and other requirements for registered banks and monitoring compliance with those requirements.* However, under the new arrangements the Bank will monitor banks using their public disclosure statements, whereas under existing arrangements, the Bank monitors banks using private prudential returns.

- *Continuing to hold annual consultations with the senior management of banks.*

- *Continuing to liaise with the parent bank supervisory authorities, where appropriate.*

- *Maintaining a capacity to respond effectively to an event which threatens the stability of the financial system.* In such circumstances, the Reserve Bank will seek to resolve the situation in a way which minimises disruption to the financial system. In doing so, the Bank would seek to avoid the need for any form of government support for a bank in distress. Integral to the new approach is a policy that any resolution of a bank distress situation should aim to ensure that losses are borne by the shareholders and creditors of the bank in question, at no cost to the taxpayer.

Capital ratio requirement

The Reserve Bank will retain the existing minimum capital ratio requirements for locally incorporated banks. The requirements are consistent with the BIS Capital Accord and require banks to maintain tier one capital equivalent to at least 4 percent of risk weighted exposures, and total capital equivalent to at least 8 percent. Although the Bank considers that disclosure alone, without minimum requirements, should provide sufficient incentives for banks to at least adhere to the international norm of 8 percent, it believes that retention of the capital requirement offers benefits in terms of international credibility, at little, if any, marginal cost to banks.

Disclosure

A key feature of the new approach to banking supervision is the development of a new disclosure regime. The regime will require all banks to issue public disclosure statements at quarterly intervals. Banks will be required to make their full disclosure statements available on request, and to display a one or two page "Key Information Summary" in all branches.

The disclosure requirements are intended to be very comprehensive, and will include:

- An income statement and balance sheet.

- Information on the composition of the board of directors and any conflicts of interest directors may have.

- Detailed information on asset quality and provisioning.

- Information on the number of exposures banks have to individual counterparties, measured in bands relative to the bank's equity (ie the number of exposures between 10 percent and 20 percent of a bank's equity; the number between 20 percent and 30 percent; and so on).

- Information on exposures to related parties (ie those entities capable of exercising significant influence over a bank).

- Sectoral exposure information.

- Detailed information on a bank's capital adequacy, including its off balance sheet exposures.

- Information on a bank's market risk exposures, both as at end of quarter and peak during the quarter.

The disclosure arrangements are intended to serve a number of purposes. First, they are a means of reinforcing the incentives for bank management to adopt and maintain prudent risk positions. Second, disclosure provides a basis for creditors to make relatively informed judgements about the financial soundness of a bank and to compare one bank with another. And third, the disclosure regime is expected to strengthen a government's ability to resist pressure to rescue a bank in difficulty.

External audit increased

Banks' disclosure statements will be subject to external audit twice a year, compared to the existing annual audit requirement. However, in recognition that external audits can impose substantial costs on banks, the audit at the half year may be of a "limited review" nature.

Credit ratings disclosure

Banks with a credit rating applicable to long term senior unsecured debt will be required to disclose the rating prominently in their disclosure statements. Where a bank has no such rating, it will be required to disclose prominently that fact. This policy is expected to strengthen market disciplines on banks and provide creditors with a relatively simple means of comparing one bank with another.

Abolition of regulatory limits on large exposures and foreign exchange open positions

The Reserve Bank intends to remove the existing regulatory limits on banks' exposures to individual counterparties (currently set at 35 percent of total capital) and on open foreign exchange positions (40 percent of capital). The Bank considers that the disclosure regime will provide sufficient incentives for banks to maintain prudent risk positions, making the limits unnecessary. Furthermore, the Reserve Bank doubts that the placing of limits on large exposures is an efficient way of containing banks' concentration risk. There is a danger that a limit will be seen as an officially approved level of exposure, with attendant moral hazard problems. Moreover, if the limit is set at a relatively high level, it is unlikely to be effective in reducing losses attributable to concentration risk. Yet if the limit is pitched at a relatively low level, it can impinge excessively on a bank's ability to meet customer needs. Perversely, a limit on large exposures could also increase the risk profile of a bank's lending book by diverting credit to riskier borrowers.

Uniform and transparent regulatory requirements

The Reserve Bank plans to continue its practice of applying a uniform set of regulatory requirements on banks, where practicable. Rather than having different regulatory requirements for each bank - for example, capital ratios - the intention is to have uniform measures across all banks. In addition, banks will be required to disclose their prudential requirements to any person who requests the information. The Bank considers that this approach reduces the potential for regulatory forbearance by the supervisor.

Directors' responsibilities

An important feature of the new arrangements is a requirement that the directors of a bank (or their appointed agents) must sign the disclosure statements as being not false or misleading. The consequences of producing a disclosure statement which is false or misleading are serious, and include fines and imprisonment. Moreover, if creditors lose money as a result of reliance on a false or misleading disclosure statement, directors face potentially unlimited personal liability.

In addition to signing the disclosure statements, directors must make certain attestations in the statements. These attestations include a statement as to whether the directors are satisfied that their bank's risk management systems are adequate for managing the bank's risks, and that the systems are being properly applied. The Reserve Bank considers that this attestation will sharpen the incentives for directors to seek to ensure that their bank has appropriate systems in place to identify, monitor and manage its business risks. The attestation also reinforces the Reserve Bank's desire to ensure that responsibility for the management of a bank ultimately rests with that bank's directors.

Exposures to related parties

The Reserve Bank will retain a limit on the amount a bank may lend to related parties - ie any party capable of exercising significant influence on a bank. A limit is considered appropriate, given that a related party could coerce a bank to lend to it on non-commercial terms. Under the new arrangements, the limit will be based on a bank's tier one capital, rather than on total capital, as at present. This recognises the Reserve Bank's view that tier one capital is the only capital capable of "keeping a bank's doors open" while absorbing losses.

In addition to the limit, banks will be required to make public disclosures of their exposures to related parties, and directors will be required to sign attestations asserting that the exposure is not contrary to the interests of the bank.

Internal controls guidelines withdrawn

The Reserve Bank has withdrawn its guidelines on banks' internal control systems. The guidelines were issued in 1992 as a means of encouraging banks to maintain adequate risk management systems. They were also intended to provide guidance to external auditors or others when conducting reviews of a bank's internal controls.

The Bank is satisfied that the new disclosure framework and directors' attestations obviate the need for internal controls, guidelines and mandatory external reviews of a bank's control systems. The Bank believes that the new approach will provide strong incentives for banks to ensure that their control systems are adequate. Moreover, the Bank contends that the presence of Reserve Bank guidelines can be problematic, in that they risk being seen as "approved" minimum standards, which in fact they can never be. There is also a danger they will be seen as required minima, thereby causing banks to incur compliance costs, whether the controls are appropriate for their particular type of business or not.

Response to breaches of capital requirements

Another feature of the new approach to banking supervision is the adoption of a more structured approach to a breach of the minimum capital ratio requirements. This is intended to reduce the scope for regulatory forbearance by the banking supervisor and therefore to reduce the risks associated with such forbearance. Where a bank's tier one capital falls below 4 percent of risk weighted exposures or its total capital falls below 8 percent, the bank will be required to submit to the Reserve Bank a plan for restoring its capital to at least the minimum required levels. The bank would be expected to disclose the plan in its public disclosure statement at the first practicable opportunity. The plan would be required to include the following elements:

- No distributions are to be made to the bank's shareholders until the minimum capital requirements have been complied with.

- No increase in the amount of the bank's exposure to a related party from the level which prevailed at the time of the first occurrence of the breach will be permitted. Where a reduction in capital results in a bank being in breach of the limit on related party exposures, the bank would be required to reduce its exposure to related parties to a level which complies with the limit.

- Where a bank's tier one capital falls below 3 percent of risk weighted exposures, gross credit exposures must not be increased from the level which prevailed at the time of the first occurrence of the breach. The bank's plan for restoring capital to at least the minimum level would be expected to state compliance with this requirement.

If necessary, the Reserve Bank would enforce this policy by giving a direction to the bank, pursuant to the provisions in the Reserve Bank Act.

V Reactions to the new approach

There have been mixed reactions to the Reserve Bank's banking supervision policies. There has been a considerable degree of support, both in New Zealand and overseas, including from consumer lobby groups, academics and business commentators.

Understandably, there has been a somewhat more hesitant reaction from New Zealand's bankers. While most of the banks are supportive of the general direction of the reforms, a number of banks are uncomfortable at the degree of transparency which the new disclosure regime will bring to the banking system. They are also concerned that the new disclosure regime may impose substantial compliance costs. Some have also raised questions as to whether the Reserve Bank will be adequately placed under the new approach to maintain a sound banking system. Against these concerns, the banks have reacted positively to the removal of some of the existing prudential regulation, particularly the abolition of the limit on the amount which banks may lend to individual customers.

VI Conclusion

The Reserve Bank is confident that the new approach will be at least as effective in promoting a sound banking system as the more conventional approaches to banking supervision, but at lower efficiency costs, and with a reduction in risk to the taxpayer. The Bank is satisfied that the new approach to banking supervision, and the Bank's role within it, is fully consistent with the Bank's undertakings in respect of the Basle Concordat. (The Basle Concordat is an international agreement setting out in general terms the roles and responsibilities of "home country" and "host country" banking supervisors. It is designed to ensure that all banks are subject to an adequate level of supervision in all the jurisdictions in which they operate.)

Although the Bank's review of banking supervision arrangements is now at an end, the details of the disclosure regime are still in the process of finalisation. A revised set of proposals was released to banks and others in December last year for a second round of substantive consultation. The Bank expects to have finalised the disclosure proposals ready for implementation in the December quarter this year. It is from that time that most of the other banking supervision changes will take effect.

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