

The review of bank supervision arrangements in New Zealand: the main elements of the debate¹

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The Bank's review of banking supervision arrangements involved consideration of the structure and development of the banking system, the objectives and history of supervision, the local and international policy environments, and a number of analytical arguments. This article summarises the influences which these various elements had on our discussions and conclusions.

I Introduction

In the period since late 1991, the Reserve Bank of New Zealand has been conducting a major review of its banking supervision policies and procedures. The review has been through a number of stages, including some rounds of consultation with the private sector. The policy conclusions were finalised at the end of 1994, and our current efforts are being directed towards settling the details of implementation. It is hoped that the new regime will be fully operational by 1 January 1996.

It is not the purpose of this article to describe the conclusions of the review in any detail – that has been done in a number of other places³. Rather, this note seeks to describe some of the key issues which arose in the course of the review, and to explain how they were dealt with within the context of the broader policy reforms which have occurred in New Zealand over the last decade or so. Inevitably, the discussion is selective, and it does not constitute a full account of the review process. To keep the paper manageable, it does not deal to any significant extent with the failure-management of banks, although that is a closely related topic.

The remainder of the article falls into four main sections: first, a discussion of the various “environmental” influences within which we were developing our ideas; secondly, a brief review of the initial developments in supervision arrangements; thirdly, a summary of the key

analytical arguments which informed much of the discussion; and finally a summary of the general conclusions reached.

II Some background and history

It is only relatively recently that formal arrangements for prudential supervision and regulation have been introduced in New Zealand. The reasons for this, and the nature of the forces which led to change, can be discussed under a number of headings:

Structure of the banking system

For a long period up to the mid-1980s, the banking sector consisted of a small number of commercial banks (four in 1984), and a number of savings banks which offered a more limited range of banking services. All of these entities were subject to a wide range of controls over their interest rates and their investments – including government security ratios and sectoral lending requirements. These controls implied that extensive credit-rationing was a continuing feature of the system, and banks were able to confine their lending very much to low-risk areas. An extensive exchange control apparatus was in place, so that little cross-border competition was possible. There was little scope for effective competition within the sector and not much financial innovation occurred. The banking sector as a whole could be characterised as “boringly stable”.

Moreover, banks generally had strong owners with deep pockets: the commercial banks (and their savings bank subsidiaries) were owned either by strong foreign parents or by the government itself. The other savings banks were also either in government ownership, or enjoyed an explicit government guarantee of their deposit liabilities.

It is worth emphasising at this point that New Zealand does not have, and never has had, any system of deposit insurance. Indeed, somewhat surprisingly, it is not

¹ This paper was presented at a meeting of the OECD Committee on Financial Markets, Paris, 20-21 June 1995.

² Everyone who participated in the banking supervision review made a contribution to this paper. I have drawn ideas and words from many places, but particularly from Bruce White and David Archer.

³ See “Review of Banking Supervision: Reserve Bank's Policy Conclusions”, December 1994; and “Revised Disclosure Proposals for Registered Banks”, July 1995. See also “Banking Supervision: New Zealand Adopts a New Approach” - an article published in various professional journals and the RBNZ Bulletin, June 1995.

apparent from the record that any serious consideration was ever given to the idea. The reasons for this perhaps lie in some of the factors just mentioned: the perception that the banking system was very safe; the fact that there have been no bank failures in New Zealand in living memory⁴; the explicit Government guarantee (up until 1989) of deposits with trustee savings banks and Post Office Savings Bank; and the implicit guarantee enjoyed by the Bank of New Zealand (the largest commercial bank) because of its government ownership.

The absence of competitive pressures, and the ownership structure of the industry, implied that the possibility of bank failure was so remote that it was never seriously contemplated. While the Reserve Bank kept in reasonably close touch with the banks, it was not felt necessary to develop any specific supervisory tools.

The emergence of risks

This complacency was progressively broken down by a number of changes.

a. While competition among banks was limited, it became rather more heated outside the banking sector. In spite of progressive attempts to extend the control apparatus, a good deal of disintermediation occurred, and the market shares of the banks were eroded.

b. Once the non-banks had captured a significant share of the deposit-taking and lending businesses, they started to exert significant pressure to enter other business areas still denied to them by regulation - notably foreign exchange dealing. These demands were gradually met, and this contributed to a progressive breakdown in the barriers between banks and non-banks.

c. The 1984-85 financial sector reforms - which swept away all interest rate controls, all ratio requirements and all exchange controls - introduced much more vigorous domestic competition within the financial sector, and also opened the doors towards the emergence of more active foreign competition. Banks were generally not well prepared to cope with their new freedom, and did not have appropriate management skills or risk management practices in place. In some cases, they entered this new era with unsatisfactory portfolio structures, as a consequence of the previous regulations.

d. In 1986, an amendment to the Reserve Bank of New Zealand Act explicitly allowed for the entry of new banks to the market. Under this policy, 21 new banks were

approved. Of these, 11 were existing participants in the domestic market, seeking to move into a broader range of service provision, while 10 were effectively new participants.

e. The opening-up of New Zealand's financial markets to both increased competition and more immediate foreign influences coincided with a major economic policy reform programme, which included the floating of the exchange rate, the establishment of a new monetary policy framework, major fiscal adjustment and public sector reform, and extensive deregulation in the "real" sector of the economy. Inevitably, this period involved adjustments in interest rates and asset prices which were outside the range of previous experience, increased volatility in some areas, and difficult structural adjustments in the private sector - with a number of significant business failures.

f. Government decisions to withdraw from any direct involvement in the banking sector led to the sales of the Post Office Savings Bank (1989) and the Bank of New Zealand (1992), and the withdrawal of the explicit guarantee of deposits at trustee savings banks (1988).

g. Some aspects of banking business started to change quite significantly from the early 1980s. In particular, there were significant developments in the payments system, including the extensive introduction of electronic payments for both retail and high-value transactions; and moves by banks into new products and new business areas, including derivatives, insurance and funds management. However, these innovations were sometimes technically or market driven, and full analysis of the risk characteristics of both traditional and new business and payment arrangements has tended to lag behind until relatively recently. The significance of these risks is now increasingly understood.

These developments -- essentially increased competition, moves towards "globalisation", financial sector deregulation, privatisation, and financial innovation - have been common to most OECD countries, but the extent and the pace of change have probably been greater in New Zealand than anywhere else. Collectively, they imply that the New Zealand financial sector - and the banking sector in particular - are now subject to a significantly broader range of risks than they were a decade ago. However, the increased flexibility and experience now available also mean that banks and others have better capacity - and better tools - for managing those risks effectively.

International regulatory developments

The development of the original "Basle Concordat" in 1975, and its subsequent elaborations, have been of consider-

⁴ Although one substantial 'near-bank', DFC, failed in 1989.

able interest to New Zealand. The Concordat is aimed at ensuring that international banks (banks which operate in more than one country) are supervised appropriately – in particular, it established the principles that no banking establishment should escape supervision, and that supervision should be adequate. It also seeks to define the roles of “home” and “host” supervisors. Following the Concordat, much effort has been devoted by international supervisors to the task of defining common standards, approaches and guidelines, so that the “adequacy” of supervision is given some operational content – although national variations are not generally excluded.

New Zealand occupies a somewhat unusual position in relation to the Concordat (compared with most OECD countries) in that we can be viewed almost exclusively as a “host” supervisor. The domestic banking sector is around 90 percent (by assets) foreign owned; and no international banking groups are headquartered in New Zealand. New Zealand is also unusual in another respect, already mentioned, in that we have no deposit insurance scheme operating in New Zealand.

New Zealand has always supported the basic principles of the Concordat, and has accepted an obligation to play its part in putting it into practice. However, these two unusual features – in particular – mean that we have not always found the more detailed guidelines fully appropriate to our own circumstances. Thus, while the work of the Basle Committee and others have provided us with an immense amount of useful information and analysis on key issues, we have found it necessary to exercise our own judgement on these matters, and at times decided on pursuing a different route. The nature of these differences will be apparent from the later discussion.

However, it remains an important goal, both for the authorities and for the banks that we supervise, that our bank supervision regime should be internationally credible.

Public sector reforms

The development and review of bank supervision arrangements took place at the same time as a wide-ranging public sector reform process. These reforms focused both on **what** the appropriate role and objectives of the State should be in each policy area, and **how** these roles and objectives could best be achieved. While this sounds quite innocent, the seriousness with which it has been carried through has had a profound effect on the culture of New Zealand’s public sector, and the Reserve Bank is no exception to this.

With regard to the **content** of policies, some of the key guiding principles with relevance to banking supervision have included:

- a. Policies should have a medium term orientation, rather than a short-term focus.
- b. The degree of government direct intervention in the economy should be reduced as far as possible, in order to allow markets to function more efficiently.
- c. Policies which distort prices should be eliminated as far as possible, so that key price signals come from the market and not from the authorities.
- d. Internal and external competition should be encouraged in all markets, and any unwarranted barriers to competition should be removed.
- e. Policies should be designed and implemented in a competitively neutral manner, so that like activities are treated in the same way irrespective of their precise location.

In terms of the policy **process**, the basic aim was to move the bureaucracy away from a “process” orientation, and towards a “results” orientation. Crudely put, there has been less emphasis on “doing things right” and more focus on “doing the right things”. There has also been close attention to finding cost-effective methods of delivery. Within this paradigm, we have seen the emergence of more explicit strategic planning, incorporating more careful specification of desired outcomes and outputs; more careful separation of the Government’s “ownership” and “purchasing” interests; greater independence for public sector managers in choosing the techniques for delivery of their required outputs; and a substantially higher emphasis on performance assessment and accountability. For the Reserve Bank, perhaps the most notable feature has been the move towards specifying a single clear objective for each policy activity, rather than the multiple objectives which tended to be associated with these activities in the past.

These principles and approaches have worked very well in some areas of public administration, particularly in entities which are akin to “production” organisations. However, they cannot be applied so satisfactorily to entities which do not fit the “production” description well - and a banking supervision organisation does not. It is rather like a peacetime army. It is relatively straightforward to specify when things have gone badly wrong with a supervision regime: newspaper headlines provide instant feedback, although a bank failure does not automatically imply that there has been a supervisory failure. However, it is a far more challenging task to specify either the right outcomes or the right outputs of a supervision regime when there is no crisis: history teaches some

lessons, and provides some probabilities, but it would be unwise to rely on these. Similarly, it is particularly difficult to produce reliable cost-effectiveness assessments of differing approaches to supervision: both the costs and the benefits have substantial intangible elements. Finally, financial and banking crises often have their roots in areas outside the supervisors' purview or control (in either a geographical or a functional sense), and shocks can emerge with little or no warning. These factors suggest that bank supervisors need to be suitably modest about what they can achieve, and suitably cautious about arguing that more supervision always leads to better social outcomes.

III Initial approaches to supervision and related regulatory developments

In broad terms, there have been three distinct strands of development:

Securities market regulation

While the public sector carried out some "prudential" activities in earlier years, these were somewhat fragmented, and a number of dubious practices emerged in the 1970s, mainly in the non-bank sector. These eventually led to the passing of the Securities Act 1978, which established a Securities Commission, introduced mandatory disclosure in relation to offers of securities to the public, placed some controls on advertisements, and required issuers of debt securities to have a trust deed.

The original Securities Act contained a wide range of exemptions. In particular, the whole banking sector was effectively exempted from most aspects of the regime, at least in relation to deposit-taking and the issue of other debt securities. However, the banks' exemption from the prospectus requirements was eventually eliminated, and banks were brought under the Securities Act disclosure framework in the late 1980s. Banks are still not required to have a trust deed, and the associated supervision by a trustee.

The basic purpose of the Securities Act disclosure regime is to help ensure that investors are provided with sufficient information to enable them to make informed decisions about alternative investments. The Commission (or the Registrar of Companies) is not required to take any view on the merit or safety of different investments, securities or deposits. It can refuse to register, or cancel, prospectuses only if they are incomplete (in relation to the statutory requirements), contain any false or misleading statement, or omit something material.

While the Securities Act now covers most private sector deposit-taking activities, it should be noted that there are no restrictions – in this Act or elsewhere – on who can enter this business. In other words, there is no licensing regime for deposit-takers.

Reserve Bank prudential supervision

In parallel with opening the door to new bank entrants, the Reserve Bank took its first steps into formal bank supervision in 1987. The Bank was empowered to register and supervise banks (and initially some other institutions), and to deal with situations of financial distress. The bank could exercise its powers only for the purpose of promoting a sound and efficient financial system, or for avoiding damage to the financial system if a supervised institution got into difficulties.

Registration as a bank was not mandatory, but in the event all large banking organisations registered. The benefits included the right to use the name "bank", and any additional status or credibility involved – including the right to a 20 per cent risk weighting in the capital framework. Registration did not – *per se* – give banks access to any new activities or financial services.

The Reserve Bank's initial approach to supervision was very much at the "light" end of the spectrum. This reflected the view that the primary responsibility for managing a bank rests with its directors and managers, and that it would be unhelpful to detract from this responsibility. The initial supervisory structure consisted of a minimum capital ratio, a connected party exposure limit, and some consultation and off-site monitoring. However, as time went on, the regime was progressively extended – partly in response to the financial distress which emerged in the banking system following substantial falls in asset prices and a weakening domestic economy after 1987; and partly following regulatory developments in many other countries. By late 1991, when the review began, New Zealand's banking supervision system was broadly similar to that in several other OECD countries, and involved quite detailed quarterly prudential reports to the Reserve Bank.

Other regulatory initiatives

While neither the securities market regime nor the banking supervision framework were designed to look after depositors directly, a number of other regulatory developments have had some impact on the banking system in this respect. They have contributed in two main ways – by strengthening the incentives for the issuers of financial

securities to adopt and maintain prudent management practices; and by providing investors with greater capacity to protect their own interests.

The main developments have been:

- a. The Companies Act 1993 was a comprehensive rewrite of company law. It included clarification and strengthening of directors' duties, a formalised solvency test, and a strengthening of the rights of minority shareholders.
- b. The Financial Reporting Act 1993 provided for the first time for mandatory compliance with accounting standards. This is intended to improve both the quality and the comparability of financial reports.
- c. Mandatory disclosure requirements for investment **products** (as opposed to issuers) are currently being developed. These are intended to provide for clear disclosure of the key characteristics of the product in a standard format, and thus facilitate comparison of alternatives. There will also be mandatory disclosure of the qualifications of investment advisers, and their procedures for handling client funds.
- d. Several pieces of legislation have introduced or extended consumer protections – including the Credit Contracts Act 1981, the Fair Trading Act 1986, and the Consumer Guarantees Act 1993. These all apply fully to the financial sector.
- e. As well as government initiatives, there have also been some self-regulatory developments. In particular, the banking industry has developed and promulgated a Code of Banking Practice, and has introduced a Banking Ombudsman scheme, to help handle disputes between banks and customers.

IV The analytical arguments

The key elements of the review of banking supervision arrangements comprised:

- a. Consideration of all of the above background
- b. Careful consideration of the desired outcomes
- c. Analysis of the market incentives to produce these outcomes
- d. Identification of any market failures or externalities
- e. Identification and evaluation of the options for intervention

The nature of the public policy interests

At the outset, it was necessary to consider the basic objective of bank supervision – and, in particular, whether the aim should be to protect individual depositors, individual banks, or the banking system as a whole. While it is not always easy to keep these different “customers” completely separate, it was reasonably straightforward – in the New Zealand context - to confirm that the supervisor's primary duty is to safeguard the system.

The judgement that no duty is owed to individual depositors is perhaps as much political as analytical in nature. It reflects the current government ethos in New Zealand that its principle role lies in the establishment and maintenance of property rights. Within that framework, businesses and individuals should be given a high degree of freedom to conduct their affairs as they think fit, provided that they accept themselves any risks which may be involved. The government is not in the business of providing a safety net in relation to business activities. The view is also consistent with New Zealand's history, in that no widespread deposit insurance or deposit guarantees have ever been available.

However, there is certainly an argument that the financial system should contain a “safe haven” sector, to give those who are particularly risk averse the freedom of choice to put their money into risk-free investments. While government securities can fill this role in some respects, they do not have the accessibility or transaction convenience required for some purposes. But to acknowledge the fact that New Zealand does not currently offer a convenient safe-haven is not to make a case for offering a warranty to the whole banking system, whether by supervision, insurance or guarantee. The need could be met in a much more focused way, through development of a “narrow” bank, or through a much more restricted form of warranty, at much lower potential risk to the Government. These are issues to which the Reserve Bank will be giving more thought in the future.

The conclusion that no duty is owed directly to individual banks (and, in particular, their owners and managers) is probably less contentious. The failure of a bank - *per se* - is of no more concern to the authorities than the failure of a supermarket. It only becomes a concern if it impacts seriously on the system as a whole.

The notion that the banking system as a whole is worth safeguarding is generally accepted. The central position of the banking industry in the economy implies that disruption to the banking system could cause widespread damage to the economy.

Market incentives on banks and their customers

For the purposes of this discussion, the banking industry can be distinguished from other industries mainly on account of its balance sheet structure. In particular, banks typically have liabilities which are predominantly in the form of “debt”, and a large proportion of their liabilities are typically repayable on demand. Depositors can often have a significant proportion of their wealth in banks, and sometimes ask banks to handle very large transactions on their behalf. The stakes, for depositors, can therefore be quite high. Bank assets, on the other hand, are often concentrated in “loans” which are both illiquid and inherently uncertain in their value. Clearly, the stability of any firm whose funding is structured along these lines is critically dependent on depositors maintaining confidence in its solvency. If solvency is in doubt – even in a small sense – depositors have both the freedom and the incentive to promptly withdraw their funds.

However, depositors have little real capacity to evaluate the asset side of a bank’s balance sheet. They effectively have to rely on the skills of the banker in performing credit assessments and managing risks, which are not directly observable. Thus, there is a situation of asymmetric information, in the sense that depositors are not fully able to assess the risks they are taking when placing funds with a particular bank. Three generic types of approach to dealing with asymmetric information in the banking sector can be identified.

First, in principle, deposit “contracts” could be developed, analogous to the financial covenants which are often observed in securities markets and to the trust deed arrangements generally required of non-bank financial institutions. Such contracts would effectively limit the bank’s ability to take risks, and include some monitoring and enforcement provisions – probably through some agency arrangements. However, it is not self-evident that this would represent the most efficient way of organising banking business: it could involve significant costs, and limit the flexibility of banks to respond to changing circumstances and to take advantage of new business opportunities. In other words, it could remove some of the key characteristics which have made banking a successful industry. This is probably why such contracts do not generally feature in the banking sector.

A second approach could be described as the incentives-matching solution. Depositors, aware of their inability to monitor the bank’s performance effectively, would preserve their ability to “run” by keeping their deposits liquid. Bankers, aware of their vulnerability to losses of confidence, would aim to build, and jealously protect, their reputations. They can promote their reputations by voluntarily disclosing the strength of their financial positions,

by subjecting their accounts to audit and other external assessments, and by obtaining credit ratings. All of these things are likely to happen in the absence of any regulation. Indeed, it is instructive to note that the capital positions of banks in the era prior to bank regulation were often much stronger in many countries than they are today.

The third generic approach is for governments to intervene to alter the nature of the asymmetric information equilibrium. One route would be to introduce regulatory restrictions across the banking sector, to proxy those that might feature in a typical deposit “contract” (if such a thing existed). Another possibility would be to introduce some form of external monitoring of banks, so that depositors can be given some comfort from an independent and informed assessment that their bank is safe. Monitoring will be discussed later in the paper, but note that it does not necessarily have to be carried out by a bank supervisor.

Overall, there seems to be nothing in the analysis of the information asymmetry “problem” which suggests that the market is not capable of providing a market solution. Whether such a solution would be optimally delivered in a free market is perhaps not entirely clear, and little relevant empirical evidence can be brought to bear on the question. However, there are some other reasons for thinking that some form of regulation and external monitoring of banks would be in the public interest, to which we now turn.

The grounds for intervention in banking

This section considers the arguments for intervention in the banking sector which were found to be persuasive in the course of the review. These were judged against the basic public policy principle that some kind of market failure or externality generally needs to be identified before a case for government intervention can be established.

Two basic arguments were found to be compelling. The first is the nature of the second-round impacts of a bank failure or a situation of bank distress. These include:

- a. The classic contagion effect, where a problem in one or more banks leads to loss of confidence in other banks.
- b. A contagious effect on classes of bank borrowers which may have contributed to bank stress, leading to some kind of “credit crunch”.
- c. Losses incurred by other banks through direct or indirect exposures to a failed bank - a “domino” effect.

d. Potential costs incurred by bank customers prevented from carrying out planned transactions - particularly if the payment system is subject to disruption.

These are all effects which could convert an individual bank problem into a systemic problem. They also have a common element that some of the costs of the initial failure may be borne by third-parties which have no direct relationship with the problem bank. While in this sense they are classic externalities, this does not mean that third parties are necessarily powerless in guarding themselves against such events. Clearly, the risk that such problems will emerge is very much a function of the structure of the banking industry in different countries, and the particular source of the initial problem. It is therefore difficult to come to any general view of the size of these risks. The judgment in New Zealand was that - for the time being at least - they are material, although they are probably easily exaggerated.

The second key concern was the extent of the government's implicit guarantee to banks (or to depositors). While the present supervision arrangements contain no deposit protection element, and the Reserve Bank has been diligent in reminding people that it offers no warranties of individual banks, there is nevertheless a clear "political" risk that a material bank failure, and/or a systemic threat, could generate very strong pressures for a bail-out. This risk may be exacerbated by an approach to bank supervision which involves monitoring of **private** information by the supervisor, and requiring banks to comply with rules established by the supervisor. This creates two issues: first, if the Government is indeed a de facto insurer, then it needs to manage its risks in that respect. Secondly, if private agents act on the assumption that the government will stand behind banks, then a familiar moral-hazard problem arises. Bank customers and counter-parties will pay less attention to the financial performance of their banks, and bank managers will have more freedom to engage in riskier activities - in effect, trading on the guarantee.

Again, the exact size of the implicit guarantee/moral hazard problem is not observable, and is a matter for speculation. The nature of New Zealand's reforms over recent years suggests that it is probably now considerably lower than it used to be. However, our judgment was that it remains material.

V Options for intervention

Moving from the "problem identification" stage to the "choice of techniques" involved a number of considerations. A key to the process was the principle that "problems" should be attacked as close to their source as possible. This led to two key conclusions:

a. Any direct transmission mechanisms for systemic problems should be reduced as far as possible. The main thrust in this respect has been to promote some major payment system reforms, including the adoption of real time gross settlement, which is targeted for implementation in 1996. This should markedly reduce the size of interbank exposures from the present uncomfortably high levels and ensure that residual exposures are more readily observed and managed. There is also work to be done to improve the legal basis for determining payment finality, and to tidy up some aspects of the failure management provisions for banks.

b. Supervision arrangements should be designed in a way which minimises the implicit government guarantee rather than institutionalising it.

Three other principles were also influential:

c. Market incentives and public policy incentives have much in common in this area, and it would therefore be appropriate to utilise market incentives as much as possible.

d. The regime should meet the public policy principles outlined above: in particular, it should allow for an open, competitive and flexible banking system, and not contain any unwarranted privileges or restrictions for banks in comparison with non-banks.

e. Recognising that all interventions involve administrative and compliance costs, and allocative distortions, all aspects of the regime need to pass a "positive net benefits" test - even if this cannot be wholly objective.

Against this background, the following decisions on future bank supervision arrangements were made:

Rules

The principal mandatory elements will be:

a. While there will continue to be no restrictions on the conduct of banking business, any entity wishing to call itself a "bank" will be required to register with the Reserve Bank, and will be subject to the requirements below. The criteria for registration will be that intending banks have appropriate standing and (for locally incorporated banks) a minimum capital level of NZ\$15 million.

b. Banks will be subject to a minimum capital requirement of eight percent of risk-weighted assets, calculated in line with the Basle Committee's framework. The Reserve Bank considers that capital adequacy is fundamental in two respects: first, it provides a buffer so that losses

of a reasonable size can be absorbed without bringing the bank down. Secondly, it helps to ensure that the owners of a bank have a sufficiently large stake in its success to give them the incentive to closely monitor its activities and its risk management methods. Although the Reserve Bank is confident that disclosure of banks' capital positions creates strong incentives for banks to hold capital equivalent to international norms, it was considered appropriate to retain the BIS standards as mandatory minima for reasons of international credibility and as a trigger for intervention where that minimum level is breached. Associated with the capital requirement will be a restriction on exposures to connected persons (of 75 per cent of tier one capital), to prevent a bank being decapitalised through the back door.

c. Banks will be required to issue public disclosure statements at quarterly intervals. The disclosure requirements will be very comprehensive, and will include information on:

- the income statement and balance sheet
- directors and their interests
- asset quality and provisioning
- the number of large exposures (including interbank exposures) as measured relative to the bank's equity
- related party exposures as measured relative to the bank's equity
- sectoral exposures
- capital adequacy, including off-balance-sheet items
- market risk exposures
- credit rating (if held)

The disclosure statements required will have to be certified by directors as not false or misleading on each occasion, and will be subject to external audit twice per year. In addition, directors will be required to provide an attestation that the bank has adequate systems in place to monitor and control risks, and that these systems are being properly applied.

The proposed disclosure regime is the key ingredient of the new approach. It is envisaged that public disclosure in the form envisaged – which involves considerably more transparency than at present – will place very strong incentives on the owners, directors and managers of banks to ensure that the bank's business is conducted prudently. It will require banks to take greater responsibility themselves for understanding and managing their risks, rather than simply relying on a supervisory regime to set the appropriate standards. Note, in this context, that the existing large exposure restrictions (for both foreign exchange and credit risks) and the internal controls guide-

lines issued by the Reserve Bank have already been withdrawn. It should also be noted that the disclosure framework will be tightly integrated with a new accounting standard, which will be applicable to financial institutions generally – so that, once due process has been completed, banks will not be subject to a more onerous regime than other institutions, except in respect of the frequency of disclosure. This approach will also be consistent with the development of greater harmonisation of banking and securities market regulation, which is desirable on competitive grounds, and helps to avoid regulatory arbitrage. In terms of compliance costs, the banks are likely to face additional costs in meeting their new disclosure obligations. Offsetting this, to some extent, will be the cessation of reporting to the Reserve Bank, the abolition of existing bank supervision fees, and the additional business freedom gained through the removal of some direct controls.

Monitoring

The decision to adopt a comprehensive public disclosure regime determined the basic shape of the arrangements to monitor the financial condition of banks and compliance with the mandatory requirements. In the front line – where they should be – are the owners, directors and managers of banks, who have the primary obligation. In the second row are independent experts such as auditors and rating agencies. At the third level, probably, are other banks who are important counterparties, and should find this information very helpful in managing their interbank credit risks. Next come private sector analysts, and depositors themselves – who should be able to use the available public information to form reliable views about the soundness of different banks. It seems likely that situations of emerging stress will often gain public attention more quickly under these arrangements, and – given the transparency involved – that they will be dealt with more effectively (and pre-emptively) by the banks themselves.

The Reserve Bank itself will also retain a monitoring role, but of more limited scope and intensity than in the past. It will generally be based on the public information released by banks, which will be used to check the compliance of banks with the mandatory requirements, and build a system-wide picture of conditions in the industry.⁵ Normally, the Bank will not seek private information beyond the public statements, and will not inspect banks.

⁵ Note that the public information to be released by banks is comparable, in both detail and frequency, to that currently provided privately to the Reserve Bank in the form of statutory prudential reports.

These roles are deliberately avoided in terms of the goal of minimising the implicit Government guarantee of banks. However, the Bank is certainly not proposing to cut itself off from the industry: dialogues and consultations will be held - both formally and informally – so that we can keep closely in touch with emerging trends and new issues.

Enforcement

In most respects, the public nature of the regime should imply that it is pretty much self-enforcing. A framework for essentially automatic sanctions (in the event of capital falling below the minimum level) is described in the policy proposals. Such automatic sanctions are expected to have a useful role to play in limiting regulatory forbearance in the event of a bank coming under stress.

In any event, the regime is underpinned by a fairly wide range of enforcement options. Banks and their individual directors are subject to both civil and criminal liability in respect of disclosure statements which contain false or misleading information. The Reserve Bank has powers to investigate the affairs of registered banks, give them directions, cancel their registration, and to recommend that they be placed into statutory management.

VI Conclusion

The Reserve Bank is confident that its new banking supervision arrangements will be at least as effective in promoting a sound banking system as more conventional approaches to bank supervision, but at lower efficiency costs to the banking system, and at reduced risk to the New Zealand taxpayer. We have sought primarily to design a system which reinforces the incentives banks themselves face to be prudent, and which does not undermine the incentives for the markets themselves to monitor banks. While the outcome of the review puts a somewhat greater distance between the Reserve Bank and individual banks, we do not see this as a move towards greater laxity: on the contrary, the new regime is seen as placing a very high degree of discipline on banks operating in the New Zealand market.

