# Banking soundness and the role of the market

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## Introduction

My address this morning is on “Banking Soundness and the Role of the Market”. As most of you will already know, this is a subject of particular relevance to New Zealand, given that we have adopted a banking supervision approach which places considerable emphasis on the role of the market in promoting a sound financial system. In my speech today I will be outlining the key features of our new approach to banking supervision and the reasons why we have gone in this direction. Although much of my address will focus on the New Zealand experience, I will attempt to draw some general conclusions about the role market disciplines can play in promoting a sound and efficient financial system - conclusions that may have relevance for the design of banking supervision arrangements in other countries.

Before I outline the new approach to banking supervision in New Zealand, I think it would be useful to give you a little background on the supervisory structure which operated at the time that the Reserve Bank of New Zealand conducted its review of banking supervision.

## Background to New Zealand’s banking supervision arrangements

New Zealand first adopted a formalised approach to banking supervision in 1987. For most of the period from then until the end of 1995 New Zealand’s approach to banking supervision was relatively orthodox. It involved:

- minimum capital requirements (based on the Basle Capital Accord);
- limits on the amount which banks could lend to individual customers and related parties;
- a limit on banks’ open foreign exchange positions;
- off-site monitoring of banks, using information provided privately to the Reserve Bank;
- annual consultations with the senior management of banks; and
- a range of powers to enable the Reserve Bank to respond to bank distress or failure.

However, the former system of banking supervision differed in some important respects from the approaches adopted in many other countries. In particular, New Zealand’s supervisory framework:

- did not involve the licensing or supervision of deposit-taking or the business of banking - only those entities wishing to use the word “bank” in their name were subject to supervision;
- did not feature deposit insurance;
- did not seek to protect depositors *per se* - instead, it sought to protect the financial system as a whole; and
- did not involve any form of on-site examination of banks.

These distinguishing features continue to apply under the new supervisory framework.

In late 1991 we commenced a major review of our banking supervision arrangements. The review was motivated by a number of concerns.

- Probably the main reason for commencing the review was a concern that conventional approaches to banking supervision generally make insufficient use of market disciplines as a means of promoting a sound and efficient financial system. We believed that there was considerable scope to use market disciplines to promote systemic stability. In particular, we wished to provide the market with a greater capacity to hold the directors and management to account for the sound management of their bank. And we wanted to improve the market’s ability to make well informed decisions as to which banks they would do business with. As I note later in this address, we concluded that the introduction of a well focused and comprehensive disclosure regime would go a long way towards achieving these objectives.

- Another factor which led us to review our banking supervision arrangements was a concern at the compliance costs and regulatory distortions which can be associated with conventional approaches to banking supervision. This concern reflects our view that banking supervisors tend to have strong incentives to promote a stable financial system, without always having appropriate regard to the compliance costs and regulatory distortions to which supervision and prudential regulation can give rise.

- We were also concerned at the taxpayer risk involved in the traditional approach to banking supervision. Although this risk is present regardless of the form banking supervision takes, it is likely to be greater where the banking supervisor, and *only* the banking supervisor, has regular access to financial information on a bank. It is also likely to be greater the more intensive the supervision process is. We wanted to explore ways of reducing the risk of the government being called upon to rescue a bank in distress.

- Finally, we recognised that conventional banking supervision can only go so far in promoting a sound banking system. There are inherent limitations in the extent to which prudential regulation and supervision, even supervision which includes on-site examinations, can minimise the incidence of bank distress and failure. This is evidenced by the fact that countries with intensive supervisory regimes have not been immune from serious episodes of financial distress. Indeed, we were concerned that banking supervision could even be increasing the risk of bank failure or distress, by potentially reducing the incentives for bank directors and managers to make their own considered judgements about what constitutes prudent behaviour.

## The new approach to banking supervision in New Zealand

In the light of these concerns, and following a lengthy period of review, we concluded that the concerns we had identified could be substantially addressed by placing greater reliance on market disciplines through public disclosure by banks, increasing the accountability of bank directors and management, and reducing the extent of prudential regulation. The new banking supervision arrangements, which came into force on 1 January 1996, reflect these conclusions.

The new approach differs from the former regime in two main areas. First, a new disclosure regime applicable to all banks operating in New Zealand has been introduced. The disclosure regime is designed to strengthen substantially the market disciplines on banks and sharpen the incentives for the directors and management of banks to manage their banks' affairs in a sound and responsible manner. I will outline the main features of the disclosure arrangements shortly.

The second major change involved a reduction in the extent of prudential regulation of banks. The main changes included:

- the removal of the former limit on the amount which banks may lend to their customers;

- the removal of the limit on banks' open foreign exchange exposures;

- the removal of the Reserve Bank's guidelines on internal controls and the associated audit requirements; and

- the removal of the need for banks privately to report their financial position and risk exposures to the Reserve Bank.

We were satisfied that the introduction of the new disclosure regime obviated the need for many of the former prudential controls on banks.

Undoubtedly the feature of the new approach that has attracted most attention is the disclosure regime. Let me briefly outline its main features.

- Under the new arrangements, all banks operating in New Zealand must publish a disclosure statement each quarter. The disclosure statements are in two forms: a brief Key Information Summary, which is aimed at the ordinary depositor; and a more comprehensive General Disclosure Statement, which is aimed principally at the professional analyst.

- The Key Information Summary contains a short summary of key information on a bank, including:

  - the bank's credit rating (or a statement that the bank has no credit rating);

  - the bank's capital ratios, measured using the Basle framework; and

  - information on peak exposure concentration, peak exposures to related parties, asset quality, shareholder guarantees (if any) and profitability.

The Key Information Summary must be displayed prominently in, and be available on demand from, every bank branch.

- The General Disclosure Statement contains wider-ranging and much more detailed information on a bank and its banking group, including:
    - corporate information and some information on parent banks (where applicable);
    - comprehensive financial statements (including a five year summary of key financial data);
    - credit rating information (including any changes to the rating in the two years preceding a bank's most recent disclosure statement balance date);
    - detailed information on capital adequacy, asset quality and various risk exposures (including exposure concentration and related party exposures);
    - information on funds management and securitisation activities, risk management systems, and a summary of the prudential regulations imposed on the bank in question by the Reserve Bank of New Zealand;
    - information on the bank's exposure to market risk, both peak and end of period (and in respect of the full banking book).
- The disclosure statements issued by banks are subject to full external audit at the end of year and a limited scope audit review at the half year. Disclosure statements issued at the other quarters in the year are not required to be audited.
- One of the most important features of the disclosure framework is the role it accords bank directors. Each director is required to sign their bank's disclosure statements (or authorise someone to sign on his or her behalf) and to make certain attestations in the disclosure statements, including:
    - whether the bank is complying with the prudential requirements imposed on it by the Reserve Bank;
    - whether the bank has systems in place to adequately monitor and control its banking risks and whether those systems are being properly applied;
    - whether the bank's exposure to related parties is contrary to the interests of the bank; and
    - whether the disclosure statement contains all the required disclosures and is not false or misleading.
- Directors face severe criminal and civil penalties (including up to three years' jail and personal liability for creditors' losses) if a disclosure statement is held to be false or misleading.

The disclosure arrangements are expected to bring a number of important benefits to the New Zealand financial system:

- We are confident that the disclosure arrangements are playing an important role in strengthening market disciplines on banks. Under the new arrangements the market has considerably greater information on a bank's financial performance and risk positions than was previously the case. And the information is available more frequently and in a more timely manner. The market therefore has greater scope to react to developments affecting a bank's financial condition - rewarding those banks which are well managed and penalising those which appear to be less well managed. The strongest banks are likely to benefit from that strength by operating at lower costs; weaker banks are likely to be under pressure to strengthen their position. Over the longer term we believe that stronger market disciplines will make a major contribution to the soundness of New Zealand's financial system.
- Another benefit which we expect to see from the disclosure regime is a growing emphasis on the important role which bank directors play in overseeing the prudent management of their banks. The disclosure framework reinforces and provides a sharper focus on the duties of bank directors. In particular, it sharpens the focus on directors' duties to ensure that their bank has the necessary systems in place to identify, monitor and manage adequately the bank's various business risks, and to ensure that those systems are being properly applied at all times.
- The disclosure requirements are also likely to increase the accountability of bank directors and, indirectly, the accountability of various levels of management within the banks. As a result of the disclosure arrangements, we would expect to see directors taking greater care than might otherwise have been the case to ensure that they are adequately discharging their obligations. In so doing, it is likely that

directors will take steps to ensure that there are appropriate accountability mechanisms within the management hierarchy.

- Over time, we expect that the increased accountability of bank directors will lead to an improvement in the quality of bank boards. Shareholders now face stronger incentives to ensure that the directors of their banks have the appropriate skills, experience, integrity and judgement to fulfil the duties expected of them.

- Another important benefit which we hope will flow from the disclosure regime is a reduction in the risk that the taxpayer will be called upon to rescue a bank. As a result of the disclosure arrangements we hope that there will be a stronger public perception that the management and directors of a bank have the sole responsibility for the management of their bank's affairs. Moreover, the public now has access to much the same information on banks as does the Reserve Bank, thereby eliminating the monopoly of information which supervisors generally tend to have in respect of a bank's financial condition. Both of these factors should assist in enabling future governments to resist the inevitable pressures to rescue a bank in distress or to insulate creditors from losses - at least to some extent.

Although the new supervisory framework places great emphasis on the role that market disciplines can play in promoting systemic stability, it is important to note that the Reserve Bank of New Zealand has not abandoned its responsibilities for the financial system. We recognise that, for the time being at least, systemic stability is best served by a combination of market disciplines and banking supervision. In particular, we see value in:

- retaining some control over which entities may call themselves banks in New Zealand;

- the Reserve Bank maintaining a sound understanding of the state of the financial system; and

- the Reserve Bank retaining a capacity to respond to financial distress or bank failure, where this threatens financial system stability.

In this context, a number of the Reserve Bank's core functions have been retained.

- The Reserve Bank continues to have responsibility for registering new banks.

- Banks continue to be subject to minimum capital requirements (in line with the Basle Capital Accord) and a limit on lending to related parties. Although we believe that disclosure alone would ensure that banks would maintain capital at least equivalent to the 8% minimum, we consider that retention of the minimum capital requirements reinforces the credibility of the new supervisory framework, at no additional cost to banks.

- The Reserve Bank continues to monitor banks on a quarterly basis. However, monitoring is now conducted principally using banks' public disclosure statements, in contrast to the former system of monitoring on the basis of information provided privately to the Reserve Bank. In most respects, banks' disclosure statements contain information which is more comprehensive and more reliable than the information previously provided privately to the Reserve Bank.

- The Reserve Bank also continues to consult with the senior management of banks. Formal prudential consultations are held annually, and generally focus on the strategic direction of the banks, major changes in their operations and other high level issues. In addition, as Governor of the Reserve Bank of New Zealand, I meet with the chief executives of the larger banks on a regular basis to discuss a broad range of issues, including issues relating to the banking industry and to the wider economy.

- And, importantly, the Reserve Bank retains a wide-ranging capacity to respond to financial distress or bank failure where a bank's financial condition poses a serious threat to the stability of the banking system.

As with the former supervision arrangements, the objective underlying the above responsibilities is the promotion of a sound and efficient financial system. Depositor protection does not feature in the Reserve Bank's objectives.

## Reactions to the new approach to banking supervision

All in all, I believe that the new approach has been relatively well accepted. But it has taken time for that acceptance to be achieved. It is fair to say that, during the review process, reservations about the new approach were expressed from a number of quarters, both at home and abroad. I think it would be useful to mention some of these.

One of the observations made has been that New Zealand is "free riding" on the efforts of the home supervisors. We firmly reject this notion. We believe that the new supervisory framework is at least as effective at promoting prudent banking practices as are the more traditional approaches to banking supervision. And we are satisfied that the new framework enables the Reserve Bank of New Zealand to fulfil its duties as a host supervisor within the terms of the Basle Concordat. In that regard, under the new approach to banking supervision, the Reserve Bank of New Zealand remains well informed about the activities and financial condition of all banks operating in New Zealand, and well placed to respond to incipient financial distress where appropriate. Indeed, as I have already noted, the disclosure regime provides the Reserve Bank (and the public) with information which is generally more comprehensive than the information previously received by the Reserve Bank.

But it is certainly true that any host supervisor will - inevitably - rely to some extent on the global supervision of the home supervisor. After all, this is an intrinsic part of the Basle Concordat. The most a host supervisor can realistically achieve is to promote prudent banking practices in the local operations of the banks within its jurisdiction.

In the context of the above point, some commentators have suggested that the Reserve Bank of New Zealand is not well placed to anticipate emerging financial distress in the absence of conducting on-site examinations of banks or otherwise obtaining private information from banks. Although I acknowledge that on-site examinations do increase the information available to banking supervisors, I am not at all convinced that the information obtained from such examinations enables the supervisors reliably to anticipate incipient financial distress. In modern banking, risk positions can and do change rapidly. A week in politics might be a long time, but in banking it is a very long time indeed! This is becoming increasingly the case. The information obtained from on-site examinations, or from any other sources for that matter, can only provide a snapshot of a bank's risk positions at a particular point in time, and even then generally only in respect of a subset of the bank's business. For these reasons I believe any such information is of limited usefulness in assessing the dynamics of a bank's risk positions or in anticipating financial distress.

I acknowledge, of course, that publicly disclosed information also has these limitations. But at least public disclosure brings with it the incentives for the sound management of banking risks. I am not at all sure that the private disclosure of information to a banking supervisor - whether on-site or off-site - creates these types of incentives.

A further concern we have with on-site examinations or the off-site collection of detailed private information on banks, at least in the New Zealand context, is the risk that these approaches can blur the lines of responsibility for the management of banks. If the banking supervisor has responsibility for regular on-site examinations, it presumably follows that the supervisor also has responsibility for encouraging or requiring a bank to modify its risk positions or make other adjustments to its balance sheet where the supervisor has concerns in relation to the bank's risk profile. This has the potential to erode the incentives for the directors and management of banks to take ultimate responsibility for the management of banking risks, effectively passing some of this responsibility to the banking supervisor. It also has the potential to create public perceptions that the responsibility for managing banking risks is effectively shared between a bank's directors and the banking supervisors. In turn, this makes it very difficult indeed for a government to eschew responsibility for rescuing a bank in difficulty.

I acknowledge that any system of banking supervision - even one that relies principally on public disclosure - will inevitably create public expectations that the supervisory authority takes some responsibility for the management of banking risks. And I acknowledge that any system of banking supervision creates a risk for the taxpayer in the event that a bank gets into difficulty. However, in order to minimise these risks, the Reserve Bank of New Zealand prefers to keep the spotlight clearly focused on the directors and management of a bank, rather than risk a further blurring of their accountability. We believe that the avoidance of having an on-site examination role or otherwise regularly obtaining private information from banks assists in this regard and reinforces market disciplines on banks.

Another observation frequently made is that New Zealand would not have adopted the new framework had a substantial part of its banking system been domestically owned. It is my firmly-held conviction that we would have adopted this approach even if all or most of our banks had been locally-owned. I say this because we believe that the regime is actually more likely to promote prudent banking behaviour than do the more traditional approaches, but with a lower likelihood of moral hazard and regulatory distortion. In this context, I should note that, at the time we commenced our review of banking supervision, in late 1991, a significant part of the New Zealand banking system was still domestically owned. Indeed, as I see it, many of the changes we have implemented in New Zealand would be of equal relevance to those jurisdictions in which the core of the banking system is domestically owned.

Another criticism made of the New Zealand approach is that comprehensive and frequent disclosure can, in some circumstances, exacerbate financial system distress, rather than promote systemic stability. I acknowledge that, in some circumstances, disclosure could exacerbate a bank's difficulties. For example, where a bank is required to disclose a loss or a severe deterioration in asset quality, this could lead to a sharp adverse reaction by the market, possibly causing the bank in question to come under liquidity pressure. Of course, this possibility exists with even the barest disclosure requirements - such as with the release of an annual report or a six monthly interim disclosure. And the risks of adverse market reaction are present even in the absence of disclosure requirements - for example, as a result of market speculation as to a bank's financial condition. Indeed, in some circumstances the disclosure of comprehensive information might actually *reduce* the risk of the market reacting adversely to misinformation or to an absence of information. In any case, where a bank knows in advance that it will be making adverse disclosures, it would generally have the opportunity to take steps to reduce the risk of an adverse market reaction. These steps would include the disclosure of the remedial measures being taken to address the bank's difficulties.

Of course, the risk of a severe market reaction to an adverse disclosure creates the very incentives for banks to ensure that they manage their affairs in such a way that there will be no adverse developments to disclose. In the longer term, therefore, the risk of adverse market reaction could be expected to promote a sounder financial system.

One of the criticisms often made of public disclosure by banks is that the vast majority of depositors will not read banks' disclosure statements. On this assumption, some observers suggest that disclosure is of very limited effectiveness. We do not agree. It is certainly true that most depositors are unlikely to read the disclosure statements. But the disclosure regime in New Zealand is not predicated on the assumption of wide readership by the ordinary depositor. The source of market disciplines does not lie in wide public readership. Rather, the efficacy of the disclosure regime rests on the assumption that the disclosure statements will be read by the agents of depositors, such as the financial news media, financial analysts and investment advisers, and by wholesale creditors and fellow bankers. It is the risk of adverse reactions by these types of disclosure users that creates the incentives for bank directors and management to manage their banks' affairs in such a way as to avoid the need to make adverse disclosures.

Although the disclosure regime does not rely on the mass readership of disclosure statements by depositors, the Reserve Bank of New Zealand is encouraging depositors to take a greater interest in their banks' disclosures. Over much of last year we actively promoted publicity about the new disclosure arrangements. And we prepared a "user's guide" to assist depositors (and their agents) to understand the disclosures being made by banks. The user's guide is now available in every bank branch in the country. While it is unlikely to be a "best seller", it is encouraging to note that there has, in fact, been a surprising degree of interest in it from the public. We hope that, over time, an increasing proportion of depositors will take a keener interest in their banks' financial condition.

Another observation made about the new framework is that our approach places an excessive emphasis on the role of bank directors - that we are asking too much of them. To illustrate this point, during the review process, I had a visit from the chief executive of one major international bank with an operation in New Zealand. He had come to protest strongly at the requirement that bank directors would have to sign the disclosure statements every quarter and attest to the appropriateness of their risk management systems. When I asked why, he said "... bank directors understand absolutely nothing about banking...". This comment is quite unfair about many bank directors, of course, but there is an uncomfortable element of truth in it in some cases. The blame for this situation almost certainly lies, in part, on a supervision regime which had assumed too much of the responsibility for the viability of banks. We very much hope that a regime which will continue to have some key regulations, but which is based primarily on market disclosure and director attestations, will improve that situation.

## Early indications of the effects of the disclosure regime

Although it is far too early to make conclusive assessments of the success or otherwise of the new supervisory approach, there have been some encouraging signs that the disclosure requirements are meeting a number of their objectives. I will briefly highlight a few of these.

- We have been encouraged by the fact that the financial news media in New Zealand have taken a close interest in the new bank disclosure regime. The quarterly disclosure statements have received quite detailed scrutiny from the news media, resulting in greater and more focused public exposure of banks' financial results and risk positions. We hope that this type of media attention will sharpen the incentives for banks' directors and management to manage their banks' affairs prudently.

  A good example of the news media's interest in banks' disclosure statements was the media's interest in one bank's disclosure of its non-compliance with a Reserve Bank prudential requirement. We were surprised at the intensity of the media's interest in this disclosure - as, I suspect, were the management and directors of the bank in question. Hopefully, this type of media attention, and the attendant adverse publicity to which it inevitably gives rise, will encourage banks to ensure that they comply with Reserve Bank requirements in the future. I am inclined to think that the threat of adverse publicity is likely to be a more effective discipline on banks than are many of the standard supervisory sanctions for breaches of regulatory requirements.

- Interestingly, the disclosure regime seems to be strengthening the extent to which banks scrutinise each other's financial performance and risk positions. We are aware that banks are making considerable use of the disclosure statements to monitor each other. The additional and more frequent information now available could be expected to assist banks in managing their inter-bank exposure positions and in assessing the extent and nature of the business they conduct with each other. We believe that the banking industry itself is one of the most potent sources of market disciplines on individual banks.

- Anecdotal feedback suggests that the obligations now placed on bank directors are causing the directors of some banks to exercise greater scrutiny of their bank's risk positions. In turn, this seems to be focusing greater attention on the systems they have in place for identifying and managing risks. Moreover, it seems that some banks are taking steps to increase the accountability of various levels of management within their banks. We are also aware that some banks have engaged external consultants to review aspects of their risk management systems. It seems that part of the motivation for conducting these reviews lies in the disclosure requirements - particularly the director attestation as to the adequacy of a bank's risk management systems.

These are all pleasing developments. We hope that they auger well for the success of the new arrangements. I am confident they will. But we are under no illusion that the new arrangements provide guarantees of financial system stability. Of course they do not. No system of banking supervision can do that. The most we are entitled to believe is that the disclosure regime will significantly reduce the likelihood of financial system instability in the future - at lower regulatory, compliance and taxpayer costs than other supervisory options might be expected to achieve.

## General observations on incorporating market disciplines into banking supervision

Before I conclude this address, I should probably make some comments about the extent to which market disciplines could be better incorporated into the supervisory frameworks in other countries.

I should first of all make it clear that the Reserve Bank of New Zealand is not promoting the New Zealand supervisory model as the ideal model for other countries to adopt. We make no such claims. The model we have adopted meets our particular needs, but it might not necessarily be suitable for other countries. Clearly, each country needs to make its own judgement as to what type of supervisory framework is best suited to its unique requirements. That judgement will inevitably depend on many considerations, including:

- the objectives which banking supervision is expected to meet, and whether those objectives include depositor protection;

- the existence or otherwise of deposit insurance arrangements;

- the structure of the banking system; and

- the infrastructure within which banking operates, such as banking law and accounting standards.

Having said this, I do believe that market disciplines can play a substantial role in most financial systems. In particular, I think policy makers in many countries could usefully give careful thought to the merits of introducing comprehensive and well focused disclosure requirements for banks. Similarly, I believe there would be much to gain from the adoption of policies designed to strengthen the responsibilities of bank directors, so that the ultimate responsibility for the management of banking risks lies squarely in the boardroom, rather than being awkwardly balanced between the banking supervisor and the bank director.

But it is fair to say that the effectiveness of market disciplines will much depend on the structure of the regulatory arrangements in place and the nature of the infrastructure within which the banking system operates. In particular, the following factors would seem to play an important role in determining the effectiveness of using disclosure as a mechanism for promoting systemic stability.

- Market disciplines are more likely to be effective where governments do not insulate depositors from losses - whether explicitly in the form of deposit insurance or through implicit depositor protection. Understandably, depositors and other creditors are less likely to take an interest in a bank's financial condition where they know, or have good cause to surmise, that they will be insulated from losses should a bank get into difficulty. In such circumstances, banks which are performing poorly are less likely to face adverse market reaction than in an environment where creditors operate under the expectation that they are likely to lose money in the event of a bank failure. In part, this is why, in New Zealand, we have eschewed deposit insurance or depositor protection, and have sought to make it clear to depositors, among others, that they should not expect the government to insulate them from losses in the event of a bank failure.

- It is also fair to say that market disciplines are more likely to be effective where the supervisory requirements applied to banks are kept to a minimum. I say this for two reasons. First, the greater the supervisory requirements, the more likely it is that the market will perceive that the government is underwriting individual banks. And second, the greater the supervisory requirements, the less likely it is that bank directors and management will view themselves as having ultimate responsibility for the management of their banks.

- The effectiveness of market disciplines will also depend on the structure of the financial system. In particular, it seems likely that market disciplines would be more effective where a bank is domestically owned - that is, where no other bank stands behind it. Where a bank is owned by another bank, the market would naturally have regard to the financial condition of the parent bank when assessing how it should react to disclosures made by the local bank. Market disciplines might therefore be somewhat more subdued in a financial system characterised by foreign ownership than in one dominated by locally owned banks. Having said this, I am fully satisfied that even in a financial system which is largely foreign owned, such as in the New Zealand financial system, there is very considerable scope to use market disciplines to promote improved risk management by the subsidiaries and branches of foreign banks. Indeed, it is possible that New Zealand's disclosure regime might well be adding to the incentives on overseas parent banks to supervise their New Zealand operations more vigilantly and to give greater attention to their own financial condition.

- The extent of government ownership of the banking system is also likely to influence the effectiveness of market disciplines. I think we would all agree that the market is less likely to impose meaningful disciplines on a bank which is state owned than would be the case with a privately owned bank - assuming, of course, that the market has faith in the financial soundness and political stability of the government in question. However, even where a bank is state owned, a robust disclosure regime might well strengthen the accountability of the directors and management of the bank, leading to improved risk management within the bank.

- It will come as no surprise to you that I believe that market disciplines are more likely to be effective where banks are required to make comprehensive disclosures on a frequent and timely basis. The disclosure requirements should focus on the key aspects of a bank's financial performance and risk profile, and should be made with sufficient frequency and timeliness as to provide the market with a meaningful basis for assessing a bank's financial condition and comparing one bank with another. Disclosure is likely to be more meaningful and effective if it is supported by robust accounting standards which have the force of law. Certainly, in the case of New Zealand, we have found that our disclosure regime has been assisted greatly by the introduction of legally binding and more rigorously drafted accounting standards. Moreover, disclosure requirements should ideally be coupled with an appropriate legal framework governing bank directors - a framework designed to focus directors' attention on their duties to manage the affairs of their bank in a sound manner, and to hold them to account for any breaches of those duties.

- However, as they say, there is a time and a place for everything. And so it is with disclosure. I think we would all agree that it would not be helpful to introduce new disclosure requirements at a time when the banking system is in a fragile state. Doing so could well exacerbate the situation. That is why, in New Zealand, we introduced the disclosure regime at a time when the financial system was in a strong position and therefore when disclosure would assist in maintaining confidence in the banking system, rather than detracting from it.

- Finally, the effectiveness of market disciplines through public disclosure will obviously be influenced by the infrastructure within which banking operates. By "infrastructure", I refer to such matters as:

  - the nature and adequacy of corporate law;

- the adequacy of accounting standards and audi ing requirements;
- the sophistication and integrity of the accounting profession; and
- the adequacy of the financial news media and financial professionals.

All else being equal, the more well developed the infrastructure, the more likely it is that market disciplines will be effective. This suggests that, in the case of some developing countries, where perhaps the infrastructure is not well developed, the scope for using disclosure to promote market disciplines is somewhat more limited than would otherwise be the case. But even in such cases, I would not dismiss the potential merits of developing relatively simple disclosure requirements, drawing on international accounting and auditing standards as appropriate, as a means of promoting some rudimentary market disciplines.

## Conclusion

Let me conclude by reiterating my view that market disciplines can play a powerful role in promoting systemic stability, in conjunction with some degree of banking supervision. I think there is considerable scope for policy makers to give further thought to how market disciplines could be better used to reinforce the efforts of banking supervisors in the quest for systemic stability. However, in giving thought to this matter, it may well be necessary for policy makers to re-assess some fundamental aspects of the conventional approaches to banking supervision and their relationship to the promotion of market disciplines. These include such issues as depositor protection, deposit insurance, the extent of prudential regulation of banks, and the intensity with which banking supervision is conducted. These are all substantial issues of course, and I have little doubt that there will be continuing international debate as to where the appropriate balance should lie. I very much hope that the approach which we in New Zealand have adopted will assist in promoting international debate on supervisory options.

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