
Core principles for effective banking supervision - an assessment of New Zealand's position

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1 Introduction

In September 1997 the Basle Committee on Banking Supervision (a committee of banking supervisory authorities established by the central bank governors of the Group of Ten countries¹) published a set of Core Principles for Banking Supervision. These Core Principles are intended to provide a set of minimum requirements for effective banking supervision and to serve as a basic reference for supervisory and other public authorities in all countries and internationally. The Committee believes that achieving consistency with the Core Principles by every country will be a significant step in the process of improving financial stability domestically and internationally.

Supervisory authorities throughout the world are being encouraged to endorse the Core Principles. This article assesses New Zealand's position in relation to each of the Core Principles.

2 Banking supervision in New Zealand

New Zealand's system of banking supervision addresses virtually all of the areas covered by the Core Principles. However, the means by which these areas are addressed, in some cases, differ from those contemplated by the Principles. This is because New Zealand has a system of supervision which places primary reliance on mandatory public disclosure of financial and prudential information, audit requirements and director attestations. In most other countries, on-site inspections and prudential limits are the main supervisory tools.

The approach taken in New Zealand is designed to promote a sound and efficient financial system primarily by making use of market disciplines. Comprehensive disclosure require-

ments improve the ability of the market to react quickly to developments affecting a bank's financial condition – rewarding those banks which are well managed and penalising those which fail to manage their affairs prudently. The risk of adverse reactions by the market reinforces incentives for banks to manage their affairs in a way which avoids the need for adverse disclosures to be made while still allowing them flexibility in managing their affairs, and avoiding excessive compliance costs.

The requirement that directors make quarterly attestations about a number of key prudential matters, in particular the adequacy of systems and controls and the veracity of the information contained in disclosure statements, reinforces the role of directors in overseeing and taking responsibility for the prudent management of their banks. In the long run this is likely to be more effective than other types of supervisory intervention which may reduce incentives for directors to exercise their responsibilities appropriately, and which may not cater adequately for the individual circumstances of each institution.

Overall we are confident that New Zealand has policies in place which deal effectively with each of the matters dealt with in the Core Principles, albeit using slightly different methods in some cases.

3 New Zealand's compliance with the Core Principles

This section comments on New Zealand's position in relation to each of the 25 Core Principles.

Principle 1: An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is

¹ Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States.

also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Responsibilities and objectives of supervisory agencies

The Reserve Bank of New Zealand is the only agency in New Zealand with responsibility for banking supervision.

The Reserve Bank of New Zealand Act 1989 (the Act) sets out the objectives of supervision and the Reserve Bank's responsibilities in respect of its supervisory role.

The objectives of banking supervision are promoting the maintenance of a sound and efficient financial system; or avoiding significant damage to the financial system that could result from the failure of a registered bank.

The Reserve Bank's responsibilities include the following:

- maintenance of a register of registered banks;
- determination of applications for registration as a registered bank;
- specification of conditions of registration for registered banks;
- publication of a Statement of Principles setting out the principles on which the Bank acts, or proposes to act, in determining applications for registration and imposing, varying, removing or adding to conditions of registration for registered banks;
- prescribing financial and prudential information which registered banks are required to disclose;
- dealing with crises affecting registered banks; and
- monitoring compliance with disclosure and other prudential requirements and, where necessary, initiating corrective action.

Operational independence and availability of resources

The Act specifies the supervisory powers which can be exercised by the Bank. The Bank has complete operational independence in exercising these powers. However, some crisis management powers, the power to make regulations and the power to specify the information banks are required to disclose in published disclosure statements cannot be exercised directly by the Bank. These powers must be exercised by the Treasurer or the Governor General acting on a recommendation from the Reserve Bank. The Bank is satisfied that these arrangements give it an appropriate degree of operational independence.

The Reserve Bank has the necessary resources to carry out its supervisory duties. The Bank is required to enter into a funding agreement with the Government which specifies the amount it can spend in carrying out its functions and in exercising the powers conferred on it by the Act. Each funding agreement covers a period of five years. However, provision exists for the Treasurer and Governor to vary the terms of the agreement during its currency should this be necessary. The Bank is satisfied that this arrangement ensures that it has the resources necessary for carrying out its supervisory role.

Legal framework

The Act provides the legal framework for the registration and supervision of banks. The relevant provisions of the Act are explained below.

Section 70 states that any person may apply to the Bank to be registered as a registered bank.

Section 73 sets out the matters the Bank must have regard to when considering an application for registration.

Section 74 empowers the Bank to impose conditions of registration on registered banks.

Section 75 requires the Bank to publish the principles on which it acts in determining applications for registration and in imposing, varying, removing or adding to conditions of registration.

Section 78 specifies the matters which the Bank is required to consider when making an assessment of whether or not a bank has carried on its business in a prudent manner, and states that the Governor may issue guidelines for the purpose of interpreting any of those matters.

Section 81 makes provision for the Governor General, on the advice of the Treasurer, given in accordance with a recommendation from the Reserve Bank, to prescribe information to be published by registered banks. Two Orders in Council specifying disclosure requirements have been issued under this section of the Act.

Section 93 gives the Bank powers to obtain information from registered banks.

Section 94 provides that the Bank may require any information or data supplied pursuant to section 93 to be audited by an auditor approved by the Reserve Bank.

Section 95 empowers the Bank to require registered banks to obtain reports on their financial and accounting systems and controls.

Compliance issues and safety and soundness concerns

The provisions in the Act which address compliance issues and/or safety and soundness concerns are described below.

Section 77 states that the Bank can recommend deregistration of a bank where that bank:

- has not complied with a condition of registration; or
- has not carried on its business in a prudent manner; or
- has failed to comply with an obligation imposed under the Act; or
- was registered on information that was false or misleading in a material particular, or
- has suffered a material loss of standing in the financial market since being registered; or
- is being wound up.

Section 83 provides that the Bank may require corrective action to be taken when a bank publishes a false or misleading disclosure statement.

Section 89 contains offence provisions relating to the failure to supply information and the provision of false or misleading information.

Section 94 contains offence provisions relating to the failure to have information supplied to the Bank audited when required to do so by notice in writing.

Section 95 allows the Bank to obtain a report on the financial and accounting systems of a registered bank. This provision may be used where the Reserve Bank has reason to believe that the bank is not maintaining adequate internal controls and accounting systems. Banks which fail to supply such a report commit an offence against the Act.

Section 99 allows the Bank to appoint a person to enter and search a registered bank's premises in order to obtain information and documents, where it has reason to believe that information supplied by the bank is false or misleading or where the bank has failed to supply required information. Hindering or obstructing such a person is an offence against the Act.

Section 101 provides that, where the Reserve Bank is satisfied that it is necessary or desirable to do so in order to determine whether or not it should exercise its power to recommend statutory management or its power to require a bank to consult with it, it may appoint someone to investigate the affairs of a registered bank.

Section 103 makes it an offence to hinder or obstruct a person appointed to investigate the affairs of a registered bank.

Section 105 makes it an offence to disclose supervisory information protected by the confidentiality provisions contained in that section.

Section 111 of the Act provides that, if the Reserve Bank has reasonable grounds to believe that any of the following applies to a registered bank or an associated person of a registered bank:

- it is insolvent, or is likely to become insolvent;
- it is about to suspend payment or is unable to meet its obligations;
- its affairs are being conducted in a manner prejudicial to the soundness of the financial system;

- its circumstances are prejudicial to the soundness of the financial system;

or that any of the following applies to the registered bank:

- its business has not been or is not being conducted in a prudent manner;
- it has failed to comply with any requirement imposed under the Act (or regulations issued under the Act);
- it has been convicted of an offence under the Act; or
- it has failed to comply with a condition of registration;

the Reserve Bank may require the registered bank and any associated person of the registered bank to consult with it regarding the resolution of the difficulties it faces. It is an offence not to comply with a notice to consult.

Section 113 provides that, where the Reserve Bank has given notice of a requirement to consult, it may, with the prior consent of the Treasurer, give written directions to the bank or an associated person of the registered bank.

Section 114 makes it an offence to contravene directions given under section 113.

Section 115 makes it an offence, other than in certain circumstances, to disclose that a notice has been given under section 111 or that directions have been given under section 113.

Section 117 states that where the Reserve Bank is satisfied on reasonable grounds that: a registered bank is insolvent, or is likely to become insolvent; a registered bank has suspended payment or is about to do so or is unable to meet its obligations; a bank or an associated person has failed to comply with a direction; the affairs of a registered bank or an associated person are being conducted in a manner prejudicial to the soundness of the financial system; or the circumstances of a registered bank or an associated person are such as to be prejudicial to the soundness of the financial system; the Bank has the power to recommend to the Treasurer that the registered bank and any associated person be placed under statutory management.

Legal protection for supervisors

Section 179 of the Act specifies that directors and employees of the Reserve Bank are not personally liable for actions taken in their capacity as directors or employees or for omitting to exercise powers conferred by the Act, unless those actions or omissions were undertaken in bad faith.

Information sharing and confidentiality

Section 105 of the Act protects the confidentiality of information obtained by the Reserve Bank in connection with the exercise of its bank registration and supervisory powers. However, specific provision is made for the disclosure of information to supervisory authorities in other countries and to other persons with a proper interest in receiving such information. The Bank is in regular contact with the home supervisors of the major banks operating in New Zealand, and has recently entered into a memorandum of understanding with the United Kingdom authorities on sharing of supervisory information and the confidentiality of such information.

Principle 2: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word 'bank' in names should be controlled as far as possible.

Permissible activities

The business of a registered bank must consist of, or substantially consist of, the borrowing and lending of money, or the provision of other financial services, or both. This requirement is imposed by way of a condition of registration. Compliance with conditions of registration is monitored through quarterly disclosure statements published by registered banks.

Use of the word 'bank'

Part IV of the Act restricts the use of the word 'bank' (and its derivatives) in a name or title to registered banks, authorised representative offices of overseas banks, bodies which include the word bank (or one of its derivatives) in their name where use of that word signifies a geographic place name

or surname and, subject to Reserve Bank approval, certain other bodies (eg subsidiaries of registered banks and bodies which are not financial institutions).

Principle 3: The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Criteria for registration

In terms of the Act, the Reserve Bank is required to have regard to the following factors when determining an application for registration as a registered bank: the incorporation and ownership structure of the applicant; the size of the applicant's business or proposed business; the standing of the applicant in the financial market; where applicable, the law and regulatory requirements relating to the licensing, registration or authorisation of banks in the applicant's or the controller's home jurisdiction; and the ability of the applicant to carry on business in a prudent manner. In having regard to whether or not an applicant has the ability to carry on business in a prudent manner, the Reserve Bank is required to consider the following matters:

- capital in relation to the size and nature of the business or proposed business;
- loan concentration and risk exposures;
- separation of the business from other business and interests of the owners or controllers;
- internal controls and accounting systems; and
- other matters prescribed in regulations (currently none).

There is also provision for regulations to be made specifying other matters to be taken into account. Currently there are no additional matters prescribed in regulations.

The Reserve Bank determines the detailed criteria it will apply in respect of each of these matters and sets these out in a published Statement of Principles. All applicants for registration are required to provide information relating to the above issues. They are specifically asked to provide details of the following:

- ownership of the proposed bank, including details of major shareholdings and voting rights;
- structure charts showing relationships to other companies in the same group, including subsidiaries and associates of the proposed bank;
- proposed composition of the board and shareholder representation on the board, including names and addresses of directors, their qualifications and major business interests, where relevant;
- capital structure of the proposed bank;
- a brief description of the services the proposed bank intends to provide and of the market sectors it plans to target;
- forecasts for the first three years of operation as a registered bank, covering balance sheet and profit and loss and including an outline of the basic assumptions made;
- an outline of prudential policies to be employed by the proposed bank (eg policy on capital adequacy, management of exposure concentration etc);
- an outline of the nature and extent of internal and external audit arrangements;
- a brief outline of the accounting systems and internal controls for the proposed bank, including details of reporting to senior management and directors;
- structure chart showing the proposed management structure, including the names of the chief executive and other senior executives; and
- CVs for the chief executive and other senior executives.

The Reserve Bank has the ability to reject applications which, based on an assessment of the material provided by the applicant and other relevant information, do not meet the criteria for registration set out in the Statement of Principles.

Home supervisor's consent

Where the applicant is a branch or subsidiary of an overseas bank, the Bank will seek comments from the home supervisor before determining the application. It will reject applications if the prior approval of the home supervisor has not been obtained.

Principle 4: Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

The Reserve Bank has no explicit legal authority to review and reject proposals to transfer significant ownership or controlling interests in existing banks to other parties. However, Section 77 of the Act states that the Bank can recommend the deregistration of a registered bank which has suffered a material loss of standing in the financial market since being registered. Accordingly, the Bank has a policy of formally assessing the implications for standing of any changes in a bank's shareholding affecting more than 10 percent of voting shares. The Statement of Principles advises prospective purchasers of an interest in a bank which would exceed the 10 percent threshold to approach the Reserve Bank at an early stage to discuss their plans and any implications those plans might have for the continued registration of the bank.

The Bank is satisfied that this policy allows it to exercise an appropriate degree of oversight over the transfer of significant ownership or controlling interests in banks.

Principle 5: Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to significant risks or hinder effective supervision.

Acquisitions and investments

The Bank does not have specific powers to establish criteria for reviewing major acquisitions or investments by a bank.

The Bank monitors major acquisitions and investments and corporate affiliations and structures through information contained in quarterly disclosure statements and through

regular consultations with the senior management of registered banks.

If major acquisitions or investments threaten the standing of a bank or its ability to carry on business in a prudent manner, or they result in the bank's affairs being conducted in a manner prejudicial to the soundness of the financial system, the Reserve Bank has the ability to use its crisis management powers, including the power to give directions.

Corporate affiliations and structures

The Bank has the ability to set criteria relating to the incorporation and ownership structure of a bank and to extend its supervision to include additional entities if it considers it necessary to do so in order to ensure effective supervision.

Currently the Bank is not aware of any New Zealand banks which have corporate affiliations or structures which expose banks to undue risks or hinder effective supervision. Therefore it has not set explicit criteria for ensuring that corporate affiliations or structures do not expose banks to undue risks or hinder effective supervision.

Principle 6: Banking supervisors must set minimum capital requirements for banks that reflect the risks that the banks undertake, and must define components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basle Capital Accord.

All New Zealand incorporated banks are required to comply with the minimum standards established in the Basle Capital Accord. This requirement is imposed by way of a condition of registration.

Overseas incorporated banks are subject to a condition of registration requiring them to comply with the minimum capital adequacy requirements applied by the home supervisor. Normally this requires that the bank complies with at least the Basle minima (ie a minimum tier one ratio of 4 percent of risk weighted exposures and a minimum capital ratio of 8 percent).

Principle 7: An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Bank directors are required to make quarterly attestations as to whether their bank has systems in place to monitor and control adequately the banking group's material risks, including credit risk, concentration of credit risk, interest rate risk, currency risk, equity risk, liquidity risk and other business risks and to state whether or not these systems are being properly applied.

Banks are also required to disclose detailed information about the credit risks that they face, including concentrations of credit risk, intra-day credit risk, credit risk to bank counterparties and related party credit risk. In particular they are required to provide the following:

- an explanation of the nature of each risk and the activities of the banking group which give rise to that risk;
- a general description of the methods used to identify and monitor exposure to the risk, including the frequency with which exposures are monitored; and
- a general description of the systems and procedures for controlling the risk including, where applicable, whether exposure limits are employed, any policies with respect to collateral or other security and any policies on the use of financial instruments to mitigate or hedge risks.
- quantitative information about the size of the above risks.

Quarterly disclosure statements must also contain a statement as to the nature and frequency of any reviews conducted in respect of the banking group's risk management systems, including a statement as to whether any such reviews were conducted by a party external to the banking group or its owners.

Policies, practices and procedures related to the granting of loans, and making of investments and the ongoing management of the loan and investment portfolios are discussed with the senior management of banks at regular consultations.

These measures are designed to ensure that directors take responsibility for scrutinising the bank's policies, practices

and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios and to encourage them to seek periodic reviews of risk management systems by an external party.

The required disclosures also allow users of disclosure statements to make some assessment of banks' policies, practices and procedures.

Principle 8: Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

Banks are required to disclose the methods they use to identify and monitor exposure to credit risk, and the frequency with which exposures are monitored. In addition, directors are required to attest that their bank has systems in place to monitor and control adequately its material business risks.

Banks are required to publish detailed information about their asset quality each quarter, including the level of non-accrual assets, restructured assets, real estate assets acquired through the enforcement of security and past due assets, the amount of revenue foregone in respect of holdings of non-accrual assets, restructured assets and past due assets and details of movements in provisions. This information is audited at the end of each accounting period and is subject to a limited scope audit at the end of each interim financial period.

In addition, banks are required to disclose their policies for accounting for impaired assets, including the criteria used to classify those assets, and policies for recognising and determining their carrying amounts in the statement of financial position.

This information enables users of disclosure statements to make an assessment of banks' asset quality and the adequacy of their provisioning.

Principle 9: Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Banks are required to publish information about the number of credit exposures to individual counterparties or groups of closely related counterparties which exceed 10 percent of equity, including a breakdown by equity range. Information on both end of quarter and peak exposure is required. They are also required to disclose quantitative information about significant concentrations of credit exposure including concentrations relating to customers' industry or economic sectors; geographical area, showing where applicable, the following categories separately: credit exposure concentrations within New Zealand; and credit exposure concentrations to other countries.

The information included in disclosure statements is subject to a full audit at the end of each accounting period and a limited scope audit at the end of each interim accounting period.

There are no prudential limits on exposures to individual counterparties or groups of closely related counterparties because the disclosure requirements create incentives for banks to ensure that exposure concentrations do not reach imprudent levels. At the same time the policy has the advantage of leaving banks with the flexibility to manage their own affairs as they see best, taking into account all relevant information.

Principle 10: In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

New Zealand-incorporated banks are subject to a condition of registration limiting the banking group's exposure to connected persons. Exposure to non-bank connected persons

is limited to 15 percent of tier one capital and aggregate exposure to all connected persons (ie bank and non-bank connected persons) is limited to 75 percent of tier one capital.

Banks are also required to disclose publicly their aggregate peak and end of quarter exposures to connected persons and the nature and amount of any transaction which any director has with the bank or a member of the banking group, which has been entered into on terms other than those which would, in the ordinary course of business, be given to any other person of like circumstance or means, or which could otherwise be reasonably likely to influence materially the exercise of that director's duties.

These disclosures are subject to a full audit at the end of each accounting period and a limited scope audit at the end of each interim accounting period.

New Zealand-incorporated banks are also subject to a condition of registration requiring that the bank's constitution does not allow the bank's directors to act in the interests of a holding company where to do so would conflict with the interests of the bank, to the detriment of creditors.

In addition, locally-incorporated banks are required to have at least two independent directors (ie people who are not employees of the registered bank or directors or employees of any holding company or other entity capable of controlling or significantly influencing the bank). In part, this policy is intended to ensure that there is a degree of objective scrutiny of exposures to the parent or other related parties or any other matters where the interests of the bank and parent could potentially conflict.

Each quarterly disclosure statement includes an attestation signed by directors that credit exposures to connected persons (if any) are not contrary to the interests of the New Zealand banking group.

Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate reserves against such risks.

New Zealand banks do not generally have significant exposure to country risk and transfer risk because all except one are either branches or subsidiaries of overseas banks. The one New Zealand-owned bank is a small regionally-based retail bank.

Banks are required to disclose information about significant concentrations of credit exposure to geographical areas. Disclosures relating to transfer risk are not required.

Also, directors are required to make quarterly attestations that the registered bank has systems in place to monitor and control adequately the banking group's material risks, including concentration of credit risk, and whether those systems are being properly applied.

The Bank considers that current policies are adequate given the fact that New Zealand banks have only minimal levels of exposure to country and transfer risk.

Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposure, if warranted.

Banks are required to disclose their aggregate peak and end-of-quarter interest rate exposure, foreign currency exposure and equity exposure in quarterly disclosure statements. In addition, directors are required to make attestations each quarter as to whether the registered bank has systems in place to monitor and control adequately the banking group's material risks, including interest rate risk, currency risk and equity risk and whether those systems are being properly applied.

We will shortly be requiring a full compliance audit of market risk disclosures at the end of each accounting period

and a limited scope compliance audit at the end of each interim accounting period.

The Reserve Bank has powers to impose specific exposure limits and/or to impose a specific capital charge on market risk exposures. However, the Bank considers that use of these powers is not warranted as disclosure requirements create incentives for banks to ensure that exposures do not exceed prudent levels and current levels of exposure are generally quite low.

Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against those risks.

Bank directors are required to attest that the registered bank has systems in place to monitor and control adequately the banking group's material risks, including credit risk, concentration of credit risk, interest rate risk, currency risk, equity risk, liquidity risk and other business risks, and whether those systems are being properly applied.

In addition banks are required to disclose information about each of their material business risks, including: an explanation of the nature of the risk and the activities of the banking group which give rise to that risk; a general description of the method used to identify and monitor exposure to the risk, including the frequency with which exposures are monitored; and a general description of the systems and procedures for controlling the risk including, where applicable, whether exposure limits are employed, any policies with respect to collateral or other security and any policies on the use of financial instruments to mitigate or hedge risks.

Banks are also required to include a statement as to the nature and frequency of any reviews conducted in respect of the banking group's risk management systems, including a statement as to whether any such reviews were conducted by a party external to the banking group and its owners and controllers.

The Bank is satisfied that the introduction of these requirements has encouraged a greater degree of board and senior management oversight of the risk management process.

Principle 14: Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank; paying away its funds; and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Bank directors are required to make quarterly attestations as to whether the registered bank has systems in place to monitor and control adequately the bank's material risks, including credit risk, concentration of credit risk, interest rate risk, currency risk, equity risk, liquidity risk and other business risks, and whether those systems are being properly applied. These requirements are designed to ensure that directors rather than supervisors take responsibility for the adequacy of internal controls.

In order to make these attestations directors generally place reliance on internal and/or external audit of systems and controls.

Principle 15: Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict 'know your customer' rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

The Reserve Bank requires all registered banks to confirm that they will adhere to the "Statement of Principles on Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering" published by the Committee on Banking Regulations and Supervisory Practices. In particular, banks are required to have in place effective pro-

cedures for obtaining identification from new customers and for retaining internal records of transactions.

Banks are also required to ensure that they are familiar with all relevant industry standards and 'best practice' on the deterrence and detection of money laundering. Since 1991, the New Zealand Bankers Association has had detailed Guidance Notes for Banks of Money Laundering in place. These guidelines were extensively revised and updated after legislative changes in 1996, including promulgation of the Financial Transaction Reporting Act which requires mandatory reporting to the enforcement authorities by financial institutions, regarding any transactions identified as suspicious.

The Association's member banks are committed to following the policies and procedures outlined in the guidance notes in all relevant areas including 'know your customer' procedures, staff awareness training and instruction manuals, compliance with suspicious transaction reporting requirements, in-house policies to deter money laundering, audit/inspection of compliance with internal policies and controls and facilitating co-operation with enforcement authorities.

The New Zealand Police have also, in 1997, produced a detailed manual of guidance notes for financial institutions on understanding money laundering, how to identify suspicious transactions and compliance with the various legal requirements. The reporting arrangements appear to be working effectively.

Policies and procedures for detecting money laundering are discussed with banks at consultations conducted by the Reserve Bank, which are normally held annually. The Reserve Bank also maintains close liaison with the banking industry, the securities industry regulatory authorities, local enforcement authorities and various international supervisory agencies to co-operate in identifying and monitoring suspicious financial activities.

Following recent legislative amendments, New Zealand now considers it has taken all necessary steps to comply with the 40 recommendations of the Financial Action Task Force to combat money laundering.

Principle 16: An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

The Reserve Bank gathers information about banks both through on-site consultations with senior management and through off-site review of quarterly disclosure statements.

Prudential requirements are designed in a way which encourages bank directors to obtain independent reviews of systems and controls from time to time. Therefore it is not normally necessary for the Bank to carry out its own on-site inspection of banks it supervises. However, the Bank has the power to require on-site reviews and reserves the right to exercise this power when this is warranted.

In particular, the Bank has the power to require a registered bank to supply it with a report on the financial and accounting systems and controls of the registered bank, prepared by a person approved by the Bank. Also, where there are serious concerns about a registered bank, the Bank may appoint someone to carry out an investigation of the affairs of the registered bank.

Principle 17: Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.

The Reserve Bank has formal contact with bank management through regular (generally annual) consultations. In addition, various ad hoc meetings are held as needed to discuss particular topics. Where applicable, the Bank also meets with the senior management of parent banks in home countries from time to time.

From these contacts and the information contained in quarterly disclosure statements, the Bank is able to gain a thorough understanding of each institution's operations.

Principle 18: Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

Banks are required to publish prudential and financial information on both a solo and consolidated basis in quarterly

disclosure statements. This information is collected, reviewed and analysed by the Bank's supervisory staff.

Principle 19: Banking supervisors must have a means of independent validation of supervisory information either through on-site examination or use of external auditors.

Banks are required to obtain a full audit of their disclosure statements at the end of each accounting period and to obtain a limited scope audit review at the end of each interim accounting period.

The Bank also has the power to require that any information and data that a registered bank is required to supply to it is audited by an auditor approved by the Bank. It also has the power to require a registered bank to supply a report, prepared by a person approved by the Bank, on the financial and accounting systems and controls of that registered bank.

Principle 20: An essential element of banking supervision is the ability of the supervisors to supervise the banking organisation on a consolidated basis.

The Reserve Bank supervises banking organisations on a consolidated basis. Disclosure requirements, director attestations and prudential limits are applied to the consolidated banking group.

Principle 21: Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

New Zealand accounting standards and audit requirements should ensure that banks maintain adequate records drawn up in accordance with consistent accounting policies and practices, and that published accounts enable the Bank and other users to obtain a true and fair view of the financial condition of the bank and the profitability of its business.

All companies in New Zealand are required under the Companies Act 1993 to maintain accounting records that: correctly record and explain the transactions of the company; enable, at any time, the financial position of the company to be determined with reasonable accuracy; enable the financial statements (including group financial statements) of the company to be prepared in accordance with the Financial Reporting Act 1993; and enable the financial statements of the company to be readily and properly audited.

The Financial Reporting Act 1993 requires companies to prepare financial statements in accordance with generally accepted accounting practice, including Financial Reporting Standards that have the force of law through approval by the Accounting Standards Review Board.

The Act also requires auditors' reports to be prepared which must state whether proper accounting records have been kept, whether the financial statements comply with generally accepted accounting practice and whether those financial statements give a true and fair view of the matters to which they relate.

The Bank has backup powers to ascertain whether proper accounting systems are being maintained. For example, under the Act the Reserve Bank has the power to require an independent report on the financial and accounting systems and controls of a registered bank.

Principle 22: Banking supervisors must have at their disposal adequate supervisory measures to bring about corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way.

The Act contains a number of provisions which enable the Reserve Bank to take corrective action when banks fail to meet prudential and regulatory requirements. A description of these provisions is set out below:

The power to recommend deregistration. The Bank may recommend deregistration where it considers that a registered bank was registered on the basis of false or misleading information; a registered bank has suffered a material loss of standing; a registered bank is in receivership or liquida-

tion or some other equivalent; a registered bank has not complied with a condition of registration; a registered bank has not carried on its business in a prudent manner; or a registered bank has failed to comply with an obligation imposed under the Act.

The power to require a bank to obtain an independent report on financial and accounting systems. Where the Reserve Bank has reason to believe that a registered bank is not maintaining adequate internal controls and accounting systems, it may use its power to obtain an independent report on financial and accounting systems, prepared by a person approved by the Reserve Bank.

The power to obtain information and documents. Where the Bank believes that information provided to it is false or misleading, or where a registered bank has failed to provide required information, the Reserve Bank may, if it considers it necessary, appoint a person to enter and search the bank's premises in order to obtain the information required.

The power to investigate the affairs of a registered bank. Where the Reserve Bank is satisfied that it is necessary or desirable to do so in order to determine whether or not it should exercise its power to recommend statutory management or its power to require a bank to consult with it, it may appoint someone to investigate the affairs of a registered bank.

The power to require a registered bank to consult. If the Reserve Bank has reasonable grounds to believe that any of the following applies to a registered bank or an associated person of a registered bank:

- it is, or is likely to become, insolvent;
- it is about to suspend payment or is unable to meet its obligations;
- its affairs are being conducted in a manner prejudicial to the soundness of the financial system; or
- its circumstances are prejudicial to the soundness of the financial system;

or that any of the following applies to the registered bank:

- its business has not been, or is not being, conducted in a prudent manner;

- it has failed to comply with any requirement imposed under the Act (or regulations issued under the Act);
- it has been convicted of an offence under the Act; or
- it has failed to comply with a condition of registration;

the Reserve Bank may require the registered bank and any associated person to consult with it regarding the resolution of the difficulties it faces.

The power to give directions. Where the Reserve Bank has given notice of a requirement to consult it may, with the prior consent of the Treasurer, give written directions to the bank or an associated person of the registered bank.

The power to recommend statutory management.

Where the Reserve Bank is satisfied on reasonable grounds that a registered bank is insolvent or likely to become insolvent; a registered bank has suspended payment, or is about to do so, or is unable to meet its obligations; the bank or an associated person has failed to consult as required; the registered bank or an associated person has failed to comply with a direction; or the affairs of the registered bank or an associated person are being conducted in a manner prejudicial to the soundness of the financial system, the Reserve Bank has the power to recommend to the Treasurer that the registered bank and any associated person be placed under statutory management.

When exercising their powers under the Act, statutory managers are required to have primary regard to the need to maintain public confidence in the operation and soundness of the financial system, and the need to avoid significant damage to the financial system. They are also required to have regard to the need to resolve the difficulties of the registered bank as quickly as possible, and to preserve the position and maintain the ranking of creditors' claims to the extent that this is not inconsistent with the primary objectives specified in the Act.

Breach of capital adequacy requirements

Where banks breach capital adequacy requirements the following approach is taken:

Where the tier one capital ratio falls below 4 percent and/or the total capital ratio falls below 8 percent, the registered

bank will be required to draw up a plan for restoring its capital to at least the minimum required level. The registered bank will be required to submit this plan to the Reserve Bank as soon as practicable after the first occurrence of the breach and to publish it in the bank's disclosure statement at the earliest possible opportunity.

The plan will need to include the following elements:

- A statement that no distributions to shareholders, or to holders of capital instruments which qualify as capital for the purposes of the Reserve Bank's capital adequacy framework, will be made until the bank's compliance with minimum capital adequacy requirements has been restored unless the bank is contractually obliged to make such distributions (this will only arise with lower tier two capital where it is likely that the bank will be under a contractual obligation to make interest or dividend payments).
- A statement that there will be no increase in the amount of the banking group's exposure to connected persons from the level which prevailed at the time of the first occurrence of the breach (where the level of the exposure is below the maximum limit) until tier one and total capital ratios are restored to minimum levels.
- Where a banking group's tier one capital ratio is less than 3 percent, a statement that there will be no increase in gross credit exposures from the level which prevailed at the time of the first occurrence of the breach, until such time as the tier one ratio exceeds 3 percent.

Where a bank does not publish a plan including the elements listed above, or does not abide by the plan it has provided to the Reserve Bank and published in its disclosure statement, the Bank may give directions to the bank or make use of the other crisis management powers it has under the Act.

Breach of disclosure requirements

Where the Bank considers that a disclosure statement published by a registered bank contains information that is false or misleading, or that required information is omitted, the Bank may require the registered bank to publish an amended disclosure statement or to take other corrective action.

Where a registered bank publishes false or misleading information in a disclosure statement or omits information, in the absence of any lawful justification or excuse, the bank, and the directors who signed the disclosure statement, commit an offence against the Act. Individuals committing an offence may be subject to a fine not exceeding \$25,000 or to a term of imprisonment not exceeding three years, while the registered bank may be liable to a fine of up to \$100,000.

A bank and its directors are liable to pay compensation to any person who sustains a loss by reason of subscribing for any debt security issued by a registered bank in reliance on false or misleading information contained in a disclosure statement.

Principle 23: Banking supervisors must practice global consolidated supervision adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by banking organisations worldwide, primarily at their foreign branches and subsidiaries.

New Zealand banks are supervised on a global consolidated basis. Any overseas branches or subsidiaries are subject to prudential requirements applying to the banking group.

Principle 24: A key component of consolidated supervision is establishing contact and the exchange of information with the various other supervisors involved, primarily host country supervisory authorities.

The Reserve Bank has close contact with other supervisors, particularly the home supervisors of the major banks operating in New Zealand, but also host supervisors where this is relevant.

Principle 25: Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Banks are required to meet the same standards regardless of whether they are domestic or foreign institutions.

Section 105 of the Act, which contains confidentiality provisions relating to supervisory information, specifically permits disclosure of information to any central bank, authority, or body in any other country which exercises functions corresponding to or similar to those conferred on the Bank under part V of the Act (Part V relates to bank registration and supervision).