Promoting Financial Stability: the New Zealand Approach

An address by Dr Donald T Brash, Governor of the Reserve Bank of New Zealand to the Conference for Commonwealth Central Banks on Corporate Governance for the Banking Sector, London, 6 June 2001

Introduction

It is a great pleasure to have the opportunity to speak to you today.

The theme of this conference - Corporate Governance in the Banking Sector - is a subject that has been an important element in the Commonwealth Secretariat's financial sector work in recent years. It has also been a notable feature of other international initiatives, including those of the International Monetary Fund and World Bank, in their efforts to address the causes of financial crises and to promote greater financial stability. Appropriately, improving corporate governance is seen as a significant way of encouraging banks to strengthen their capacity to manage risks. And it has rightly been viewed as an important element in the management of central banks.

Today, I want to discuss the role that corporate governance plays in the New Zealand banking supervision framework and to relate this to the importance we attach to strengthening market discipline in the financial system. But before doing this, let me briefly recap the main points made in the report issued by the Commonwealth Secretariat last year on the causes of financial instability and the policies for promoting stable financial systems. This provides a useful context within which to discuss the New Zealand approach to financial sector regulation.

Causes of financial instability

As indicated in the Commonwealth Secretariat's paper *Corporate Governance in the Financial Sector*, financial instability is caused by a combination of factors. These include:

- rapid financial sector liberalisation unsupported by measures to encourage prudent risk management in the financial sector;
- unsustainable macroeconomic policies, such as loose monetary policy and excessive fiscal spending – such policies can contribute to asset price volatility and a subsequent erosion of asset quality in the financial system;
- exchange rate arrangements that lack credibility, including unsustainable exchange rate pegs – this is particularly important where financial institutions and corporations have come to rely on an exchange rate peg, and fail to hedge their currency risk, only to sustain currency losses when the peg collapses;
- protection against imports and other policies that impede the efficient allocation of resources in the economy;
- poor banking supervision;
- inadequate financial disclosure arrangements, including poor quality accounting and auditing standards; and
- weak market disciplines in the banking and corporate sectors, reducing the incentives for high quality risk management by banks.

Policies for promoting stable financial systems

The broad range of factors that can contribute to financial crises suggests the need for an equally broad set of policy responses. Of course, the particular policies will vary from country to country, depending on a country's stage of development, the nature of its economy and the structure of its financial system. There is no single "right" policy prescription. Each country must develop policies that suit its own particular circumstances. However, at a general level, it can safely be said that the following types of policies will be needed in order to promote financial stability:

- sound, sustainable and credible macroeconomic policies, including a monetary policy aimed at promoting price stability;

- microeconomic policies that minimise distortions to relative prices and that encourage efficient allocation of resources;
- exchange rate policy that is seen as credible by all market participants, that facilitates macroeconomic adjustment and that builds in incentives for financial institutions to hedge against currency risk;
- an effective legal and judicial system, facilitating the enforcement of legal contracts;
- policies to encourage banks to manage their risks prudently, including corporate governance and financial disclosure;
- policies to encourage effective market disciplines in the financial sector, thereby strengthening the incentives for banks to manage their risks prudently;
- policies to promote robust payment systems and minimise inter-bank contagion, such as netting arrangements, real time gross settlement and failure-to-settle structures within the payment system; and
- effective and well-enforced banking supervision arrangements.

It would be tempting to discuss each of these policy areas, given their importance to the promotion of sound and efficient financial systems. But we would need a great deal longer than one day to do justice to such a broad range of complicated policy issues. Instead, I want to focus on the main theme of this conference – corporate governance in the financial sector.

Corporate governance in the financial sector

As noted in the Commonwealth Secretariat's report, improving corporate governance is an important way to promote financial stability. The effectiveness of a bank's internal governance arrangements has a very substantial effect on the ability of a bank to identify, monitor and control its risks. Although banking crises are caused by many factors, some of which are beyond the control of bank management, almost every bank failure is at least partially the result of poor risk management within the bank itself. And poor risk management is ultimately a failure of internal governance.

Although banking supervision and the regulation of banks' risk positions can go some way towards countering the effects of poor governance, supervision by some external official agency is not a substitute for sound corporate governance practices. Ultimately, banking system risks are most likely to be reduced to acceptable levels by fostering sound risk management practices within individual banks. Instilling sound corporate governance practices within banks is a crucial element of achieving this.

As the Commonwealth Secretariat's report notes, there are a number of ways in which corporate governance in the financial sector can be strengthened. These include:

- having a well designed and enforced company law;
- having codes of principles developed by professional or industry associations, setting out desired attributes of corporate governance, and associated educational and consciousness-raising initiatives;
- maintaining high quality disclosure requirements for banks and other companies, based on robust accounting and auditing standards;
- adopting measures to strengthen market disciplines in the banking sector, including by promoting a contestable and competitive banking system and seeking to ensure that bank creditors are not fully insulated from loss in a bank failure;
- effective banking supervision arrangements, with particular emphasis on policies that encourage sound governance and risk management practices; and
- leadership by example, including the adoption of sound governance, accountability and transparency practices by central banks and regulatory agencies.

New Zealand's approach to financial stability

Against this background, let me briefly summarise the New Zealand approach to promoting financial stability. This has three main strands:

- promoting self discipline by banks in the management of their risks;
- fostering effective market discipline on the banking system; and
- supervising banks for the purpose of promoting financial stability, but seeking to avoid supervisory practices that might erode market discipline and weaken the incentives for bank directors to take ultimate responsibility for the management of risks.

Let me elaborate on each of these in turn.

Banks' self discipline in managing risks

Banking supervision in New Zealand places considerable emphasis on encouraging banks' self discipline in managing risks, primarily by reinforcing the role of bank directors in taking ultimate responsibility for the stewardship of their banks. Since the mid 1990s, when a new public disclosure framework was introduced for banks, a key mechanism for encouraging banks to manage risks prudently has been the need for banks to issue public disclosure statements 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 information on the bank, including:

- the bank's credit rating;
- the bank's capital ratio, measured using the Basel framework; and
- information on exposure concentration, exposures to connected parties, asset quality 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 the bank and its banking group, including:

- comprehensive financial statements;
- credit rating information;
- detailed information on capital adequacy, asset quality and various risk exposures; and
- information on the bank's exposure to market risk.

One of the most important features of this disclosure framework is the role it accords bank directors. Each director is required to sign and 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 connected 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 potentially severe criminal penalties and civil liability where a disclosure statement is held to be false or misleading.

Complementing the disclosure requirements, banks incorporated in New Zealand are required to have a minimum of two independent directors (who must also be independent of any parent company) and a non-executive chairman. These requirements are intended to increase the board's capacity to scrutinise the performance of the management team. In addition, independent directors provide some assurance that the bank's dealings with its parent or other related parties are not in conflict with the interests of the bank in New Zealand. The disclosure requirements have increased 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 have seen directors taking greater care than might otherwise have been the case to ensure that they are adequately discharging their obligations. In so doing, directors have strong incentives to ensure that there are appropriate accountability mechanisms within the management hierarchy.

Market discipline

The New Zealand approach has also stressed the importance of market discipline as a vital element in encouraging prudent risk management within the banking industry. We have sought to do this in a number of ways.

First, our approach stresses the importance of a contestable and competitive banking system. We have no regulatory limit on the number of banks that can be licensed and we have a competitively neutral regulatory framework for the financial sector. This means that any financial institution, whether or not it is licensed as a bank, can perform a wide range of banking functions. As a result, the New Zealand financial system is particularly competitive.

Secondly, the public disclosure regime for banks is an important factor in facilitating market discipline, given that it provides the market with comprehensive information on individual banks on a regular and timely basis. 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 by operating at lower funding costs. Weaker banks are likely to come under pressure to strengthen their position.

Thirdly, New Zealand has no system of deposit insurance. The absence of deposit insurance is helpful in sharpening the market discipline on banks, given that it strengthens the incentive for depositors to monitor the financial condition of their bank and to be more discerning in their decision about where to bank than might otherwise be the case.

Of course, market discipline is only likely to be effective where creditors, including depositors, actually believe that they will be exposed to a risk of loss if their bank were to fail. If depositors and other creditors think it likely that the government will rescue a bank in distress and insulate creditors from losses, then the incentives for creditors to monitor the financial condition of their bank is greatly reduced. This has been the case in many financial systems around the world, where, time and time again, bank failures have been handled in ways that generally insulate depositors from any loss. I have little doubt that the tendency to insulate creditors from loss in bank failure events has significantly weakened the incentives for prudent risk management within the world's financial systems.

In order to strengthen the disciplines on banks, the Reserve Bank of New Zealand has for some years stressed publicly that depositors and other creditors should act on a clear presumption that they will bear their fair share of loss should a bank become insolvent.

As part of this approach, the Reserve Bank is currently undertaking work to explore the feasibility of responding to a major bank failure by re-capitalising a failed bank through the use of creditors' funds. This assumes, of course, that all shareholders' funds have been eliminated by loan losses. This would be achieved by "haircutting" depositors' and other creditors' funds in the failed bank to a sufficient extent to absorb estimated loan losses and to facilitate a re-capitalisation of the bank, with the bank's doors being re-opened for business within three or four business days of the failure.

Under this approach, a bank would be placed into statutory management once it had become apparent that the bank was insolvent or likely to become insolvent, and once it had been established that shareholder support would not be forthcoming. In this situation, statutory management would enable the bank's business to be temporarily suspended and an estimate made of the likely maximum extent of loan losses. A haircut would then be applied on a broadly *pari passu* basis across all senior unsecured liabilities (and some off-balance sheet obligations) of the bank sufficient to absorb the estimated maximum losses of the bank. These funds would be set aside using the powers of statutory management and could not be accessed by creditors. However, remaining funds would be accessible and could be drawn down by creditors once the bank is re-opened for business. In order to avoid a situation where creditors rush to withdraw funds from the bank, it would probably be necessary for the central bank or government to announce a guarantee of the remainder of creditors' funds (ie all liabilities of the failed bank other than the haircut funds), at least until a new and credible ownership structure had been devised for the bank.

The extent of the haircut would depend both on the size of the estimated loan losses and also whether the haircut is intended to only absorb losses (where new equity is provided by another party, such as the government) or to absorb losses and re-capitalise the bank. It would also depend on whether the government wished to have creditors of the bank absorb all of the bank's losses (assuming that shareholders have already lost all of their equity) or whether the government was prepared to enter into a loss-sharing arrangement, whereby the creditors and government would each bear some of the losses.

Where asset recoveries result in a smaller amount of loan losses than had been estimated, there would be scope to pay the surplus recoveries to creditors in proportion to the funds that were subject to the haircut.

The haircut proposal is intended to be one of a number of options available for responding to a bank failure situation. The decision to apply it would be for the government of the day to determine, having regard to the Reserve Bank's advice and the circumstances prevailing at the time. It is most likely to have application in situations of single bank failures, where the banking system as a whole remains substantially in good health.

At this stage, the haircut proposal is still in the early stages of development. Much work remains to be done. In the period ahead, the Reserve Bank plans to advance its research on the feasibility of using haircuts to handle the failure of systemically important banks. We are hopeful to be in a position to determine the feasibility of the haircut option in the not-too-distant future.

Banking supervision

Although promoting banks' self discipline and promoting market discipline are key components of the New Zealand approach, we do maintain a significant banking supervision framework. However, we have sought to minimise the moral hazard risks and the compliance and efficiency costs that can be associated with a heavy-handed approach to banking supervision. Hence, from the outset, New Zealand's approach to supervision has placed less emphasis on some of the traditional supervisory techniques than has been the case in many other countries. The Reserve Bank applies the standard Basel Capital Accord to banks, with some modifications, and imposes a regulatory limit on connected lending. Banks are monitored by the Reserve Bank on a quarterly basis using banks' quarterly disclosure statements. But the Reserve Bank does not impose limits on open foreign exchange positions or on credit exposures to single borrowers. It does not specify guidelines for risk management systems and does not involve itself in the screening or approving of bank directors. And the Reserve Bank does not conduct on-site examinations of banks, although it does consult the senior management team of each bank, generally on an annual basis.

Corporate governance in the central bank – leading by example

I have talked about the policies that the Reserve Bank of New Zealand has implemented to promote sound corporate governance and risk management within the banking system. But it is also worth spending a little time to discuss the importance of corporate governance in central banks. Indeed, as the Commonwealth Secretariat's report notes, an important element in promoting sound corporate governance in the banking sector is through "leadership by example" within central government and regulatory agencies.

The adoption of robust corporate governance practices in the financial sector is likely to be greater where central banks lead the way by maintaining effective governance, transparency and accountability arrangements within their own operations.

In New Zealand, the Reserve Bank is subject to a number of policies designed to promote strong internal governance. These include:

- Transparent policy objectives. In particular, the Reserve Bank's monetary policy and banking supervision objectives are set in statute and highly visible.
- A clear assignment of responsibilities for meeting policy objectives. In the Reserve Bank, the responsibility for formulating and implementing policy to meet the statutory objectives is assigned to the Governor.
- Mechanisms for ensuring that the Reserve Bank (and particularly the Governor) are held to account for the performance of their responsibilities. An important part of this is the monitoring of the Bank's performance. This

is formally the responsibility of the Bank's Board of directors, which is statutorily charged with the task of monitoring the Bank's performance across all policy areas and in terms of the management of the Bank's resources and risks. In order to perform this role with credibility, the Bank's Board comprises a majority of non-executive directors. Although I, as Governor, currently chair the Board, this will be changed next year to provide for a non-executive chair.

- An obligation to report publicly, on a regular basis, on the Bank's performance in meeting its statutory objectives. The Bank issues an *Annual Report* for this purpose. In addition, it issues quarterly *Monetary Policy Statements* to report on the Bank's performance in maintaining price stability and to explain its monetary policy stance. I also take it as axiomatic that I have an obligation to make myself available on a regular basis for direct cross examination by the news media.
- Clear disclosure of all regulatory requirements and policies promulgated by the Bank.
- An obligation to issue an annual set of financial statements, independently audited, that comply with New Zealand's accounting standards and practices, including information on accounting policies, off-balance sheet commitments and contingent liabilities.
- A culture of comprehensive planning and budgeting, and internal and external accountability for expenditure and performance. The Bank also maintains comprehensive risk management and internal audit arrangements.
- An obligation for the Governor and Deputy Chief Executive to sign publicly disclosed statements attesting to the maintenance of internal controls to promote the integrity and reliability of financial reporting.
- The Minister of Finance is empowered to appoint a person to audit the performance of the central bank in carrying out its functions.

Taken together, these policies provide a framework for encouraging effective corporate governance in the central bank and assist in encouraging the central bank to promote price stability and a sound and efficient financial system.

Conclusion

Let me conclude by reinforcing some of my key themes:

- Financial crises are rarely caused by one factor. They are almost always the product of a number of contributing factors.
- This suggests the need for a broad-based approach to the promotion of financial stability, avoiding placing too much reliance on any one policy area.
- There are no single "right" policy solutions. And there are no silver bullets. Each country must find its own combination of policies that best meets the particular circumstances of the country, the nature of its economy and the structure of its financial system.
- But there is one policy issue that must be tackled by all countries – one way or another – in seeking to promote financial stability. And that is how best to encourage banks to identify, monitor and manage their own risks prudently. For that is the key to reducing the risk of future financial crises and promoting more robust financial systems. Although there are many ways to encourage prudent risk management, fostering a culture of sound corporate governance through increased focus on the responsibilities of bank directors and strengthened market discipline is undoubtedly a very important part of the solution.