

Systemic financial crises – resolving large bank insolvencies

An address by Dr Alan Bollard, Governor, Reserve Bank of New Zealand, to the Federal Reserve Bank of Chicago Conference

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This speech addresses a theme that has received increasing attention internationally and at the Reserve Bank of New Zealand of late – the issue of how a host supervisory authority can most effectively maintain a sound banking system and respond to bank failures when the system is dominated by foreign-owned banks.

For any country, the stability of the financial system is critical to a healthy economy – a point that becomes dramatically apparent when systemically important banks fail. This is equally true for a financial system dominated by foreign-owned banks as for one composed mainly of domestically-owned banks. In either case, the supervisory authority and central bank – whether home or host – must ensure that they have the capacity to maintain a robust financial system and to respond quickly and effectively to any financial crisis – often within hours. This is a challenge for any supervisor, but it is all the more complicated when it is a foreign-owned bank that gets into difficulty, given different jurisdictions, potentially different statutory objectives between home and host authorities, and a greater degree of jurisdictional separation between taxpayers and depositors than is the case with domestically-owned banks.

In a world of increasing global and regional integration, the difficulties faced by a host supervisory authority is an issue of growing importance for many countries throughout the world. My counterparts in Central and Eastern Europe, Scandinavia and Latin America will readily relate to this theme, given that they also face increasing foreign bank participation in their financial systems. The challenge, therefore, is to ensure that home and host authorities respond to these changes in ways that enhance the stability of both of their financial systems, while continuing to derive the benefits that cross-border banking can provide.

New Zealand's banking system is dominated by foreign banks.

The Reserve Bank of New Zealand – New Zealand's banking supervision authority – is well practiced at being a host supervisory authority. Our banking system has been dominated by foreign-owned banks for over a decade now. Few, if any, countries have a banking system as foreign-dominated as ours. Let me quote some statistics to illustrate the point:

- All but two of the 16 registered banks in New Zealand are foreign-owned.
- All of the four systemically important banks in New Zealand are Australian owned – holding around 85 per cent of banking system assets.
- The four large banks dominate the banking system, with individual market shares ranging from around 15 per cent to 35 per cent of banking system assets.

Overall, the strong presence of foreign banks has brought many benefits to New Zealand, in terms of both soundness and efficiency. It has enhanced risk-management capacity within the banking system, facilitated the entry of new banking products and services, and reduced the financial system's vulnerability to domestic economic shocks.

Against these benefits, of course, there are also risks associated with such strong dominance by foreign banks. The New Zealand financial system is exposed to contagion risk from the parent banking systems – all the more so given the strong industry concentration and the dominant position of banks from just one country. Extensive foreign bank participation in the banking system can also complicate the supervision of banks in the host financial system – particularly if core functionality is outsourced to parent banks. It also complicates the process for dealing with bank crises in ways that adequately meet the needs of the host financial system.

In order to maintain a sound financial system when most of the banks are foreign owned, robust host supervision arrangements are essential; so too are structures for coordinating home and host supervision. But, as I will shortly explain, the coordination of home and host supervisory arrangements in ways that meet the needs of both countries is both complicated and challenging.

Differences in the interests of home and host supervisors

One of the important issues arising from a banking system dominated by foreign banks is the relationship between the home and host supervisory agencies and central banks. Home and host countries undertake their banking supervision roles and responsibilities within the framework of home-host supervision set out in the Basel Concordat – the internationally agreed framework for the supervision by national authorities of multinational banks. The Concordat emphasises the general responsibility of home country authorities to supervise banks' worldwide consolidated activities, as well as the host country responsibility to supervise foreign bank establishments in their territories as individual institutions. The Concordat, and its subsequent elaborations, have a strong emphasis on the need for adequate exchange of information, but have not – to date – sought to establish an international framework for the cross-border coordination of interventions responding to bank distress. It will not be easy to establish such a framework.

A host financial system derives benefit from the home supervision of the parent banks. This provides some assurance to the host supervisor that the parent bank's and consolidated group's soundness comes under regular scrutiny by the home authority, including in respect of capital adequacy, risk positions, risk management systems, governance arrangements, and parent oversight of foreign subsidiaries and branches. Equally, the home supervisor benefits from effective supervisory and bank governance arrangements in the host country – especially when the home country's banks have substantial foreign operations.

In New Zealand, we openly acknowledge the benefit that our financial system derives from the role played by the

Australian and other regulatory authorities in this regard. However, this does not cause us to be complacent or to place excessive reliance on the home supervisory authorities. We are well aware that, although home and host supervisory authorities and central banks have broadly complementary interests, they can also have divergences – and even conflicts – of interests in some key respects. Indeed, the areas of potential divergence or conflict are likely to become most apparent when the stakes are at their highest – in a bank distress situation.

The potential divergences and conflicts can arise in a number of ways. For example:

Home and host authorities may have different statutory objectives to meet in the exercise of their supervisory responsibilities. In some countries, depositor protection is a primary goal of supervision. In other countries – such as New Zealand – the soundness and efficiency of the financial system is the primary goal. Such divergences can lead to significant differences in supervisory policies and in the strategy for responding to financial crises.

There can also be conflicts of interest between the home and host authorities in the allocation of capital and risks across a multinational banking group. The home authorities have an interest in retaining as much capital within the home jurisdiction, and particularly within the parent bank, as possible. Conversely, the host authority would like to see a reasonable portion of the group's capital vested in the local subsidiary. A similar dichotomy of interest applies in respect of the spread of risk across the banking group. In times of stress, the allocation of capital and risk within the group can be crucial. Tensions between home and host authorities can quickly become apparent in those circumstances. This is especially so when the bank subsidiary is under-capitalised and the host authorities are requesting the parent bank to inject more capital. The situation is even more complicated when the bank in distress is a branch of a foreign bank.

The home and host authorities may also have different interests in deciding the response to a banking crisis. The home authorities' primary interest and (generally) their primary statutory duty is the maintenance of stability in the home financial system. They have no responsibilities for the

stability of the host financial system. To the extent that they are interested in the stability of the host financial system, it is likely to relate to the possible impact on the parent bank's operations in that system and the likely flow-on effects to the home financial system. A host supervisor therefore cannot rely on the home supervisor to act in the interests of the host financial system. Similarly, host countries do not generally owe any formal duties to home countries or their supervisory authorities.

The home and host countries can have very different views on the choice of techniques for responding to bank distress. Clearly, the authorities in each country will have a menu of choices available, ranging from institutional bail-outs to liquidation, with intermediate options available in some circumstances. These choices have to be made on the basis of an assessment of the costs and benefits of alternative approaches within each market, and there can be no assurance that different countries will – or should – necessarily come to the same conclusion.

Moreover, home and host authorities may have quite different perceptions of when a crisis is systemic. The failure of a bank operating in the home and host countries may represent a major systemic crisis or a threat to the reputation of the financial system in the host country, while being of relatively minor significance in the home country – or vice versa. In the former case, the host authorities would therefore attach great importance to a quick and effective resolution of the crisis, while the home authorities may be less concerned. Again, this could impede the ability to implement a coordinated response to the crisis.

These matters are not straightforward when there is a largely bilateral relationship between home and host countries, of the kind faced by New Zealand. Matters become even more complicated when a parent bank has many operations in different countries. In these circumstances, the prospect of a large number of supervisors being able to agree on co-ordinated action within a short time-frame is not good. The international record tends to show that supervisors have effectively been placed in a position where they have had to act on their own judgement, in the light of their own particular circumstances, when complex cross-border bank insolvencies have occurred.

The need for robust host supervision arrangements

For these reasons, and in the absence of any fair and formalised, operationally and legally robust, international framework, we at the Reserve Bank of New Zealand think it would be very imprudent for a host authority to rely on the home authority to protect the host financial system. This does not mean that we are not still considering the issues with an open mind. But at this point, we need to continue to place importance on our ability to supervise the New Zealand banking system and to respond to a banking crisis in ways that enable us to protect New Zealand's interests without placing undue reliance on the actions of the home authorities. That said, we also recognise that the most effective response to a cross-border crisis would desirably involve close cooperation and coordination between the home and host authorities.

We are therefore actively working towards the implementation of enhanced home/host supervisory and crisis-response arrangements, while still retaining a strong capacity to independently manage a banking crisis. Our dual aims are to maintain the capacity to protect the New Zealand financial system on a stand-alone basis, while also building the framework for closer coordination between the host and home authorities. Let me highlight the key features of both aspects of this approach.

Our supervisory tools are similar to those of a home supervisor. While we have adopted a somewhat less intrusive approach than some supervisors, we require all banks, whether foreign-owned or domestically-owned, to comply with the same basic requirements, including in respect of minimum capital adequacy, related party exposure limits, comprehensive public disclosure requirements, governance requirements, and so forth. We monitor all banks on a regular basis and consult with the senior management teams of each bank annually, again, regardless of whether they are foreign-owned or domestically-owned. We also take a close interest in the parent banks of the systemically important banks in New Zealand, including monitoring their financial condition and meeting with their senior management teams.

In all of these areas, we have sought to dovetail our supervisory arrangements with those of the home supervisors – particularly Australia – in order to keep banks' compliance costs relatively low and to avoid excessive operational inefficiencies for banks. We are a welcoming, but responsible, host. This approach is reflected in a range of areas, including in the approach we have taken to the prudential requirements for banks and in the way we monitor and assess banks. Looking forward, we see scope for further dovetailing of this nature in the context of closer coordination between the New Zealand and Australian authorities.

However, the dominance of foreign banks in the New Zealand banking system has resulted in some additional supervisory measures being taken to ensure that the interests of the New Zealand financial system can be protected. By and large, these policies are common to many countries, particularly countries with substantial foreign bank participation. In New Zealand, they form a key part of being a responsible host supervisor. I would like to highlight two of our most recent requirements:

- that all systemically important banks be incorporated in New Zealand; and
- that foreign-owned banks in New Zealand are not overly reliant on parent bank or other outsourced functionality.

Like many supervisors, we require all systemically important banks to be incorporated in New Zealand, rather than operate as a branch of a foreign bank. Currently, all but one of the systemically important banks in New Zealand are locally incorporated. We are working with the other bank to determine how it can meet our requirements.

The local incorporation policy has three main objectives.

First, local incorporation is an important element of being able to respond to a financial crisis effectively, in New Zealand's interests. It provides a significantly higher degree of certainty over the balance sheet of a bank in New Zealand, enabling a statutory manager to assume control of a failed or distressed bank with greater certainty over legal jurisdiction than would be the case with a branch.

Second, local incorporation enhances the Reserve Bank's ability to supervise the banks on an ongoing basis in the interests of the New Zealand financial system. It enables the imposition of minimum capital adequacy requirements and risk limits, and provides a degree of separation between the subsidiary and the parent, thereby reducing intra-group contagion risk. Not least, local incorporation makes it much more difficult, legally and practically, for assets to be removed from the local operation to the parent bank; any such transaction must be for good value. This is not the case for a branch.

Third, local incorporation establishes a basis for sound bank governance in the host country, including a board of directors with a responsibility to act in the interests of the local bank. This is particularly important in New Zealand, given the strong emphasis we place on the role of corporate governance as the foundation for effective risk management. In our supervision framework, we stress the need for the local board of directors to take ultimate responsibility for overseeing the management of the bank, including its risk management capacity. Of course, we also recognise that, subject to complying with the laws and regulations of the country in question, the parent bank has the right to determine the strategic direction and overall management of its foreign operations – in New Zealand and elsewhere. But we wish to ensure that, within this overall constraint, the local board has much more than a rubber-stamping role.

Another important policy requirement that we are developing to protect the New Zealand financial system relates to the growing practice of outsourcing core bank functionality. Here, I am referring to the tendency for foreign-owned banks to move large parts of their functionality to the parent bank or to third parties – which are often in another country. In New Zealand, this has been occurring on a significant scale. And it has not just been confined to the obvious areas, such as IT systems, accounting functions and the like. Outsourcing to the parent banks has also included the movement of risk management capacity, some treasury functions, and some senior and mid-level management and technical expertise.

Outsourcing makes it more difficult to supervise a bank effectively on an ongoing basis. This is especially so where core risk-management functionality has been migrated

offshore. In these circumstances, there is a limit to what any supervisor can achieve in seeking to promote sound risk-management structures within the local bank. It also has the potential to weaken the role of the local board, thereby compromising the ability to ensure that governance arrangements are adequate to protect the interests of the local bank.

But when the storm clouds gather, the effect of outsourcing can be very serious for a host banking system. In a situation where a parent bank is in acute difficulty, it is likely that its foreign operations will also be in difficulty. If the parent bank is unable or unwilling to provide financial support to the subsidiary, and if the home authorities are unable or unwilling to extend official support to the foreign subsidiaries of the parent bank, then the host authority needs to have sufficient functionality in the bank in its jurisdiction to maintain systemically important functions.

A bank that relies substantially on outsourced services to its parent, or on inadequately outsourced arrangements to unrelated third parties, will not have that capacity. It will be substantially dependent on the outsource provider in order to maintain even quite basic functions. In a situation where the outsource provider is in serious strife, there is no guarantee that the bank will be able to maintain essential functions. In this situation, the host authority has limited scope to manage the crisis in its own jurisdiction.

For these reasons, and in accordance with our legislation, we have initiated an outsourcing policy for application to all systemically important banks and potentially to some of the other banks. In essence, the policy will require banks to maintain sufficient functionality within the jurisdictional reach of its board of directors – and of a statutory manager if the bank has failed – to enable the bank to maintain all essential functions if the parent bank, or any other service provider, fails. We have no difficulty with outsourcing, provided that it is done properly and prudently, and that it meets our required outcomes. We must have the capacity to manage a bank distress or failure in ways that minimise damage to the New Zealand financial system.

Managing financial crises

As with any supervisory authority and central bank, the Reserve Bank of New Zealand attaches great importance to the ongoing preparedness to respond to a financial crisis. We have a broad range of measures in place and under development to ensure that we have the capacity to resolve a banking crisis in ways that maintain a robust financial system, preserve market disciplines, and minimise moral hazard risks. In this regard, our statutory duty is to protect the soundness and efficiency of the New Zealand financial system, rather than seeking to protect particular institutions or depositors.

The tools required by a host supervisor to respond effectively to a banking crisis are much the same as those required by a home supervisor. However, in the case of a host supervisor, two elements are worth emphasising:

- First, there is a need for clear legal and operational capacity to assume control of, and to maintain operational capacity within, banks that are in acute distress or insolvent.
- Second, there is a need for balance sheet certainty for banks operating in the host country.

As I outlined earlier, our supervisory policies are intended to deliver these outcomes.

I wish to make particular reference to one aspect of our crisis management work - the development of what we currently call “bank creditor recapitalisation”. This is a mechanism that would enable the Reserve Bank to respond to a bank failure – including the failure of a systemically important settlement bank – in a manner that avoids or minimises the cost to the taxpayer, while still maintaining systemic stability. It comprises a number of elements, including:

- applying a “haircut” to depositors and other creditors of the failed bank at a level assessed to be sufficient to absorb likely losses;
- giving depositors access to the non-haircut portion of their deposits within a very short period of the failure occurring, but providing a government guarantee of those deposits so as to encourage depositors to keep their funds at the bank; and

- facilitating either the recapitalisation of the bank or some other resolution option that is consistent with maintaining a sound financial system.

While we are still developing the concept, we see this failure management structure as an important potential option for meeting systemic stability objectives, while preserving – indeed enhancing – market disciplines.

Enhanced cooperation and coordination between home and host authorities

Although these measures are all essential, we are mindful that a banking crisis in a largely foreign-owned banking system should preferably include coordination between the home and host supervisors and central banks. This is most likely to occur when there is a well-developed relationship of cooperation between the parent and host authorities – in good times and bad, in sickness and in health.

We are therefore now developing our thinking, and building on the existing relationships we have with the supervisor and central bank in Australia, as to the arrangements required to ensure that there is effective coordination between home and host authorities, both in the day-to-day supervisory process and, especially, in periods of financial distress. We want to ensure that there is a clear understanding between the banking supervisors, the central banks, and the finance ministries of both countries as to their respective roles and responsibilities. We want to explore the scope for more defined and potentially more formalised cooperation and coordination so that both sides are better placed to supervise their respective financial systems more efficiently and effectively. And we want to have well-designed structures for responding swiftly and effectively to cross-border financial crises in ways that recognise the respective roles of the relevant government agencies in each country.

What would be the key elements in these arrangements? Ideally, they would include a number of attributes, such as:

- Closer cooperation between the home and host authorities in the design and implementation of supervision policy, possibly including areas of

policy harmonisation and mutual recognition. The implementation of Basel II provides a good opportunity for this, as do a number of other supervisory policy areas. Indeed, the implementation of Basel II is perhaps the greatest “fair weather” challenge for cooperation and coordination between home and host regulators for many years. Striking a balance between the consistent adoption of Basel II methodology, while retaining the ability to set capital requirements that reflect each country’s risks, is essential. This is not to mention the challenges arising from the more regulatory intensive nature of some elements of the Basel II requirements.

- * Improved coordination of on-site and off-site supervision in some areas, including the regular candid exchange of information on banks operating in each other’s jurisdictions;
- agreement on the allocation of responsibility for the provision of liquidity support between the home and host central banks in defined circumstances;
- formal understandings on the respective roles of the home and host supervisors, central banks and finance ministries in responding to a cross-border bank failure, including protocols for determining when and how a joint home/host bank resolution strategy could be used to resolve a cross-border crisis;
- facilitating coordination of public communication between the home and host authorities in responding to cross-border financial crisis, where appropriate.

This framework for coordination and cooperation needs to be pre-determined in order to be reliable. Memoranda of Understanding between home and host authorities can be useful, but they might not prove to be sufficiently reliable in a crisis situation. Indeed, most Memoranda of Understanding between home and host authorities tend to take a soft-edged approach to the respective obligations of the parties, creating too much uncertainty for them to be useful in a crisis.

Some form of formalised cooperation arrangement between the home and host authorities is therefore likely to be necessary. This needs to strike a balance between

creating reasonable certainty of coordination in specified circumstances, while preserving the flexibility for each country's authorities to take independent steps to protect their own interests. It also needs to be structured in ways that recognise that bank ownership – and hence home country supervision – can change. There is therefore a need to avoid being locked into arrangements that might later prove to be unworkable or no longer appropriate. And there is a need for home/host arrangements to maintain a degree of internal consistency in the supervisory frameworks of the respective countries, so as to maintain clarity and to avoid conferring any competitive advantages or disadvantages on particular categories of banks. Creating the right balance in all of this is no easy task.

Even if formalised coordination frameworks can be developed, their utility ultimately depends on how effective they are in a crisis. Rather than wait for a financial crisis to occur to see if the coordination arrangements work, it would be better to periodically test their effectiveness. Although no form of testing can ever fully simulate a real crisis and the tensions that go with it, we think that periodic crisis simulation exercises involving home and host supervisors, central banks and finance ministries will become an important mechanism in testing coordination arrangements. They could also make a material contribution towards building closer and more cooperative relationships between home and host authorities and central banks.

Conclusion

Maintaining a sound and efficient financial system and being able to respond to a crisis effectively is a crucial prerequisite for a country's economic and social welfare. This is true whether the financial system is largely composed of domestic banks or dominated by foreign banks. And it is

critical in a small, open, indebted, economy, such as New Zealand's, given the potential vulnerability to international sentiment and cross-border capital flows.

In the absence of any fair and formalised, operationally and legally robust, transnational regulatory framework, the financial stability buck stops at national laws and the supervisor's and central bank's duties under those laws. The financial stability stakes are too high to pass on such a responsibility lightly. In banking, while the home and host authorities have some complementary interests, they also have areas of potentially diverging and conflicting interests, as well as jurisdictional limits.

The Reserve Bank of New Zealand is committed to doing all it can to maintain a sound and efficient financial system in New Zealand. We believe that it is essential to maintain the frameworks needed to fulfil our responsibilities. This includes a clear legal and practical basis to supervise the financial system and the capacity to respond to a financial crisis effectively on a stand-alone basis if necessary. Equally, we must have a clear legal basis for providing liquidity support when required, on the basis of bank balance sheets and capital positions that are as meaningful and clear as they can be in the circumstances.

But, we also recognise the benefits of mutual recognition and harmonisation of regulatory policies, where sensible, and the benefits of cooperation and coordination between the home and host supervisory authorities. The efficiency and effectiveness of our banking supervision will be greater, and the crisis management options wider, the closer the home and host authorities are.

The Reserve Bank of New Zealand is committed to remaining a welcoming, albeit responsible, host. However, the regulatory risks and rewards have never been greater.