The Reserve Bank of New Zealand Amendment Act 2003

James Twaddle, Financial Stability Department

In August 2003, the Reserve Bank of New Zealand Amendment Act 2003 was enacted. The Amendment Act represents a continued evolution of the legislative framework in which the Reserve Bank operates. This article provides an overview of the main changes and the motivations behind them.

1 Introduction

The Reserve Bank of New Zealand Amendment Act 2003 amended the Reserve Bank of New Zealand Act 1989, the Act that sets out the Reserve Bank's functions and powers. The Amendment Act represents a continued evolution of New Zealand's central banking framework, with the main changes being to the Reserve Bank's banking supervision powers.

This article provides an overview of some of the more significant changes introduced by the Amendment Act and reviews the motivation behind them. Detailed discussion of the implications of the changes and how the Reserve Bank plans to use its new powers will be discussed in future *Bulletin* articles.

The next section of this article discusses the evolution of our approach to regulating and supervising banks, which has motivated some of the changes contained in the Amendment Act. The third section reviews the statutory changes relating to banking and payment systems. Finally, we review the changes to Reserve Bank governance arrangements.

2 Evolution of the Reserve Bank's approach to banking supervision

The main changes to the Reserve Bank Act relate to the Bank's powers to register and supervise banks. The amendments clarify and strengthen the Bank's supervisory powers in a range of areas, including requiring significant changes of bank ownership to be subject to the Bank's consent, widening the matters to which the Bank may have regard when considering the registration of a bank, and widening the matters on which the Bank can require a registered bank to obtain an independent report.

These amendments represent a further evolution of the Reserve Bank's approach to the registration and supervision of banks. Under the Act, the Reserve Bank is directed to use its powers to register and supervise banks for the purposes of:

- 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.

For some years now, the Reserve Bank's approach to banking supervision has placed a strong emphasis on banks managing their own affairs prudently and on reinforcing effective market disciplines on banks. Since the mid-1990s, the Reserve Bank has fostered "self discipline" within banks by emphasizing directors' and managers' responsibility for the prudent identification, monitoring and control of banking risks. We have done this primarily by requiring bank directors to sign quarterly, public attestations on the adequacy of their banks' risk management systems. We have also fostered market discipline in the banking system by requiring banks to issue quarterly public disclosures, by maintaining an open and competitive banking system, and by promoting a clear presumption that neither the government nor the Reserve Bank would protect depositors and other creditors against loss in the event of a bank failure.

Both market and self discipline reinforce the incentives already faced by banks and their stakeholders. While the Reserve Bank prefers to use existing incentives wherever possible to promote the sound management of banking risks, we do set some prudential rules when we see a clear need to do so to further strengthen the banking system. Examples of such rules include requirements for banks to hold a minimum level of capital relative to their credit exposures (currently set to the international norm of 8 per cent), a limit on exposures to connected parties, a limit on non-banking business being conducted within the banking group, and a requirement for bank boards to have a minimum of two non-executive and independent directors.

Since the initial formulation of our approach, the banking world and the New Zealand financial landscape have continued to evolve. Banks globally have developed more sophisticated tools for managing the risks they face, which in some areas have changed their approach to taking risks. Banks, like many other businesses, have also integrated information technology more fully into their operations. New technology has allowed banks to offer customers new ways to access their accounts and has led to a range of new and more complex financial products being offered.

These technological advances have allowed greater centralisation of some banking functions, enabling banks to realise the efficiency gains that centralisation can create. A type of centralisation that is relevant to New Zealand is where some New Zealand banks have outsourced some of their core banking functions, such as computer processing and risk management, to their Australian parent bank or other parts of the parent banking group to achieve greater cost efficiencies.

A high level of foreign ownership of New Zealand banks has been a feature of the New Zealand banking environment for a long time, as has been the concentration of that ownership in Australia. The sale of the National Bank of New Zealand (NBNZ) to ANZ in 2003 further concentrated the ownership of New Zealand banks in Australia. Such concentrations can be a source of risk to the domestic financial system because an adverse event in Australia, such as a severe drought or financial crisis, can be transmitted to New Zealand by way of the Australian-owned banks. An example of a transmission channel could be a shock to the capital or liquidity of the Australian bank impacting on its willingness to provide capital or liquidity to its New Zealand operations. However, there can also be benefits from having the larger New Zealand banks owned by large overseas parents, such as the parent bank's ability to support the New Zealand bank if it were to get into difficulties.

The progressive outsourcing of core banking functionality, and the increased concentration of the banking system in Australian ownership, has raised particular issues for the approach to New Zealand's banking supervision. In particular, it has suggested the need for closer attention to be paid to the adequacy of outsourcing arrangements and the implications for the ability of New Zealand bank subsidiaries to function effectively if the parent bank or another outsourcing provider were to fail. It has also suggested a greater focus on the jurisdiction of a bank's incorporation and the implications of this in the event of bank failure. In this context, the Bank needs to be satisfied that a bank failure could be managed effectively in the interests of the New Zealand banking system.

The Reserve Bank's approach to supervision and regulation cannot stand still in the face of these developments. Over the past few years, we have been making more use of regulatory discipline in areas such as banks' lending to connected parties, the way banks can structure their holdings of insurance business, and the jurisdiction of a bank's incorporation.

The Amendment Act is a further step in the evolution of our approach. It provides the Bank with greater powers to maintain a sound and efficient financial system, particularly in respect of such matters as ensuring that changes in bank ownership do not weaken the banking system, and widening the scope for the Bank to require banks to undergo independent reviews of their risk management systems. These changes do not herald a major change in the Bank's approach to banking supervision. We continue to think that incentive-compatible regulation is the best approach to deliver a sound and efficient financial system, and so will continue to place a strong emphasis on banks' self discipline and on market discipline. The new amendments will assist the Bank to reinforce market and corporate governance mechanisms for promoting a sound banking system through the selective use of a more focused regulatory discipline on banks.

The new Amendment Act powers are already being applied. Shortly after the Amendment Act was passed, the Reserve Bank applied some of the Act's provisions to the purchase by ANZ of NBNZ. Pursuant to a new power in the Amendment Act, ANZ was required to obtain the Reserve

Bank's consent to its purchase of NBNZ. We decided that in assessing ANZ's application, it was appropriate to consider the same criteria that apply for bank registration applications. Where the Amendment Act added new considerations for bank registration applications, these were considered in the context of the change of ownership application from ANZ. In two of these new areas – outsourcing and the suitability of directors and senior management for their positions – the Reserve Bank imposed conditions on its consent to the change in ownership.

The areas where the Reserve Bank imposed conditions of consent to the purchase of NBNZ by ANZ are all on the Reserve Bank's agenda for the development of policies applicable to all registered banks. Indeed, the evolution of our approach will continue in the next few years, as we start to use the Amendment Act powers outlined in the next section, and continue to think about issues, such as the increasing integration of local banks with the operations of their overseas parents, the role of local bank boards, how to manage a bank failure, and the extent to which there should be closer integration of the New Zealand and Australian banking systems and regulatory frameworks.

3 Amendment Act changes relating to banking and payment systems

Table 1, opposite, summarises the main changes to the Reserve Bank Act. Most of the changes relate to bank registration and supervision, which are covered by the changes to Parts IV and V, and to payment systems, which are covered by the introduction of new Parts VB and VC. This section covers the changes relating to banking and payment systems and the following section covers the Part III changes, relating to the governance of the Reserve Bank.

Amendments to Part IV – Use of the word 'bank'

The business of banking in New Zealand is not licensed, so there are no restrictions on who can undertake banking business, such as deposit-taking or the lending of money, provided that such businesses meet other applicable laws and regulations (such as the requirements of the Securities Act). However, the ability to use the word 'bank' (or 'banking' and 'banker') is restricted by the Reserve Bank Act. With some exceptions, an entity wishing to use 'bank' or a derivative of this word must be registered as a bank with the Reserve Bank. This restriction is aimed at ensuring that non-bank financial institutions do not pass themselves off as a bank and so mislead the public as to their nature and financial standing.

The Reserve Bank's experience applying the restrictions on using 'bank' in names was that there were loopholes in the legislation that had been exploited by some non-bank financial institutions. Consequently, the restrictions on the use of 'bank', and the exemptions from the restrictions, have been tightened in the Amendment Act. Also strengthened were the Reserve Bank's powers to monitor and enforce the restrictions.

One important change is that the 'bank' name restrictions now apply to carrying on any activity, rather than simply carrying on business. Also, where previously exemptions from the restrictions were allowed when 'bank' was part of a person's name or referred to a geographic place, these exemptions now only apply if the word 'bank' is not being used by a financial institution or in a manner that could mean it could reasonably be mistaken for a financial institution.

Non-bank financial institutions can continue to offer and promote banking products as they have done previously, but the Amendment Act requires that if they use the word 'bank' (or one of its derivatives) in an advertisement they must also include a reasonably prominent statement that they are not a registered bank.

Amendments to Part V – Registration and supervision of banks

As noted earlier in this article, the evolving features of the banking environment in New Zealand, and the Reserve Bank's experience using its supervisory powers, prompted changes to the Act in relation to the registration and supervision of banks. Five of the changes represent important policy development areas for the Reserve Bank, as discussed below.

Table 1
Major changes to the Reserve Bank of New Zealand Act

Part	Area	Main changes
III	Governance of the Reserve Bank	• The Governor no longer chairs the Reserve Bank Board; the chair is now chosen from among the non- executive directors. • Deputy Governors are no longer members of the Board and the minimum number of non-executive directors has increased from four to five. • The Board is required to publish an annual report on their assessment of the performance of the Reserve Bank and the Governor.
IV	Use of the word word 'bank'	• Tightens restrictions on the use of the word 'bank'. • Tightens the exemptions to the 'bank' name restrictions. • Requires that whenever the word 'bank' is used in an advertisement by a non-bank financial institution, a disclaimer must accompany the advertisement stating that it is not a registered bank.
V	Registration and supervision of banks	• Introduces a requirement for Reserve Bank approval of significant changes in bank ownership. • Introduces outsourcing and director and senior manager suitability, among other things, as factors for the Reserve Bank to consider in registering and/or supervising banks. • Widens the areas where the Reserve Bank can require a bank to get an independent report by an approved person; the Reserve Bank can now require publication of those reports. • Streamlines bank failure management powers.
VB	Payment system oversight	• Formalises the Reserve Bank's oversight responsibility for payment systems by empowering the Bank to obtain and publish information on payment systems, and to require that information to be audited.
VC	Payment system designation	• Gives the Reserve Bank the power to designate payment systems to provide for certainty of the finality of payment transactions. • Makes rules of a designated payment system (including netting rules) valid and enforceable, and provides that settlements in designated payment systems cannot be reversed.

Change of ownership restrictions: The most publicly visible of the changes to date is the introduction of requirements for potential purchasers of an ownership interest in a registered bank to obtain Reserve Bank consent before giving effect to a transaction that would result in their ownership stake exceeding 10 per cent. The Reserve Bank can impose conditions on its consent to changes of ownership - a power the Reserve Bank exercised in the case of ANZ's purchase of NBNZ.[1]

The primary motivation for the change was that the financial strength, standing, risk appetite, and reputation of a parent bank, or of a bank's owners, can have a significant impact on the bank in New Zealand. For example, the perceived willingness of a bank's owner to provide financial support to the bank if it got into difficulty can influence the bank's soundness and creditworthiness. The change of ownership

1 For the ANZ purchase of NBNZ the conditions of consent: (i) required Reserve Bank approval before any outsourcing by NBNZ or a merger between the two banks; (ii) did not allow any director or senior management appointment at the NBNZ until the Reserve Bank said it raised no objection to that appointment; and (iii) put in place restrictions to strengthen the responsibility of the NBNZ chief executive to the NBNZ board.

restriction gives the Reserve Bank the power to disallow a change of ownership if it assesses factors such as the impact of the change on the bank's credit-worthiness as being unfavourable. The new power is consistent with standard international banking supervision practice and brings New Zealand closer into line with accepted international norms.

Outsourcing*:* Banks have increasingly made use of outsourcing as a means of generating efficiencies and keeping their costs down in areas such as risk management, financial accounting and computer processing. In the normal course of business, the efficiencies that outsourcing can generate can be good for the New Zealand financial system. However, outsourcing arrangements that are not robust, or make no contingency arrangements for the failure of the supplier of the outsourcing services, can limit the Reserve Bank's options when a bank is in distress or failing. In particular, outsourcing of core functionality that is not supported by contingency arrangements would create major difficulties in maintaining a bank's operations in the event that the parent bank or another outsource provider failed.

In response to these developments, outsourcing has now been added to the factors that the Reserve Bank can consider when assessing whether a bank is conducting its affairs prudently. This has the effect of allowing the Reserve Bank to place conditions of registration on banks' outsourcing arrangements.

Suitability requirements for bank directors and senior management: Our approach to banking supervision places substantial reliance on bank directors and senior managers, and governance arrangements that allow them to exert meaningful oversight and management of the bank. The introduction of suitability requirements for bank directors and senior management is part of encouraging a culture of good governance in banks. The Reserve Bank now has to consider the suitability of directors and senior managers for their positions when registering banks and has the option of considering it on an ongoing basis through a bank's conditions of registration.

Independent reports: Prior to the Amendment Act being enacted, the Reserve Bank had the power to require a bank to supply it with a report on the bank's financial and accounting systems and controls, prepared by an independent person approved by the Reserve Bank. However, the range of issues where an independent report could be required was fairly limited, relating mainly to accounting systems and internal controls.

The Amendment Act allows the use of independent reports in a wider range of circumstances by extending the matters where they can be required to almost any aspect of banking business, including corporate, financial, and prudential matters relating to the bank. The coverage of independent reports has also been extended to include some additional parties related to the bank, such as sister companies.

These changes make independent reports a tool that can be used in a wider range of circumstances, such as where technical expertise is required to assess information. The Reserve Bank now also has the power to require an independent report to be published, in a form specified by the Reserve Bank: so independent reports can now be used in a way that contributes to market discipline and reinforces banks' self discipline and corporate governance.

Bank failure management powers: The Amendment Act introduces several changes to the Reserve Bank's powers to respond to a bank distress or failure situation. In order to enable the Bank to move quickly when a bank gets into difficulty, the Bank's powers to give directions to a bank, and to remove, replace, or appoint directors, have been streamlined by removing the need for the Bank to consult with a bank before giving such directions. As before, the Act lists the types of circumstances when these powers can be used, and the Minister of Finance's prior consent is needed before the powers are exercised.

There are also several changes to the statutory management powers of the Reserve Bank, aimed at giving the Bank more flexibility in a statutory management situation. The most noteworthy of the changes is to require a statutory manager to be appointed for a specified period instead of indefinitely.

Other changes: There are a number of other changes to the Bank's banking supervision powers. The most significant of these are:

- Overseas incorporated banks must now have their New Zealand chief executive sign the bank's disclosure statements along with the bank's directors. This change reflects the important role that the CEO of a New Zealand branch plays in ensuring that the branch's affairs are being conducted prudently, and that the directors of an overseas incorporated bank tend to focus their attention on the bank as a whole, rather than the affairs of a branch operation (given that the branch is legally inseparable from the bank generally).

- The Reserve Bank can authorise supervisors of a New Zealand bank's parent bank (the 'home' supervisor) to conduct on-site inspections of an overseas bank's New Zealand operations or require a New Zealand subsidiary to provide the home supervisor with customer-specific information. This provision is intended to assist an offshore supervisory agency to conduct on-site examinations of the New Zealand operations of a bank based in their jurisdiction, in ways that enable the foreign supervisor to obtain client-specific information where necessary (while preserving confidentiality of information).
- Banks are required to disclose information on their sister companies in either their disclosure statement or to the Reserve Bank.
- Risk management systems are now explicitly identified as a consideration for assessing whether a bank is carrying out business in a prudent manner, whereas previously the Reserve Bank had considered banks' risk management systems under the heading of 'internal accounting systems and controls' when assessing whether a bank was carrying out its business in a prudent manner. The amendment clarifies the Bank's power in this regard.

New parts VB and VC – Payment system oversight and designation

The Reserve Bank has always viewed payment systems as an important component of the financial system. Payment systems are the plumbing of the financial system, linking banks, their customers, merchants, and other financial institutions, and are essential for the efficient conduct of business. Payment systems are also important from a policy perspective because of their ability to transmit shocks among financial institutions and to be a source of shocks to financial institutions.

The Amendment Act formalises the Reserve Bank's payment system oversight mandate. The Bank is required to use its new powers to promote the maintenance of a sound and efficient financial system. The new payment system oversight powers empower the Bank to collect information relating to payment systems, to have that information audited, and to disclose that information. The Act does not give the Bank the authority to regulate payment systems, other than indirectly in the process of designating a payment system.

The Amendment Act also confers a new power on the Reserve Bank to designate payment systems. Designation removes any doubt over the legal status of payments made through a designated payment system by making the rules, of designated payment systems and any netting arrangements under the rules, valid and enforceable. Settlements through designated payment systems cannot be reversed in the event that a participant in the payment system (such as a bank) is placed into liquidation or statutory management, although the underlying transactions can still be subject to challenge by a liquidator under the normal rules of insolvency. Payment system designation is discussed more fully in an article by Loretta DeSourdy in this edition of the *Bulletin*.

4 Changes to Reserve Bank governance arrangements

In 2000, the Government appointed Professor Lars Svensson, an international expert on monetary policy, to conduct an independent review of the operation of monetary policy. Several of Professor Svensson's recommendations related to the governance arrangements at the Reserve Bank. A number of them were subsequently incorporated into the Amendment Act.

The most significant of the changes in the Act relate to the membership of the Reserve Bank Board. The previous arrangements, where the Governor chaired the Board and Deputy Governors were Board members, were not ideal from a governance perspective, given the Board's main role of monitoring and assessing the performance of the Governor and the Reserve Bank. Under the new arrangements, the Governor remains on the Board but ceases to be the chair – the chair must be one of the non-executive directors, and the Deputy Governors are not Board members. To maintain a reasonable number of Board members, given the removal of the Deputy Governors from the Board, the minimum number of non-executive directors has been increased by one to five. In addition, the Act now requires the Board to report annually to the Minister of Finance on the Board's assessment of the performance of the Reserve Bank and Governor, formalising the practice adopted by the Board in recent years.

Taken together, these changes make the Reserve Bank's governance arrangements more consistent with what is considered best practice in corporate governance and better aligned with the particular role of the Bank's Board.

5 Conclusion

The world of banking and finance is constantly evolving. To be effective and efficient, legislation also needs to evolve, adapting existing frameworks to confront new problems, and occasionally developing new frameworks to approach both old and new problems. The 2003 amendments to the Reserve Bank Act adapt the Bank's existing philosophy for banking regulation to meet the evolving environment and to refine our approach based on our experience in recent years. Future *Bulletin* articles will elaborate on how we plan to apply some of the powers introduced by the Amendment Act.