SPEECHES

Supervising overseas-owned banks: New Zealand's experience

An address by, Dr Alan Bollard, Governor, Reserve Bank of New Zealand, to the Trans-Tasman Business Circle in Sydney

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In many respects the Australian and New Zealand economies are similar. With banking, however, there is a big difference - the New Zealand banking system comprises banks owned overwhelmingly from abroad, whereas in Australia the banks are mainly Australian-owned.

Of course, the main overseas-owned banks in New Zealand are Australian-owned banks and, in this sense, it might be said that banking is another thing we have in common. But that would be to overlook that banking authorities in countries with predominantly overseas-owned banks face some additional, and different, issues from those in which the banks are mainly locally-owned.

These differences include different roles in the supervision of banks, depending on whether one is the supervisor of the "home" country parent bank, or, as is predominantly the role of the RBNZ, a "host" supervisor of overseas-owned banks.

More broadly, and more importantly, for a country whose banking system comprises predominantly overseas-owned banks, there are different issues concerning the capacity of its banking system to weather a crisis. In this regard, overseas ownership can be both an undoubted strength, but also a potential risk.

There are also issues concerning the depth and breadth of financial services that overseas-owned banks provide to the local economy. In New Zealand we are a very welcoming host of overseas-owned banks, but we also look for our "guests" to be good guests, and to make a positive contribution to the New Zealand economy.

A number of things have happened recently to raise interest in these issues.

First, there has been the take-over by the ANZ of the National Bank of New Zealand, previously owned by the British bank, Lloyds TSB. This means that about 85 per cent of New Zealand's banks, measured by total assets, are now Australian-owned. Australia and New Zealand also now share the same "big four" banks. The ANZ owns the merged ANZ National in New Zealand; NAB owns the BNZ; the Commonwealth owns ASB; and Westpac in New Zealand trades as a branch operation.

Second, early this year the New Zealand Minister of Finance and the Australian Treasurer put trans-Tasman banking supervision on the initial agenda of issues for working towards a single trans-Tasman economic market. The other issues identified for consideration were accounting standards and competition policy. On banking supervision, Ministers commissioned New Zealand and Australian officials to report jointly on trans-Tasman mutual recognition and harmonisation possibilities. This process is now well advanced, with a report currently before Ministers. I expect that Ministers will be indicating soon the direction to be taken.

Third, there have been issues in New Zealand in relation to the seemingly small amount of tax the banks have been paying.

And this has all been happening at a time when the RBNZ has been seeking to reinvigorate the regulatory arrangements for New Zealand's banking system, to give it more resilience in times of financial stress. This has been behind our policies to require systemically-important banks (and some others) in New Zealand to be incorporated in New Zealand, that better ensure effective banking sector corporate governance, and that place some constraints on banks out-sourcing key operations.

I will say more on these policies, and on our approach to banking supervision in New Zealand more generally, in a moment, but before doing that I would like to provide some context. Banking supervision policy needs to be viewed against the backdrop of the importance of the role of the banking system in the economy.

Why the banking system matters

Banks play a key role in mobilising and allocating the economy's resources - mobilising from those who, for the meantime, have surplus resources, and allocating to where resources can be put to best use. This role is particularly important for meeting the funding requirements of growing small- and medium-sized firms, given that these firms have limited abilities to access funding directly from the securities markets, or from abroad. With SMEs comprising a large share of the New Zealand economy, as is also the case in Australia, this makes the banking system important for the economy's growth prospects.

Equally as critical is the role banks play in the payments system. The overwhelmingly- used means of payment these days is the bank deposit, whether it be to pay for the groceries, to pay wages, to make settlement on a property transaction, or to settle dealings in the wholesale financial markets. And we use a number of bank-provided systems to make these payments. These include EFTPOS, cheques, telephone banking, and internet banking.

If it were not for the fact that a small number of banks dominate the banking system, bank failures might not be so much of a problem. But to shut down a bank with a 20 per cent plus market share, and thus to shut down the ability of perhaps 20 percent of the economy to access working capital and to make payments, is quite another thing - to say nothing of the risk that one bank failure can precipitate others, and wider financial system collapse.

Banks therefore play a critical role, but at the same time they are potentially fragile organisations. They are different from most other firms, because their ability to operate is so dependent on maintenance of market confidence in their financial soundness. If a manufacturing firm's solvency is in doubt, the public generally does not suddenly stop buying the product. But if there is material doubt in the market-place about a bank's ability to meet its financial obligations, without official intervention to restore public confidence, it can no longer operate.

This fragility is inherent in what banks do. Their business is to take deposits and make loans, which means that, necessarily, they are very highly geared. No other industry operates with a capital ratio as low as 8 per cent.

And for deposit liabilities to serve as a means of payment, they need to be liquid. Hence, banks generally have a balance sheet structure also characterised by borrowing short and lending long. With this financial structure, the margins for error are fine and, in an uncertain and competitive market-place, there are always risks.

Indeed, banks on occasion do get into trouble, and probably more often than is commonly thought. Recently in Australia, there have been some high profile incidents at the NAB. In the late 1980s and early 1990s, both Australia and New Zealand had much more serious incidents to deal with. There was the failure of state banks and the parlous condition of Westpac in Australia, and similar problems at the BNZ and DFC in New Zealand. Before that, in 1979, there was the problem at Bank of Adelaide, and both countries have experienced fringe financial institution failures.

None of this makes Australia and New Zealand unique. It is easy to find other countries that have experienced banking system difficulties that were even more serious. Sweden, Finland and Norway all experienced systemic banking collapses in the early 1990s, which required fiscal support in the vicinity of 5-10 per cent of GDP. In the Asian financial crisis later in the 1990s, Indonesia, Korea and Thailand all needed to provide fiscal support to their banking systems in excess of 30 per cent of GDP. Other cases include Japan (8 per cent of GDP), Spain (16 per cent) and the United States saving and loan crisis (3.2 per cent).

And these are just the fiscal costs. The cost of bank failures is not limited to the cost of rescuing banks or bailing out depositors. The real economy costs can be greater and longer term, including weakened investor and consumer confidence, higher borrowing costs, potentially protracted credit contractions and, in consequence, lower economic growth.

Given this combination of critical importance and potential fragility, no country can afford to view its banking system with indifference. The banking system is something that is central to a nation's economy. And that applies whether the banks are locally- or foreign-owned. Indeed, some countries, including Australia, appear to see banks - at least the large, systemically-important, ones - as being so central to their economy as to preclude them from being foreign-controlled.

By contrast, in New Zealand, as a matter of policy, we don't restrict foreign ownership in banks, and all our systemically-important banks are foreign-owned. But, while we have seen no need to restrict foreign ownership, we do see a need for regulation of overseas-owned banks so as to provide reasonable assurance that the New Zealand banking system could weather a period of banking stress.

Sometimes it is suggested that having banks that are owned by substantial foreign-owned banks is actually an advantage, because the foreign owners can be relied on to mount a bail out if the need arises. While this may often be true, I think it would be imprudent to rely on such an assumption.

To be sure, experience indicates that, usually, parent banks do stand behind their overseas operations, since not to do so could seriously undermine market confidence in the parent's own financial position, and would involve writing off the franchise value embedded in their overseas investment. But there will be occasions when an overseas owner is either unable, because of its own financial weakness, or because of home country regulatory constraints, to provide that support.

These cross-border issues are something that many countries, particularly the growing number with a significant foreign bank presence, are having to come to grips with. Increasingly we are being confronted with the fact that shareholders, customers, and taxpayers, not only have different interests in the banking system, but increasingly reside in different jurisdictions.

The international framework for supervision of multi-national banks

The internationally-agreed framework for the supervision of multinational banks, as devised by the Basel Committee on Banking Supervision, is known as the Basel Concordat (not to be confused with the Basel Accord on capital standards for banks). The Concordat assigns clear, and deliberately overlapping, roles to the supervisors of multinational banks in those banks' "home" and "host" countries.

The home country supervisor is responsible for consolidated supervision of the global bank. It sets standards to be met on a group consolidated basis, for example, that group capital is sufficient to support the global business. (Some home country supervisors additionally set standards to be met by the bank in its home country alone - so-called "solo" standards.) Host supervisors, that is, the authorities in the other countries where the bank operates, are charged with supervising the bank in their individual jurisdictions. This framework recognises the reciprocal and over-lapping, though not identical, interests of the respective authorities, and the importance of sharing information.

As mainly a host supervisor, the prime role of the RBNZ is to promote sound banking by the overseas-owned banks operating in "our patch". We do this mainly for our own purposes, in recognition of the vital role of our banking system to the New Zealand economy, but there is also a significant element of contributing to the effective supervision of the multinational banking groups of which the overseas-owned New Zealand banks are a part.

In return, we have a close, reciprocal interest in the parents of the overseas-owned banks in New Zealand, and in the supervision of those banks by the relevant overseas authorities. With New Zealand's banks almost entirely foreign-owned, there is at least as large a probability that shocks to the New Zealand banking system will originate from abroad as from within New Zealand.

RBNZ supervision for promoting banking soundness

The Reserve Bank of New Zealand, as the New Zealand banking supervisor, conducts its supervision of New Zealand banks that are overseas-owned within this internationally-agreed framework. (In New Zealand, unlike in Australia, the central bank is also the bank supervisor.)

The RBNZ's responsibility to supervise banks in New Zealand is prescribed in the Reserve Bank of New Zealand Act. This Act requires us to use the powers it gives to the Bank to promote the soundness and efficiency of the New Zealand financial system, and to avoid significant damage to the financial system that could be caused by the failure of a registered bank.

There are three central pillars to how we promote sound prudential management by banks, including by overseas-owned banks, in New Zealand.

First, we look to the banks themselves for self-regulation. This is about policies and structures that promote effective governance by banks' boards of directors, including effective oversight by local boards of the local banks' managements. We expect high standards of corporate governance from the boards of New Zealand banks, and this expectation is reinforced by some quite severe penalties that could apply should a bank's directors fail to properly discharge their responsibilities.

In these regards, we have observed a trend for overseas-owned banks in New Zealand increasingly to adopt "matrix management" arrangements, under which the reporting and accountability lines of local managements to their local boards may be weakened by direct reporting lines to overseas head-office managements. Hence, we took the opportunity when approving the amalgamation of the ANZ and National banks, to reinforce that the board of the merged bank must carry prime responsibility for oversight of the bank in New Zealand. Consistent with this, we have required that the chief executive of the bank must be appointed by, and be primarily accountable to, the New Zealand board.

We will be consulting with other systemically-important banks about the application of similar requirements to them. We are also reviewing more generally the governance arrangements in banks to ensure that bank boards are sufficiently empowered to oversee the management of their bank in New Zealand and that they bear the appropriate accountabilities in performing their responsibilities.

A second pillar is market discipline. For many years, banks in New Zealand have been subject to obligations to make quite comprehensive quarterly financial and prudential disclosures to the market-place. These disclosures, combined with a policy of not bailing out failed institutions, help to strengthen market scrutiny of banks, and the market disciplines that go with that.

This is an area of policy where the RBNZ has played a leading role, although other countries' banking authorities too are now seeing an important place for disclosure by banks as a means of reinforcing prudential discipline. Globally, banks are making much fuller disclosures to the market than used to be the case, and that trend will be reinforced by new international disclosure requirements being introduced as part of the new Basel 2 capital requirements, on which I will say a little more in a moment.

Third, we have some regulatory and supervisory requirements. Although our regulatory framework is somewhat less intrusive than that of many countries, it nonetheless contains most of the standard features. The IMF in its Financial Sector Assessment Programme (FSAP) review of the New Zealand financial system last year confirmed that we have a good model for host country supervision.

The centre-piece of the regulatory requirements is a requirement that banks in New Zealand be adequately capitalised. We apply the standard Basel I capital accord in much the same way as do other supervisors. In the case of overseas-owned banks, we require the bank in New Zealand to be sufficiently capitalised in its own right, with not less than 8 per cent capital. This serves two purposes. It reinforces the responsibilities of the local board and management, since they have a balance sheet for which they are clearly responsible. And it provides a financial buffer should the bank incur losses in New Zealand, or should the parent bank fail and its New Zealand subsidiary have to be "cut loose".

Banking supervision and failure management

This brings me to the second element of our statutory responsibilities - to avoid significant damage to the financial system that could be caused by the failure of a registered bank. Absolutely critical in this situation would be that the New Zealand authorities have the ability to take control of the failed bank in New Zealand. Without that ability to take control, and to take control quickly, we could not manage the situation.

And in the case of a systemically-important bank, just shutting the doors generally would not be an acceptable response. In most cases, our objective would be to maintain the provision of critical banking services, but without resorting to a bail-out; certainly not a bail-out of existing shareholders, and desirably not of depositors and creditors, who could expect to bear some of the losses. To achieve those outcomes, the New Zealand authorities would need to have access to the critical operating and information systems necessary to operate the bank, and more or less immediately on the failure occurring.

I should hasten to add that none of this means that, in the event of a bank crisis involving an overseas-owned bank, the RBNZ's first preference would be to act unilaterally. In most situations a co-ordinated response involving home and host country authorities would be much preferred - from both authorities' points of view.

But a co-ordinated response requires that both authorities have a capacity to manage the situation in their jurisdiction. It would also be unrealistic to assume that co-ordination would always be readily achievable, as there would be a risk that the interests of the different regulatory authorities would diverge. This could occur if, for example, an economic shock places stress on the financial system in one country, but not the other; or the respective regulators in the two jurisdictions have different priorities in terms of the future of the failed bank.

This is why we focus on ensuring that we have an effective failure-management capacity in respect of banks operating in New Zealand, including those that are owned from abroad. That in turn requires those banks, at least those that are systemically-important, to have key systems and key management available, either on the ground, or at least within our jurisdictional reach. This is another issue we addressed with the ANZ in the context of the ANZ-National Bank amalgamation, and intend also to take up with the other systemically-important banks.

Another key requirement, if local authorities are to be able to manage a bank failure, is that there is clarity about the local bank's balance sheet, that is, clarity on what its financial obligations are, and on what assets it has to meet those obligations. That clarity is not readily achievable for a bank that is a branch of an overseas bank because, legally, the assets and liabilities of a branch are inseparable from those of the overseas parent or head office. This is the main reasoning behind most countries' requirements that systemically-important banks be incorporated locally, a requirement that now also applies in New Zealand.

All systemically-important banks in New Zealand currently comply with the requirement to be incorporated locally, except for Westpac. Westpac has always been a branch bank in New Zealand. It has been engaged in discussions with us on this issue for some time, and currently has before us a proposal under which it would "buttress" its present branch structure, in ways it believes would deliver the policy outcomes we are seeking. However, as the proposal is still under our consideration, it would be inappropriate for me to comment further on that alternative structure at this time.

Are these RBNZ banking supervision requirements burdensome?

Our requirements of overseas-owned banks in New Zealand are not onerous or costly for those banks. Let me explain why not.

First, there is nothing in what we require that APRA would not require of an overseas- owned bank that was systemically important to Australia. I say "would not" because Australian policy to date has precluded systemically-important overseas-owned banks in Australia.

Second, the Reserve Bank of New Zealand Act requires that we promote the efficiency as well as the soundness of the New Zealand financial system. This is a responsibility we take seriously, and it is reflected in what we do in a number of ways. Not least, we see retaining the openness of the New Zealand banking system to overseas ownership as important for promoting competition and innovation in the New Zealand banking market.

Another feature of our approach to banking regulation, as it applies to all banks in New Zealand, not just overseas-owned banks, is that it is largely "principles" based, and relatively light on "black-letter" regulation.

Our approach to banking supervision is sometimes described as "light-handed". That is a description that may give the wrong impression, at least if it gives the impression that we are not serious about our role. We are serious about the principles we apply, and in seeing to it that they are applied. But we endeavour to supervise in a way that not only is effective, but also is cost-efficient, including for the banks. The way to achieve that, we think, is to get the basic structures and incentives right - particularly the incentives for directors to monitor and to exercise effective oversight so as to avoid having to disclose bad news.

Also, as already outlined, our supervision of overseas-owned banks is conducted very much within the internationally-agreed framework of "home-host" supervision. We seek to ensure that our requirements do not cut against home-country requirements and, consistent with meeting our own responsibilities, dovetail as much as possible with those requirements.

My more general point here is that avoiding unnecessary compliance costs is something we attach importance to. On the whole, I think we have been quite successful in achieving that. And, as part of the effort to enhance trans-Tasman co-ordination, we will be reviewing our requirements to see where we could achieve better alignment.

It also bears stating that our requirements do not deny the many overseas-owned banks operating in New Zealand the benefits of large overseas-bank parentage, nor overseas banks the benefits of a New Zealand presence.

New Zealand banks with overseas parentage benefit a lot from that parentage. Parent banks generally are a source of capital, a source of rating strength, which helps to lower New Zealand bank funding costs, as well as a source of risk management and systems expertise.

For overseas banks, New Zealand is an open and welcoming market, with a level playing field for local and overseas participants. And for the Australian-owned banks, New Zealand has provided a significant addition to their home market, and one that, in recent years, has been very profitable. With operations on both sides of the Tasman, the Australian banks are well placed to service trans-Tasman customers, and our banking supervision requirements place few, if any, impediments in the way of that.

Next steps

Having said all that, the recent report to Ministers that I mentioned in my opening remarks has usefully sharpened the focus on achieving increased coordination of trans-Tasman banking supervision. We already have a formal Memorandum of Understanding with APRA and we will be looking to work with APRA on how best the two organisations can coordinate, both in terms of day-to-day prudential supervision and crisis management. New Zealand certainly will be prepared to carry its share of the regulatory burden under such co-ordinated arrangements.

At the same time, co-ordination need not mean that our requirements need always be identical to those of APRA. On some matters we may adopt different approaches. One that is starting to receive some publicity concerns the implementation of new Basel 2 capital adequacy standards for banks. Under Basel 2, national authorities will have a choice between adopting a more sophisticated, internal model-based, approach to calculating capital requirements, or a simpler methodology that is closer to the existing Basel 1 regime.

APRA has indicated that it proposes to apply the internal model-based regime in its consolidated supervision of Australian banks' global operations, which, of course, encompass their operations in New Zealand. In considering this issue, we will be looking to ensure that the adoption of Basel 2 does not result in a general weakening in the capital adequacy of New Zealand banks, and our general preference is for a simpler rather than more complex approach, in part to keep compliance costs down. But we are also aware that if our and APRA's requirements are not reasonably well-aligned, that could increase compliance costs, and we will be seeking to avoid that.

More generally, given the high degree of integration of the New Zealand banking system with the Australian banking system, there may well be an opportunity to develop arrangements for trans-Tasman banking supervision into a world-class model of "home- host" supervision. One area where more coordination may be possible is banks' disclosure requirements, where international developments in accounting and disclosure standards will have implications for both countries. Another area where more structured co-ordination obviously would be useful is in crisis management.

Concluding remarks

By way of conclusion let me recap on what I see as the main points.

First, the banking system matters. For any country, the banking system is one of the most critical elements of its economic infrastructure. This is as true for a country whose banking system comprises mainly overseas-owned banks, as it is for one whose banks are predominantly locally-owned. In that sense, while almost all the banks in New Zealand are overseas-owned, the banking system as a whole must still meet New Zealand's needs - in fair weather and foul.

Second, it is essential that the New Zealand authorities can supervise the New Zealand banking system and can respond quickly, decisively and effectively to a banking crisis. All countries need to shoulder the responsibility for the sound functioning of their banking systems. This is why we require systemically-important banks in New Zealand to be incorporated locally. And it is why we require such banks to maintain the capacity to function on a stand-alone basis, if required. Without that capacity, there is a material risk of the banking system becoming dysfunctional in a banking crisis. Avoiding that risk we see as being fundamental to the soundness of the New Zealand financial system. The measures we are introducing to counter that risk recently have been affirmed by Standard and Poors, who have noted that they "could well enhance the strength of the New Zealand banking sector and its ability to withstand a period of financial stress".

Third, the Reserve Bank is concerned to ensure that its supervision is efficient as well as effective. This is reflected in our emphasis on principles, and structures that emphasise incentives and accountabilities, rather than detailed prescriptive, or "black-letter", regulation. It is also reflected in the internationally-agreed framework for the supervision of international banking groups, within which we operate. This sets up a basis for co-ordination amongst home and host country authorities, and avoids unnecessary duplication.

With regard to the supervision of trans-Tasman banks, we already have a formal arrangement with APRA which provides, mainly, for information sharing. In the period ahead we will be looking to build on that arrangement, in a way that ensures that our supervision of Australian-owned banks in New Zealand is both effective and cost-efficient. Indeed, with the New Zealand banking system now comprising predominantly Australian-owned banks, there exists an opportunity to develop arrangements for the supervision of trans-Tasman banks that would be a world-class model of cross-border banking supervision.