

# **Reserve Bank of New Zealand revised corporate governance requirements for registered banks**

## **Feedback statement and regulatory impact assessment**

### **Introduction**

1. The Bank issued a consultation paper in June 2010, proposing revisions to the existing supervisory requirements on corporate governance for locally-incorporated registered banks. The existing requirements are included within the Banking Supervision Handbook document *Statement of Principles: Bank Registration and Supervision* (BS1). The proposal was that the expanded new requirements should be contained in a new stand-alone Banking Supervision Handbook document *Corporate Governance* (BS14). The consultation sought views on the proposed BS14 and also on consequential amendments to BS1.
2. The consultation period closed on 27 August 2010, although the Reserve Bank accepted several submissions sent in after that date. The Reserve Bank received 14 submissions in all, from locally-incorporated banks and other interested parties, and also held a number of subsequent discussions with some of the banks.
3. The Reserve Bank has revised BS14 in the light of comments received, and has now published the final versions of BS14 and BS1 at the same time as this document. The new policy requirements will come fully into effect once the Reserve Bank has imposed the new standard conditions of registration for corporate governance on the banks affected: we will be consulting banks on proposed new conditions of registration during the first quarter of 2011. The guidelines included in BS14 take effect immediately.
4. The rest of this paper has the following sections: a feedback statement, summarising the comments we received on each element of the main policy proposals and setting out our response; a regulatory impact assessment of the proposed policy; Appendix 1 showing the draft criteria for director independence as consulted on; and Appendix 2 showing the previous supervisory requirements relating to corporate governance.

### **Summary of submissions received and resulting policy decisions**

5. The following is a summary of the policy requirements we proposed in the draft BS14:
  - minimum board size five;
  - majority of directors must be independent;
  - majority of independent directors must be ordinarily resident in New Zealand;
  - a prescriptive set of criteria for director independence, tighter than the current definition (see Appendix 1 for details);
  - board chairperson must normally be independent, but can be non-independent if he or she fails the independence test only to the extent of sitting on a holding company board;

- there must be an audit committee, minimum size three, all non-executive directors, the majority also independent, and the chairperson of the committee must be independent and not the chair of the board;
- remove the exemption from corporate governance requirements for banks which are fully, unconditionally, and irrevocably guaranteed by an AAA-rated parent;
- flexibility on the board size and composition requirements for very small newly registered banks; and
- guidelines covering the individual and collective knowledge and experience of board members.

The following goes through each key area in turn summarising the comments received and our responses to those comments.

#### Board size and required number of independent directors

6. There were no concerns raised about the proposed increase in the minimum board size from two to five, nor the exceptions to this for small start-up operations. BS14 is unchanged in these areas.
7. The proposal to require a majority of independent directors for all locally-incorporated banks gave rise to significant concerns among banks that are wholly-owned subsidiaries. These banks gave a number of reasons why they felt that this requirement is unnecessary to address the concerns the Reserve Bank may have, including the following:
  - the duties imposed on a director of a company by Section 131 of the Companies Act to act in what the director believes to be the best interests of the company;
  - the restriction imposed on a bank's constitution in its conditions of registration, which reinforces the effect of Section 131 of the Companies Act (see under the heading "Acting only in the best interests of the bank" below);
  - other Companies Act restrictions, such as the prohibition on distributions to shareholders if the company would not still satisfy the solvency test;
  - Reserve Bank prudential requirements such as limits on connected lending; and
  - in the case of Kiwibank, additional oversight arrangements arising from the bank being 100% owned by a state-owned enterprise.
8. The banks also gave a number of reasons why they view the proposal as problematic:
  - it takes away the shareholder's legitimately held rights and ability to influence the proper management of its investment and protection of its interests; and
  - it weakens the link between parent and subsidiary and may reduce parent willingness to put in more capital in a crisis: this perception could affect investor confidence and/or result in a rating downgrade.
9. The responses gave a number of alternative suggestions made for the proportion of independent directors on a board. These included matching APRA's requirements for subsidiaries of other banks, namely, for a board size up to 7 members, a minimum of 2 independent directors plus an independent chairperson; and for a board size 8 or more, at

least 3 independents plus an independent chairperson. Some responses also indicated that requiring at least half of the board to be independent (rather than a strict majority) would be acceptable.

10. In the light of the arguments put forward why this requirement is excessive for bank subsidiaries, we propose to relax the proposal and require at least half of the board to be independent. As noted above, the chairperson must be one of the independent directors. This requirement will apply equally to all locally-incorporated banks.
11. The draft BS14 said nothing about the number of non-executive directors on the board, since the proposed requirement on independent directors meant that a majority of directors would automatically also be non-executive. As this will no longer be the case, we have added a requirement to the standard conditions of registration in BS14 that a bank's board must have a majority of non-executive directors. We think that this is a key requirement which should be retained in all cases (we note that APRA also requires it for all locally-incorporated banks, including subsidiaries of other banks).

### Residency

12. The proposal in BS14 was that a majority of the bank's independent directors must be ordinarily resident in New Zealand. Views expressed on this were as follows:
  - residency is not relevant to a suitably experienced and qualified director's ability to be independently minded;
  - it is increasingly common for NZ's most skilled and experienced directors to move freely between NZ and Australia (and elsewhere);
  - the requirement further shrinks the pool of available good quality directors; and
  - something closer to APRA's residence requirements would be preferable (for foreign-owned and incorporated regulated institutions, they require at least two directors to be ordinarily resident in Australia, at least one of whom must also be independent).
13. We believe that a local residency requirement does have a role to play in contributing to the Reserve Bank's supervisory objectives. The enforcement of rights and liabilities and other legislation is facilitated in the case of directors who are present in the country. We also do not see that a residency requirement is likely to have a material impact on the owner's ability to exercise control over their investment.
14. Nevertheless, in light of the comments, we propose that the requirement be relaxed slightly, so that at least half of the independent directors on the board must be New Zealand resident. Combined with the reduction in the required number of independent directors, this means for instance that a board with eight directors must contain at least two New Zealand residents. This requirement applies equally to locally-owned banks, although we would not expect it normally to be binding in their case.

Criteria for director independence generally

15. Most respondents broadly agreed with the aim of the test, “to ensure that the director is free from any business or other association that could materially interfere with the exercise of their independent judgement”. However, there were a number of concerns raised about the implications of capturing this in a set of prescriptive criteria (see Appendix 1), particularly in relation to criteria (d), (e) and (f). It was felt that that on the one hand, this could rule out strong candidates who would in practice bring an independent approach to the role, while on the other could give an illusion of independence for other directors who technically pass all the tests.
16. Among other suggestions to move to a principles-based approach, several respondents pointed to the standard condition of registration that requires a bank to obtain confirmation of non-objection from the Reserve Bank before any new director is appointed. They suggested we use this power to assess whether each new director is independent, judged against guidelines on the sort of relationships that might be assumed to compromise independence.
17. The Reserve Bank is concerned that if it adopted a principles-based approach overall, it would need to be much more closely involved every time a director is proposed for appointment. There would be challenges in keeping the approach fair and consistent across banks and over time, and it seems likely that some of our decisions would be open to dispute. We are therefore keeping prescriptive tests for director independence in general, although some of the tests proposed have been dropped (as discussed below). A partial and pragmatic exception is to allow a role for Reserve Bank judgement in deciding independence in the cases of the chairperson of the bank’s board, and directors who also sit on the board of a sister company—see paragraphs 20-22 and 30-32 below.

Criterion (a): control or significant influence

18. There were no general objections to this criterion. Concerns were raised about two special cases where a director would fail this criterion for independence:
  - *Non-operating intermediate holding companies.* Being a director of any holding company would rule out being independent on the bank’s board (and in fact already does so under the current policy), but if the holding company is an inactive intermediate holding company, it was argued that this does not compromise the director’s independence.
  - *Newly registered bank following restructuring.* A potential case was noted where an entity carrying on banking and other business could be restructured, so that its banking activities would be transferred to a newly-registered bank subsidiary of the existing entity. In order to provide continuity, some of the predecessor entity’s independent directors may transfer to the bank’s board. Technically, they would therefore not count as independent for the following three years, having been on the board of a holding company. However, it is argued that this is a special case that the policy was not meant to capture, and that this situation would not rule out such directors being independent.

We accept the arguments on both of these cases and have included exceptions to criterion (a) in section 12 of the final BS14.

Criterion (b): employed by the bank or another group member

19. This was generally accepted, and is retained in the final version of the policy.

Criterion (c): director of another group company apart from subsidiaries

20. This criterion was principally targeted at directors of sister companies of the bank (parent companies are already covered by criterion (a)). The concern here was driven by potential situations in which the sister company in question is a much more significant part of the bank's whole group than the bank itself.

21. However, two banks in responding pointed to existing arrangements within their groups where there are considerable benefits from the bank sharing a number of directors with a sister company, and arguing in both these cases that this does not in itself call into question those directors' independence of action.

22. On the basis of this, we accept that it depends on the specific circumstances of the case whether being a director of a sister company compromises independence. Criterion (c) has therefore been amended, so that a sister directorship rules out independence unless the Reserve Bank has given its non-objection. If a bank wants a director to qualify as independent in such a case, the onus will be on the bank to notify the Reserve Bank of any proposed appointment of a proposed or existing independent director of the bank which would result in their being on the boards of both the bank and a sister company. Classification of the director as a new or continuing independent director will then be subject to the Reserve Bank's non-objection.

Criterion (d): material consultant/adviser

23. A number of concerns were raised about this proposed criterion, although at least one bank agreed that the restriction should apply to bank auditors, and with a reasonable length of stand-down period. Points made by the banks included:

- the bigger banks have links with most of the big legal, accounting and consulting firms, so this criterion would rule out recently retired senior partners of all New Zealand's largest professional services firms, who have been a common source of quality independent directors, given the relevance of their skills and experience;
- New Zealand has a limited pool of suitable potential external directors in the first place, and this criterion shrinks it too far;
- the three year stand-down period will mean that the best candidates will already have been appointed by other companies not subject to this restriction; and
- the criterion is too restrictive in ruling out any principal of a consultant or adviser, regardless of whether they were directly associated with service provided to the bank – this narrows the pool further, and also means that a retired principal of an adviser,

who was never involved with the bank, can be disqualified when their former firm starts to do some advisory work for the bank.

24. There appears to be limited scope to vary the parameters of this criterion while keeping it as a prescriptive test. We think however that, generally, these types of relationship carry a strong enough risk of “capture” by the bank’s executives that this should remain a prescriptive test. But the point about persons not directly associated with the service provided by a consultancy firm seems reasonable so we have taken that on board, as can be seen in the revised wording of criterion 10(1)(d) in BS14.

*Criterion (e): material supplier or customer*

25. Points were made that the CEOs of major corporates (for instance) (who also happen to be customers) provide very valuable expertise on bank boards, and that board conflict-of-interest policies are the right way to deal with concerns, rather than totally ruling out such individuals as independent directors.
26. The nature of the concern in this case appears to us rather more specific than in the case of criterion (d): there would be an obvious conflict of interest on any occasion when the bank’s relationship with the particular customer came up at a Board meeting, but not otherwise. But we accept that in practice such occasions should be easily dealt with by a standard board policy on conflicts of interest.
27. On balance therefore we have dropped this criterion.

*Criterion (f): material contractual relationship*

28. One bank noted that this criterion seems to rule out a director having a banking relationship with the bank. They suggested that it is beneficial for a director to have direct experience of the bank’s services, and that it would depend on the facts of the case whether a banking relationship would undermine a director’s independence. They also pointed to various other checks in place (such as the standard condition of registration that a bank’s exposures to connected persons must not be on more favourable terms than to unconnected persons, and disclosure requirements).
29. We think that these are reasonable points in respect of a banking relationship, and also believe that most other potential contractual relationships are already captured under the other criteria. We have therefore dropped this criterion as a separate test.

*Independent chairperson of the board*

30. There was broad support for the requirement to have an independent chairperson of the board, or a chairperson who is also on the parent bank board but is otherwise independent. One bank’s preference, however, is that this be allowed automatically rather than as a variation to the standard condition of registration.
31. In light of the change proposed to the minimum number of independent directors, we have reframed the requirement on the chairperson so that the chairperson must always be

independent, but at the same time adapting the definition of independence, just in the case of the chairperson, as follows. If the proposed chairperson of the registered bank sits on the parent bank or holding company board, but satisfies all the criteria for independence otherwise, and the Reserve Bank has no objection to the appointment, then he or she shall be considered an independent chairperson of the registered bank.

32. This is reflected in BS14 by there being a new condition of registration that a bank must notify the Reserve Bank of any proposed appointment to the position of chairperson of the bank, and the appointment can only go ahead if the Reserve Bank has given its non-objection. The chairperson must always qualify as independent, but there is an exception noted to criterion (a) of the independence tests to allow for the case where the chairperson sits on a parent company board.

Acting only in the best interests of the bank

33. We currently require that “the bank’s constitution does not include any provision permitting a director, when exercising powers or performing duties as a director, to act other than in what he or she believes is the best interests of the company (i.e. the bank)”.
34. We are not proposing any change to this. This provision applies to all locally incorporated banks. This is considered an important additional safeguard and is one of the arguments made in support of relaxing the proposed requirement on the number of independent directors.

Audit committee requirements

35. There was support all around for the requirement to have a board audit committee, and the requirements on its composition.
36. Some examples were given where there is a committee which carries out the functions of an audit committee and meets the composition requirements, but which is not precisely an Audit Committee of the Board. For instance some banks have a “board risk and audit committee” or a “board risk, audit and compliance committee.” We think that provided there is a committee which includes the normal functions of an audit committee among its responsibilities, and which meets the proposed composition requirement, the objectives of this requirement will be met. The standard condition of registration in BS14 has been adapted accordingly.
37. There was one suggestion that we should require at least one member of the audit committee to have a finance or accounting background and qualifications. We agree that this is a reasonable expectation for an audit committee, but believe that trying to pin it down precisely in a condition of registration would be problematic. We have therefore added it to the guidelines set out in BS14.

Transitional & grandfathering issues

38. There were some comments made that there needs to be a long enough transition period to avoid banks having to make wholesale changes to their boards over a short period, with the

uncertainty that that could give rise to in the market. There were also some suggestions that all existing directors could be grandfathered, for instance continuing to be treated as independent until they retire.

29. We believe that the changes we have now made to the original BS14 proposals following consultation will significantly reduce the number of changes banks will need to make to their current boards. We also think that grandfathering all existing directors would imply too long a transition period. But the banks' concerns are valid, and the objectives for bringing in the new policy changes do not point to the need for urgent changes.
30. We therefore propose that a one year transition period will be included in the new conditions of registration that are imposed on each bank to bring the policy into effect. We are aiming for the date that those new conditions are imposed to be in the first quarter of 2011. This transition period is not reflected in the standard conditions of registration for corporate governance set out in BS14.

*Changes to BS1: Statement of Principles: Bank Registration and Supervision*

31. There were no comments on the proposed changes to BS 1. We have therefore gone ahead with changes to BS1 along the lines proposed, but updated to reflect the final form of BS14.

*Disclosure*

32. There were no comments on the proposed section on disclosure in BS14, which cross-refers to Reserve Bank disclosure requirements. We note here that changes to the disclosure requirements are currently being consulted on, and if they go ahead as planned, minor updates will be needed to keep the description in BS14 up to date.

## Regulatory Impact Assessment

### Executive Summary

1. Existing corporate governance requirements for New Zealand banks are very limited. Additions to supervisory requirements in other areas in recent years (such as the local incorporation policy and the outsourcing policy) have aimed to strengthen the ability of locally-incorporated banks to operate independently in a manner more likely to allow New Zealand financial stability to be protected in a crisis. The corporate governance requirements do not do enough to complement these other initiatives by way of providing additional assurance that locally incorporated banks with sole owners will act independently of their owners where New Zealand financial stability concerns are at stake.
2. The main proposals consulted on in the draft BS14 were thus aimed at strengthening the independence of locally-incorporated banks. These included a prescriptive set of criteria to define an independent director (tighter than the existing definition), a minimum board size of five, and a requirement for a strict majority of the board to be independent.
3. In light of the feedback received, we have relaxed the minimum proportion of independent directors from a strict majority to exactly half, which we believe strikes the best balance between our concern for local subsidiaries to act independently, and a shareholder's legitimately held rights and desire to influence the proper management of its investment and protect its interests.
4. We have also relaxed the proposed new criteria for director independence. These remain largely prescriptive, but in two cases the Reserve Bank will confirm whether a director passes particular tests of independence: first, where the chairperson of the board of the registered bank also sits on a holding company board, and secondly, where a director also sits on the board of a sister company.
5. The draft BS14 consulted on would have required some banks to make significant changes to their current boards. With the changes to the policy we have now made, we estimate that banks will need to make either no changes or only minor changes. Banks will also be given a year to come into compliance with the new conditions in the policy.
6. The new corporate governance policy involves the issuance of a new Banking Supervision Handbook document BS14 *Corporate Governance*, and amendments to the document BS1 *Statement of Principles: Bank Registration and Supervision*. Locally-incorporated banks will be consulted on new sets of conditions of registration to bring the requirements of the policy into effect.

### Adequacy statement

7. The proposals will not have a significant impact on economic growth. This RIA has been prepared by the Reserve Bank and the Bank attests to its adequacy.

## Status quo and problem

8. The Reserve Bank has implemented some key supervisory requirements in recent years designed to strengthen the ability of locally-incorporated banks to operate independently in a manner more likely to enhance NZ financial stability. These include the local incorporation policy, which requires banks to be incorporated in New Zealand if they are systemically important, and the outsourcing policy, which requires in general that the board and management of a bank in New Zealand can maintain its operations if the parent bank is in distress. These policies address risks that are particularly important for the New Zealand financial system, given that locally incorporated subsidiaries of foreign-owned banks operating in New Zealand account for over 80% of the total assets of the banking system.
9. In 2003, the IMF conducted a review of New Zealand under its Financial Sector Assessment Programme (FSAP) and made a number of recommendations around “supervisory enhancements” designed to preserve the financial system’s stability in the medium and longer term. Among the recommendations was to reinforce the role of independent directors in banks.
10. There is no comprehensive set of corporate governance requirements that NZ banks must comply with. On top of the minimal requirements in the Companies Act, the Reserve Bank currently imposes a few requirements related to corporate governance. Some are only considerations at time of registration, some are ongoing conditions of registration (of which some only apply to the large banks), and some are requirements only for disclosure of relevant information. Appendix 2 summarises these requirements. Also relevant for New Zealand banks, but not binding on them, are the Securities Commission’s “Corporate Governance in New Zealand Principles and Guidelines: A Handbook for Directors, Executives and Advisers”, and the Basel Committee on Banking Supervision’s “Principles on Enhancing Corporate Governance”.
11. The Reserve Bank’s supervisory approach is based on three “pillars” – market discipline, regulatory discipline, and self-discipline. Each of the three pillars is meant to promote its financial stability objectives, both individually and by reinforcing one another. The supervisory requirements noted above are examples of steps the Reserve Bank has taken under the regulatory discipline pillar to promote financial stability. Effective corporate governance is the foundation of the self-discipline pillar.
12. The key problem with the status quo is therefore that the very limited existing corporate governance requirements are an area of weakness in the context of the other policy developments noted above. Both of these policies rely to some extent on the board of the locally-incorporated bank being able to act with sufficient independence from the parent.
13. It is worth noting that most corporate governance codes and standards do not explicitly address desirable outcomes for subsidiaries. Codes are generally expected to be applied on a group-wide basis, with the interests of the parent and group as a whole expected to coincide with those of any subsidiary. However, corporate governance arrangements of banking subsidiaries can be a relevant concern for banking supervisors: a corporate sole shareholder with its own active business to pursue may at times have interests that diverge from those of

the bank narrowly considered, and hence from those of the local banking regulator. For this reason, the Basel Committee's guidance recognises the interest that host supervisors have in the separate corporate governance arrangements of foreign bank subsidiaries in their jurisdictions. This parallels the other separate prudential requirements host supervisors typically apply to subsidiaries of overseas banks (such as capital adequacy).

14. The main concern with the existing requirements is thus whether they provide sufficient assurance that the board of a locally-incorporated bank will give sufficient weight to the interests of the bank and, indirectly, to New Zealand financial system stability, when there is a parent bank or other controlling entity.
15. A second concern is that even when a bank's board passes tests for independence of action at least in principle, the qualifications and experience of board members may raise concerns about whether the board can collectively play a proper oversight role of the bank, which can run counter to the bank being run in prudent way in the interests of financial stability. This is particularly important in the area of board oversight of a bank's financial controls and reporting systems. The problem is that the Reserve Bank has limited tools to address a concern of this sort.
16. Another specific concern is that any locally incorporated bank which is fully, unconditionally and irrevocably guaranteed by an overseas parent bank with an AAA credit rating is currently exempt from any requirements relating to corporate governance. It is questionable whether the grounds for unequal treatment between banks on this basis are strong enough to outweigh concerns of competitive equality.
17. It is worth noting that in many cases, banks' actual corporate governance arrangements comfortably exceed the current minimum requirements and give rise to limited or no current concerns. The problem in these cases is that there is no supervisory requirement to lock in the current situation.

## **Objectives**

18. The main objective is to change the minimum prudential requirements relating to corporate governance so as to strengthen board independence, or lock in the existing degree of board independence, of locally-incorporated registered banks.
19. A second objective is to set out expectations around the experience and qualifications of the board, in such a way as to allow the Reserve Bank to require changes in a bank's board if those expectations are not met.
20. A third objective is to apply the policy on a consistent basis across all locally-incorporated banks, only differentiating between them where the difference justifies a different corporate governance outcome.
21. A subsidiary objective is to impose requirements on registered banks' corporate governance only where directly relevant to the Reserve Bank's supervisory objectives. Although good corporate governance as a whole is desirable for ensuring that banks are prudently run, the aim is to supplement, rather than duplicate, codes that are already available to banks such as

the Basel principles and the Securities Commission's principles and guidelines referred to above.

## **Options**

### *Status quo*

22. The first option is to maintain the status quo. This entails relying on the existing limited corporate governance requirements imposed by the Reserve Bank and other relevant legislation as summarised in Appendix 2, and also on banks voluntarily applying the guidance such as that issued by the NZ Securities Commission and the Basel Committee.
23. In the area that is of key concern, namely sufficient independence of decision-making by the board to protect the interests of New Zealand financial stability, particularly in a crisis, existing requirements appear weak. When an entity initially applies to be registered as a bank, the Reserve Bank is able to take into account some factors relevant to board independence, for instance, whether the composition of the board is such that it does not give rise to concerns about the bank's ability to pursue its own interests when these conflict with those of the shareholders. The Reserve Bank thus applies its judgement and can reject an application if it decides that this test is not met. But the continuing requirements on board composition after registration are very limited: both the definition of independence and the required proportion of independent directors are weak by comparison with common international standards.
24. It is also worth noting that the existing requirement on the chairperson is that they be non-executive, rather than independent. This would not for instance rule out a senior executive of an overseas parent bank being the chairperson of a New Zealand registered bank.
25. As noted in the submissions received on the proposed policy, general company law background provides some underpinning for independence of decision-making by registered bank boards. The Companies Act imposes certain duties on directors to act in the best interests of the company, and this is reinforced by the standard condition of registration imposed by the Reserve Bank that prohibits a bank's constitution from allowing a director to act other than in the best interest of the company.
26. But as discussed above, for a bank that is a wholly-owned subsidiary, particularly with an overseas parent bank, there are stronger concerns than there are for the generality of companies about the degree to which the subsidiary's board will act independently of the parent when the interests of the subsidiary diverge from those of the parent.

### *Principles-based approach:*

27. One alternative to the status quo would be to strengthen the corporate governance policy using a purely principles-based approach. A principles-based or evaluative approach specifies certain outcomes or expectations based on a set of guidance, and then the bank's board makes a determination that they comply with those standards, and the Reserve Bank might then additionally take a view on whether the bank met the principles in some or all aspects of the guidance.

28. An evaluative approach is open to interpretation. Banks would have to disclose the extent of their compliance or non-compliance with standards. In addition, banks can also disclose how the principles are being complied with. The onus is on depositors or investors to gauge for themselves whether the bank adheres to the governance principles based on their disclosures. This may pose certain difficulties for the ordinary depositor particularly if there are complex and opaque group/organisational structures and business models.
29. If the supervisor plays a validating role, there are challenges in ensuring that banks are achieving roughly equal outcomes by different routes, and there is the risk of the supervisor being drawn into frequent disputes about whether general criteria have been met.
30. A principles-based approach is nevertheless common for corporate governance codes in general, and is particularly suited for “softer” attributes such as overall board quality and experience. The policy consulted on included guidelines on such areas as the experience and qualifications of board members, and the processes for reviewing board performance and selecting new members. The Reserve Bank would not (for instance) have an obligation to pass judgement on such matters every time a new director is appointed, but would be able to take them into account if particular concerns arose, in deciding whether there were grounds to take formal supervisory action against the bank.

#### *Prescriptive approach*

31. Another broad alternative is to adopt a prescriptive or rules-based approach, which would entail setting minimum standards that can either apply equally to all banks, or could vary across categories of bank. A prescriptive approach can be particularly suited to aspects of corporate governance which allow clear-cut tests, such as those around board composition (board size, number of independents and so on). In other areas which are important for corporate governance, such as the personal qualities, experience and appropriate qualifications of board members, it is less realistic to expect that precise specifications can pin down exactly how to achieve the desired outcome.
32. The policy consulted on was prescriptive in setting out the minimum board size, minimum proportion of independent directors, minimum proportion of NZ-resident directors, and the requirement to have an audit committee and its composition. The policy also set out a set of six prescriptive tests for director independence (see Appendix 1). It was also proposed that the chairperson must normally be independent, but could be non-independent to the extent of sitting on the parent bank board policy, subject to a more principles-based consideration by the Reserve Bank.
33. The proposed policy also included a prescriptive requirement for there be a separate board audit committee, with minimum requirements on its composition to ensure as far as possible its independence.

#### **Preferred option**

34. The preferred option is broadly similar to the proposal consulted on, but amended in some areas in light of consultation.

35. The final policy retains a number of prescriptive requirements. These cover the minimum board size, the minimum proportion of independent directors, non-executive directors, and New Zealand resident directors, and the requirement for the chairperson to be independent. However, in light of comments received in the consultation, the required proportion of independent directors has been reduced from a strict majority of the board to exactly half of the board, and the required proportion of New Zealand residents has been reduced from a strict majority of those independent directors to exactly half of them. We believe this strikes the best balance between our concern for local subsidiaries to act independently, and a shareholder's legitimately held rights and desire to influence the proper management of its investment and protect its interests.
36. We have also retained some prescriptive minimum requirements in the test for director independence, but in light of a number of concerns raised in the feedback, we have relaxed the requirements somewhat from those proposed. Of the six criteria listed in Appendix 1, we have retained as prescriptive tests criterion (a) (but with two specific exceptions), criterion (b), and criterion (d) (adapted to make it slightly easier to meet). We think that, generally, these types of relationship carry a strong enough presumption of "capture" by the bank's owners or executives that they should be covered by the definition, and they take the form of prescriptive tests, given the problems noted above in relying on the bank's own judgement or requiring the Reserve Bank to come to a view in every such case.
37. We have dropped criteria (e) and (f), as we think that it is a more proportionate response to rely on a bank board's conflict-of-interest policy to deal with situations arising under these headings that may undermine director independence.
38. We have introduced an element of judgmental override by the Reserve Bank in two aspects of the independence test. First, the Reserve Bank may deem that the chairperson qualifies as independent despite being on the board of a parent bank, provided it is satisfied that the circumstances give a good indication that the chairperson's independence is not undermined as a result. Secondly, where a director is also on the board of one or more sister companies of the bank (covered by the proposed criterion (c)), the Reserve Bank retains the right to rule out that director as independent: in our view, sister directorships will not generally compromise the director's independence, but could seriously do so in certain circumstances.
39. So overall, we have retained a test of independence which tightens up the current status quo by setting prescriptive tests in the areas that what we regard as the most important. It adds to this a more evaluative approach in two areas which we also regard as important, but where it is more problematic to specify exactly when the independence objective may be undermined.
40. The preferred option includes the audit committee requirements as consulted on, except that a bank board can meet this requirement if it has a committee with a broader remit, provided that it does include audit matters within its scope and meets the composition requirements. This is a new requirement compared to the status quo. Banks generally meet these requirements so it is a low burden requirement to add on, and we think it is important to lock in where banks currently are, as the matters covered by an audit committee are particularly important from a prudential supervisor's point of view.

41. Finally, the final policy includes guidelines, largely as consulted on, on such areas as the experience and qualifications of board members, and the processes for reviewing board performance and selecting new members. This is also a low burden addition to the status quo, but does give the Reserve Bank a more specific ability to take action such as requiring changes to a bank's board if there were clear concerns about its overall quality.
42. Under the preferred option, there are a number of aspects of corporate governance that the policy does not refer to. We believe it is preferable for the policy to focus only on corporate governance requirements that are most relevant to the Reserve Bank's supervisory objectives. The policy document does however refer to the two sources of comprehensive guidance that are most applicable for New Zealand banks, namely those published by the Securities Commission and the Basel Committee (referred to above).
43. We believe that the additional cost imposed by the new policy is not significant. Concerns were raised in the consultation that the tighter definition of independence and the requirement for a strict majority of independent directors would necessitate considerable changes to existing boards, and also make it harder to find the replacement directors needed. We think that the changes we have made to the proposed policy to address these concerns will mean that banks will now need to make only limited changes.
44. We received comments about the need to have a long enough transition period to avoid banks having to make wholesale changes to their boards over a short period, with the uncertainty that could give rise to in the market. The changes to the proposals following consultation have reduced the number of such changes needed. Nevertheless, we propose a transition path of up to one year following the date on which new conditions of registration are imposed to bring the policy into effect.

### **Final policy**

45. The Banking Supervision Handbook document BS1 *Statement of Principles: Bank Registration and Supervision* contains the current corporate governance requirements. These are being replaced by a new stand-alone Handbook document BS14 *Corporate Governance* which is published at the same time as this document. Consequential amendments have also been made to BS1.
46. The policy that is expressed in terms of guidelines in BS14 has immediate effect. To bring the other policy changes into effect requires amendments to banks' Conditions of Registration (CoR). The Reserve Bank will be consulting the banks on proposed changes to their CoRs with a view to finalising the changes by 31 March 2011. As noted, it is intended that the new conditions on corporate governance will include a one-year transition period.

**Appendix 1: criteria for independence in draft BS14 as consulted on**

A director of a registered bank is *independent* except in the case that the director:

- a. controls or has significant influence over the registered bank, or is an officer of an entity that controls or has significant influence over the registered bank, or met either of the foregoing conditions at any point during the three years immediately before their current appointment to the board;
- b. is employed, or has previously been employed, in an executive capacity by the registered bank or another group member, and there has not been a period of at least three years between ceasing such employment and serving on the board;
- c. is a director or has previously been a director of a group member, other than the registered bank or a subsidiary of the registered bank, and there has not been a period of at least three years between ceasing such directorship and serving on the board;
- d. has within the last three years been a principal of a material professional adviser or a material consultant to the registered bank or another group member, or an employee materially associated with the service provided;
- e. is a material supplier or customer of the registered bank or other group member, or is an officer of a material supplier or customer; or
- f. has a material contractual relationship with the registered bank or another group member, other than as a director of the registered bank.

## **Appendix 2**

Current RBNZ corporate governance requirements for New Zealand banks

BS 1: Statement of Principles:

(The following are included in matters that the Reserve Bank considers in determining whether an applicant for registration has the ability to carry on business in a prudent manner.)

- There will need to be sufficient separation between the board of a bank and its owners to ensure that the board does not have an unfettered ability to act in the interests of the owners where those interests diverge from those of the bank.
- A locally incorporated bank has its own board of directors and those directors are required under the Companies Act to act in the best interests of the company, to prevent the company from carrying on business in a manner likely to create a substantial risk of serious loss to the company's creditors and to ensure that the company does not incur an obligation unless they believe that the company will be able to perform the obligation when required to do so.
- That the proposed bank has in place policies to monitor and limit exposures to related parties.
- That the composition of the board is such that it does not give rise to concerns about the bank's ability to pursue its own interests when these conflict with those of the shareholders.

Standard Conditions of Registration for all locally-incorporated banks

- At least two directors must be independent.
- Chairperson must not be an employee of the bank.
- That the company does not have a constitution permitting a director, when exercising powers or performing duties as a director, to act other than in what he believes is the best interest of the bank.

Conditions of Registration for Large Banks (Outsourcing policy)

- That the business and affairs of the applicant are managed by, or under the direction or supervision of, the board.
- That the employment contract of the CEO or equivalent position is with the applicant and the terms and conditions of the CEO's employment agreement are determined by, and any decisions relating to the employment or termination of employment of the CEO are made by, the board of the applicant; and
- That all staff employed by the applicant have their remuneration determined by (or under the delegated authority of) the board or the CEO of the applicant and are accountable (directly or indirectly) to the CEO of the applicant.

## Reserve Bank Act

- The Act defines a NZ chief executive officer as the most senior officer of the bank who is ordinarily resident in NZ, or, subject to the written agreement of the Reserve Bank, another person nominated by the bank.

## Disclosure requirements

- For each director, whether the director is executive and/or independent, the director's technical and professional qualifications, country of residence, and any transactions giving rise to potential conflicts of interest
- A statement whether there is an audit committee, and if so, its total size, and how many independent directors, and how many other directors, it contains.