Promoting strong corporate governance in New Zealand banks

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The Reserve Bank of New Zealand has responsibility for registering and supervising banks in New Zealand. We do this for the purpose of promoting a sound and efficient financial system and for avoiding significant damage to the financial system that could result from the failure of a bank, as required by the Reserve Bank of New Zealand Act 1989.

The Bank's approach to banking supervision rests on three main pillars:

- A "self discipline" pillar, whereby we encourage sound corporate governance and risk management practices in banks.
- A "market discipline" pillar, whereby we seek to reinforce the incentives for depositors and other creditors of banks, and the market generally, to exercise scrutiny of banks and reinforce bank self discipline.
- A "regulatory discipline" pillar, whereby we apply some prudential requirements on banks, such as minimum capital ratio requirements and limits on lending to related parties, to further encourage sound risk management. We also monitor banks on a continuous basis, meet with the senior management of banks annually, and have extensive powers to deal with bank distress or failure events.

We have been reviewing each of these pillars in the last year or so, taking into account international and national developments in banking, and changes to the structure of the New Zealand banking system. In this context, we are reviewing the self discipline pillar, by looking at whether corporate governance arrangements in banks continue to be sufficient to ensure a strong level of risk management. We want to ensure that corporate governance arrangements are effective — not just for the benefit of shareholders, but also for the benefit of bank depositors and other creditors, and for the ultimate benefit of the New Zealand banking system. This recognises the fundamental role that governance plays in a bank — and in any organisation for that matter. Sound governance provides the foundation for everything else, including maintaining systems and controls for identifying, monitoring, and managing business risks effectively. Conversely, poor corporate governance tends to undermine any other efforts to promote a strong risk management culture in a company, including a bank.

The Reserve Bank has a number of policies that seek to promote sound corporate governance and risk management in banks:

- All banks incorporated in New Zealand must have a non-executive chairman and at least two non-executive and independent directors, who must be unconnected with any parent company.
- Although the responsibility for assessing the suitability of a senior manager or director of a bank rests with each bank and its shareholders, the appointments are subject to the Reserve Bank's approval. The Bank's approval is based on a "negative assurance" test, whereby we check with other regulators and other sources to ensure that the appointee does not have a criminal record or any other attributes that would be of concern.
- All banks are required to publish quarterly financial and risk-related disclosures, including information on each bank's and banking group's capital position, concentration of credit exposures to individual counterparties, related party exposures, asset quality, provisioning, and market risks. Banks must also maintain and disclose a credit rating. These disclosures are intended to strengthen the incentives for the prudent management of risks, and assist depositors, among others, to make well-informed banking decisions.
- Each disclosure statement is required to include attestations, signed by a bank's directors, stating whether or not the bank has adequate systems in place to monitor and control risks, and whether those systems are being properly applied at all times. The directors are also required to attest that prudential requirements are being complied with and that exposures to related

parties (such as a parent bank) are not contrary to the interests of the local bank.

- Each bank director is required to sign their bank's disclosure statement and to certify that disclosures made are not false or misleading. If a disclosure statement is found to be false or misleading, directors are subject to potentially severe legal penalties, including substantial fines and imprisonment. In addition, directors may face unlimited personal liability for creditors' losses where creditors relied on a bank's disclosure statement that was false or misleading.

Taken together, these policies go a long way in reinforcing existing incentives for banks to maintain strong corporate governance practices. However, in view of the importance we attach to corporate governance as the foundation for sound risk management in banks, we are currently reviewing aspects of bank governance arrangements, with a view to assessing the scope for further improvements. That review is taking into account the wide range of corporate governance developments that have occurred in recent years, both in New Zealand and around the world. It also takes into account the particular characteristics of the New Zealand banking system, especially the fact that all banks in New Zealand are wholly-owned subsidiaries of other entities (mostly banks) or branches of foreign banks, and all but two banks are foreign-owned. These are important factors in shaping the dynamics of bank management and have important implications for bank governance structures. In particular, the nature of bank ownership has a significant effect on the roles of directors and senior management of banks in New Zealand; on the nature of potential conflicts between the interests of the parent banks and the interests of the banks in New Zealand; and the capacity of local banks to maintain core operations on a stand-alone basis if the parent bank fails or otherwise becomes dysfunctional.

With these factors in mind, the kinds of issues the Reserve Bank is taking into account in its review of bank corporate governance include:

- The role of a board of directors of a bank that is wholly owned by another bank. This includes the extent to which the local board places reliance on the parent bank in satisfying itself on the local bank's systems and controls, the interaction between the local board and parent board, and the extent to which local senior management is accountable to the local board.
- The role of independent directors, the acceptable minimum number of independent directors on a bank board, and what an acceptable level of independence should be. Consideration is also being given to the role of independent directors in reviewing the dealings between a bank subsidiary and its parent, and in assessing the bank subsidiary's capacity to operate on a stand-alone basis.
- The role of board committees, especially audit committees and risk management committees, and whether these should be mandatory.
- The nature of disclosures made by banks of their corporate governance arrangements, including the functions and composition of board committees, the means by which boards have assessed the performance of management, and the means by which boards have satisfied themselves as to the adequacy of their banks' risk management systems.
- The scope of director attestations in bank disclosure statements, including whether attestations should be widened to include reference to outsourcing arrangements and some other specific risk areas.
- Whether the CEO of each bank should be required to make attestations in respect of their bank's risk management systems and related matters.
- The independence of bank auditors, including whether additional requirements might be appropriate to ensure an adequate degree of auditor independence.
- Whether it might be appropriate for the Reserve Bank to provide high-level guidance to bank directors, setting out our expectations of their role in overseeing their banks.
- The nature of the Reserve Bank's interactions with bank directors and auditors.

At this stage, these are just issues that the Reserve Bank is reflecting on. We have not yet reached any decisions on these matters. The Reserve Bank plans to release a Discussion Paper later this year to banks and other interested parties, setting out the Bank's preliminary thinking in these areas and seeking reactions to possible proposals for changes to corporate governance requirements for banks in New Zealand.

The 'bottom line' in all this, from the Reserve Bank's perspective, is that we want to be absolutely satisfied that bank boards in New Zealand have unambiguous authority and capacity to ensure that their banks are being managed prudently in the interests of the New Zealand banking system. We want to be satisfied that the boards of banks in New Zealand are clearly in the driver's seat of their bank, within the constraints of being part of a wider banking group. We want the boards to ensure that their banks are able to maintain core business functions if the parent bank or other outsource functionality provider were to fail. And we want the boards to be fully accountable for their responsibilities.