PRELIMINARY

BANKING REGULATION AND FOREIGN-OWNED BANKS

BY

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The American novelist F. Scott Fitzgerald started one of his books by noting that the rich "are different" and there is a widespread perception that banks are also different from other firms and that bank failures are different from the failure of other firms, particularly for large, systemic banks. There would probably be far fewer in the audience tonight if this lecture had been on grocery stores or steel mills. Banks have long been treated differently with respect to public policy. In the United States, banks need to obtain special charters from the states and may be chartered by the federal government, which is not available to most other firms. In New Zealand, banks must be "registered" with the Reserve Bank to use the word "bank" in their name. Bank failures are widely perceived to be more damaging to the customers of the affected banks, both depositors and borrowers, than the failure of like – sized other firms and more likely to spill over to other banks through knock-on, cascade, or domino effects, the payments system, the financial system as a whole, and even beyond to the macroeconomy.

But beyond the direct damage, bank failures are widely perceived to be more frightening than the failure of other firms. "Horror" books and movies based on bank failures are not uncommon, while few such books or movies are based on the failure of grocery stores or steel mills. Bank failures are perceived more frightening for a number of reasons:

- **Banks deal in intangibles, which makes it more difficult for many to understand their operations than, say, grocery stores or steel mills, and causes banks to be shrouded in mystery and uncertainty,**

- **Almost everyone has contact with banks in their daily life as either or both a depositor and/or borrower,**

- **Bank deposits make up a large percentage of the national money supply,**

- **Bank deposits frequently represent the owners' principal and most liquid assets,**

- **Banks operate the payments system,**

- **Bank assets can move very quickly,**

- **Bank assets are very large in the economy,**

- **Banks operate internationally, and,**

- **Banks operate in highly sophisticated and complex markets, such as derivatives markets, which are very large and very volatile.**

Breakdowns in these areas are highly disruptive. Whether or not the great public fear of bank failures is rational or justified, it exists and perception is often as important as reality and requires recognition in the formulation of public policy.

Researchers at the World Bank have identified nearly 120 systemic bank crises in 93 countries since the mid – 1970's and another 50 or so near-crises in 45 countries. Thus, more than one-half of all countries in nearly all parts of the world have experienced serious banking crises in recent memory. Many of the countries that did not suffer such crises are emerging economies that do not have a functioning banking system. The costs of these crises have been high. Bank crises are often associated with recessions in the macroeconomy, although they are more frequently the result rather than the cause of the economic downturn. Nevertheless, bank failures exacerbate economic downtowns. A survey by the International Monetary Fund that examined 54 banking crises between 1975 and 1997 reported that GDP during the crises averaged nearly 12 percent below trend output and that it took these countries, on average, three years to recover.

In addition, almost all countries did not impose the cost of bank failures only on the creditors and shareholders of the banks - - the parties that would normally bear the cost of other business firm failures - - but partially or totally protected these parties, particularly the banks' depositors, against loss. Instead, the loss was shifted to the taxpayers and, because insolvent banks were frequently permitted to operate for long periods of time after they became insolvent and increase their losses further, in many cases, these transfer costs were very high. As a percent of

GDP, transfer costs from depositors to taxpayers were estimated to be greater than 50 percent in Argentina in the early 1980's (Argentina has suffered three banking crises since the 1970's) and between 30 and 50 percent in Thailand, South Korea, Chile, and Uruguay, among others. Resolution of the New Zealand bank insolvencies of the late 1980's is estimated to have cost about 2 percent of GDP, about the same as the U.S. savings and loan failures of the 1980's and one-half of the Australian failures of the same period.

A large share of the high social cost of bank failures arises from poor and inefficient means of resolving insolvent banks. The resolutions are frequently delayed until long after the banks become insolvent and, as noted earlier, the costs are not fully imposed on the banks' creditors or owners. Good public policy demands that these costs can and should be reduced and largely removed from the shoulders of taxpayers.

In this paper, I propose a general four point or step program for efficient and low short-term and long-term cost resolution of large insolvent banks. I note both short-term and long-term costs because many of the poor resolution practices have resulted from attempts to keep immediate costs low without great concern for later costs. The program proposed is based on my analysis of actual bank resolutions throughout history, but particularly in the United States, as well as economic and finance theory. The program is general, but can and should be tweaked and tailored to the institutional particulars of different countries and I will make some comments on how near the end of the paper. One of these particulars is the importance of foreign owned banks, where New Zealand ranks number one in the world with some 99 percent of its bank assets in foreign owned banks. My analysis is based heavily on U.S experience, not only because I am most familiar with it, but because the U.S has many banks – some 8,000 currently and near 30,000 in the 1920's, - has good historical data on these banks dating back to the Civil War of the 1860's and even before, and effectively has had no state owned banks, which muddy up the waters. Unfortunately, with respect to New Zealand, foreign bank ownership in the U.S is relatively unimportant, accounting for only 5 percent of total bank assets.

I offer this program as much to stimulate thought and discussion as anything else. The program centres on:

1. **Prompt legal "closure" of insolvent banks according to an explicit "closure rule,"**

2. **Prompt estimates of recovery values and corresponding losses or "haircuts" to be imposed on the banks' depositors and other creditors,**

3. **Prompt reopening of the bank under government agency control with full guaranty of existing deposits at the haircutted or protected amounts, and**

4. **Prompt reprivatisation through recapitalisation at adequate capital levels or liquidation.**

Let me expand on these principles. To achieve them, requires a number of things.

Prompt legal closure implies terminating the interests of existing shareholders, who knowingly assumed both the returns and risks associated with ownership. One should not privatise profits and socialise losses. At the same time, senior management should generally be changed. The rules for legal closure should be thoughtfully designed to maximise efficiency and minimise losses and be publicly disclosed fully, so that all players know the rules of the game. Evidence ranging from organisational management to child rearing clearly indicates that players play both better and more predictable in a world of certainty than in a world of uncertainty. In the U.S., we have recently introduced clearly specified rules for prompt corrective action (PCA) by regulators on financially troubled banks, including a clear legal closure rule when a bank's equity declines to 2 percent of its assets and instructions to regulators to resolve the bank at least long-run cost to the insurance fund. (The U.S. has limited explicit deposit insurance.)

Regulators in the U.S also have authority to resolve banks for cause before this minimum closure requirement is hit. So that the closure rule is not breached without sufficient warning and to attempt to prevent a troubled bank from deteriorating further down to the closure trigger, PCA imposes a number of other

triggers, generally calibrated in terms of capital ratios, at which time the regulators first may and then must impose sanctions to increase the cost of poor performance to the banks. The sanctions are modelled after those that the market imposes on troubled firms in nonregulated industries, such as reductions in dividends, restriction on acquisitions and growth, a recapitalisation plan, and changes in senior management. That is, the regulatory environment is made to mimic a market environment

Prompt estimates of recovery values and depositor loss-sharing haircuts require current and accurate information on a troubled bank before its insolvency. This likely requires some on-site examination of these institutions to verify the accuracy of the publicly reported information and to obtain interim information. It is well known that, as a bank approaches insolvency, its reported books approach fiction more than fact. Current and accurate information is also required by the regulators, if they are to market the bank quickly upon declaration of insolvency.

The magnitude of depositor haircuts depends, among other things, both on the promptness of legal closure and on public policy. The quicker a bank is resolved upon declining to the specified closure-rule trigger, the smaller are the losses and therefore also the depositor haircuts likely to be. If a bank or any other firm is resolved before its true capital (net worth) position turns negative, the only loss is to its shareholders. Depositors and other creditors are fully protected. In addition, as noted, the longer an insolvent firm is not legally closed and permitted to continue to operate, the more likely is it to continue to generate operating losses and to increase its risk exposure in the process of "gambling for resurrection."

Public policy may at times wish to partially or fully protect two groups of depositors against loss:

1. **Small depositors, primarily for political reasons. They are likely to lobby the government for protection loudly and in large numbers. But it also may be economically efficient to provide them with a low cost riskless depository and to avoid the relatively high cost of having them collect and process information to monitor and discipline banks in order to protect their reasonably small accounts. Lastly, small depositors are the only ones who**

can operate on currency and thus able to run on the banking system as a whole, exchanging deposits for currency and, in the absence of central bank intervention, decreasing the money supply by a larger amount as described in basic money and banking textbooks.

2. **Large depositors, if there is a serious threat to financial stability by imposing full pro rata losses on them. This is the so-called "too big to fail" or TBTF policy. But TBTF is often abused at very high societal cost. In addition, in the U.S., TBTF really never meant what it said. With effectively only 1 ½ exceptions among a reasonably large number, all big insolvent banks were failed legally and placed in receivership. Shareholders' interests were terminated. TBTF actually referred to protection for de-jure uninsured depositors and other creditors. (In the U.S. the first $100,000 of deposits is explicitly insured by the FDIC, a government agency). De-facto protection of de-jure uninsured depositors at some large banks in the 1980s eventually became so costly that it threatened to bankrupt the FDIC and was perceived to be so unfairly applied across banks that it became politically unpopular. In addition, it became evident that protecting these depositors removed an important source of discipline on the banks and increased the likelihood of future losses. Nor is there sound evidence that imposing losses on large depositors necessarily leads to losses elsewhere or widespread financial instability. In response, reform legislation enacted in 1991, known as the FDIC Improvement Act or FDICIA, prohibited the FDIC from protecting uninsured depositors and creditors in bank resolution. But there was an exception. The FDIC could protect these claimants if not protecting them threatened aggregate financial instability and protecting them would mitigate this threat. TBTF was transformed into the systemic risk exemption or SRE.**

But invoking SRE is not easy. Five high barriers - three ex-ante and two ex-post - must be cleared and a paper trail created and maintained. The ex-ante barriers are:

1. **A recommendation to the Secretary of the Treasury to invoke SRE approved in writing by two-thirds of the board of directors of the FDIC and two-thirds of the Board of Governors of the Federal Reserve System,**
2. **Approval by the Secretary of the Treasury in writing after consultation with the President of the U.S., and**
3. **Written notification of approval by the Secretary to the Chairs of the House and Senate Banking Committees.**

If approved and invoked, two ex-post barriers exist that are likely to affect the decision whether to invoke SRE:

1. **An audit must be conducted by the congressional General Accounting Office (GAO) of the reasons for invoking SRE and the effectiveness of the actions taken, and**
2. **Any resulting loss to the FDIC from protecting uninsured claimants must be paid expeditiously by a special assessment on all other banks.**

These are high barriers to hurdle and combined with the paper trail is likely to encourage accountability and discourage hasty, unthoughtful action. To date, SRE has not been invoked in the U.S. But there has not been a fair test. No really large, money center bank has encountered serious financial difficulties. Nevertheless, uninsured depositors at all other failed banks have shared in any losses with the FDIC.

To make this program effective in minimising the short-and long-term societal cost of resolving insolvent large banks, the plan must be fully developed, in place on the shelf for immediate use, and fully and widely disclosed to the public. If it is not, political pressures at the moment of crisis will overcome any ability of policy-makers to stand back and develop a program. As a result, all or nearly all potentially damaged parties are likely to be protected. Federal Reserve Chairman Alan Greenspan has recently noted this in testifying before the U.S. Congress on resolving large U.S government sponsored entities such as Fannie Mae and Freddie Mac, which are privately owned mortgage lenders with past government ownership and retained close association with the government in the eyes of many investors. Greenspan testified that it was important to:

> **…clarify the circumstances under which [the GSEs]… can become insolvent…. This process must be clear before it is needed; otherwise the hands of any regulator would be constrained by uncertainties… Left unresolved, such uncertainties would only heighten the prospect that a crisis would result in explicit guaranteeing.**

It is important that banks of any substantial size are not physically closed for any extended length of time after they are legally closed. Among other things, physical closure implies that borrowers cannot extend maturing loans and depositors do not have full and immediate access to even the haircutted value of their accounts. The deposits are effectively frozen, frequently until proceeds are obtained from the sale or liquidation of the bank, which could be a lengthy process. Demand or current accounts are involuntarily transformed into time accounts. Fear of account freezing in bank failures is often as great in many countries as fear of reduced value of accounts due to credit losses. To keep banks open and operating during the reprivatisation process, the regulators need to arrange for advancing the expected proceeds from the pending reprivatisation to the depositors. In the U.S., the FDIC has the legal authority to advance dividends to uninsured depositors almost immediately based on a conservative estimate of the pro-rata recovery value. Insured depositors are also advanced funds, so that they have access to the par value of their accounts the next business day or so.

If the plan is widely and fully known, bankers and the public will modify their behaviour and regulators can act with greater confidence. The "tougher" and clearer the insolvency rules, the greater also will be market discipline on misbehaving bank management by bank shareholders.

Let me now turn to a few remarks on how the institutional arrangements in New Zealand affect or are affected by this program. First, to deposit insurance. New Zealand prides itself on not having an explicit deposit programme and thus not being required to protect any depositor or other claimant at insolvent banks. But there is a long distance between not being required to provide deposit insurance and not effectively providing deposit insurance. The Reserve Bank Act provides the Bank with the authority to act as a lender of last resort if it "considers it necessary for the purpose of maintaining the soundness of the financial system".

Although the purpose of any intervention may not be to protect depositors, this language is sufficiently vague to permit such an interpretation. In 2000, then Deputy Prime Minister, Jim Anderton stated "It's inconceivable that banks can be allowed to fail with all the repercussions that would go through the whole community." [1] **And in recent memory, the government has protected some depositors at insolvent institutions. Despite an immediate rebuttal by the Reserve Bank Deputy Governor that "Depositors and other creditors of banks should operate on the presumption that, if a bank were to fail the government would not insulate them from losses," such statements from Government officials serve to fuel doubts.** [2]

The Reserve Bank's website also notes that while "the RBNZ would generally recommend against any form of taxpayer – funded rescue…. the ultimate decision…. would be made by the government of the day." This strengthens the government statement and significantly weakens any no deposit insurance claim. Indeed, recent surveys suggest that a substantial percentage of the New Zealand population believes that depositors would be protected in bank failures. If so, the regulators' credibility is at stake and, in the area of prudential regulation, credibility is the most important weapon that regulators have. Unless a significant percentage of depositors truly perceive themselves at risk, emphasis on public disclosure is less effective. Disclosure is a necessary but not sufficient condition for market discipline to be effective. If few if any depositors or other bank creditors perceive themselves at risk, information disclosed is less likely to be processed and used to discipline banks. So what do I recommend?

As much as I favour not protecting large depositors, I favour explicit deposit insurance for small depositors in the form of full insurance for the first x dollars of deposits. [3] **From a practical point of view, it is difficult to avoid such protection at the time of resolution. By reducing pressure from small depositors, it is easier to leave large depositors, who both can monitor their banks efficiency and are accustomed to taking risks in their short-term investments such as commercial**

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[1] "For the record," Reserve Bank of New Zealand Bulletin, September 2000, Vol. 63, No.3, p.69

[2] ibid

paper, unprotected. Thus, on net, pressure on banks to restrain moral hazard behaviour is not necessarily reduced. Studies by the World Bank show that the costs of bank failures are lower in industrial countries that have both explicit deposit insurance and strong and credible institutions, property rights, legal systems, and regulatory independence. [4] New Zealand clearly has the latter group of characteristics. How the insurance is to be provided and who pays for it needs to be determined, but considerable evidence exists evaluating alternative structures.

To enhance credibility for keeping uninsured deposits uninsured, I would recommend imposing explicit high barriers for invoking exemptions, such as for SRE in the U.S. Of course, they need to be tailored to the institutional structure of New Zealand, but may involve written signoffs by the Reserve Bank, Minister of Finance, and Prime Minister that protecting uninsured depositors is necessary to maintain financial stability. This arrangement should be viewed as part of the package of providing explicit insurance for small depositors. Both need to be adopted together. Who pays the cost of any assistance that is provided to uninsured depositors should also be clearly specified. Should it be the other banks or taxpayers? I would prefer the other banks, as this is likely to create additional pressure not to provide the assistance. To further minimise the pressure on the government to provide support, Professor John Singleton of Victoria University has proposed having the government delegate the authority for resolution to the Reserve Bank for a specified length of time similar to the delegation it now does to the Reserve Bank on inflation targeting.

I would also recommend that New Zealand add both a simple capital leverage ratio to the Basel-type risk-based capital measure requirements that it now imposes on banks and a fuller version of the PCA that includes a number of explicit triggers for intervention by the Reserve Bank on a progressively harsher and more mandatory basis. While the market evaluates a bank's risk exposure in determining the appropriate amount of capital required, the Basel measures assume that the regulator determined weights are the same as the market

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[3] Alternatively this can be achieved by imposing haircuts only after the first x $ of deposits. This idea was proposed to me in discussions at the Reserve Bank.

[4] The analysis may not have included observations for countries that had no explicit insurance but favourable institutions. I am indebted to Ian Harrison at the Bank for this observation.

determined weights. Evidence suggests they are not and encourages game playing by the banks to reduce their risk-weighted assets. The leverage ratio minimises such gaming and puts banks on the same basis as all other firms for comparison. For example, most other firms worldwide average capital to total asset ratios of nearly 50 percent, implying leverage ratios of 2 to 3, rather than non-risk adjusted capital ratios of 6 to 8 percent with leverage ratios of 12 to 16 that better capitalised banks in developed economies maintain. By encouraging earlier regulatory intervention, multiple action triggers would both improve the probability of regulators being able to turn troubled banks around before failure and reduce the probability of delayed or weak action by the regulators.

Although some of my suggestions would increase regulation and supervision and appear to run contrary to both my preferences and the well-known preferences of the New Zealand Reserve Bank and government for self and market discipline rather than intrusive regulation and supervision, I do not believe that they would be unduly intrusive on well-operated banks. It would only be when a bank stops being well-operated and becomes troubled that the intrusiveness factor kicks in. Indeed, this is a carrot and stick structure that may be viewed as reinforcing the incentives for banks to avoid getting themselves into such unfortunate positions and would basically formalise the informal monitoring and consultation that occurs now. If I had the time, I would also discuss a plan to enhance market discipline by requiring banks to issue subordinated debt, a proposal that is receiving attention in some countries. But that is for another day.

Lastly, I will briefly comment on some unique issues raised by the high degree of foreign ownership of banks in New Zealand. As I noted earlier, some 99 percent of registered banks assets are foreign owned and 85 percent are in the largest five banks all owned by Australian banks. (The next largest percent foreign ownership is in Botswana with 97 percent followed by Luxembourg with 95 percent). Much has recently been written about the benefits of foreign bank entry, but less about the costs and almost all with respect to emerging rather than developed economies. The two primary areas of concern are economic efficiency and safety. I will touch only on the safety issues. There is little doubt that foreign bank entry enhances competition and efficiency, holding other things equal, in both developed and developing countries, and New Zealand appears to have so benefited from the

entry of major foreign banks. But the safety issue is more complex, particularly with respect to the resolution of insolvencies.

It is obvious that the legal and regulatory structures of the foreign bank's home country as well as those of the host country matter. At minimum, this increases complexity, as it requires knowledge of foreign institutional structures by host countries and the more foreign countries represented, the more complex. But is also likely to be more difficult than this as the legal and regulatory structures may conflict. The banks are then subject to two masters! A major issue is the form of organisation of the foreign facility – branch or subsidiary. Here safety and efficiency may conflict and tradeoffs between the two exist. A branch is likely to be somewhat more efficient and lower cost for the banking organisation, as it is not a separate legal entity and is firmly operated on a fully consolidated and integrated basis. Its financial health is dependent on the health of the home office and thus likely on the state of the economy in the home country. Although branches may be safer than either a sub or independent bank of equal size, as its share of assets in the home bank is likely to be more diversified, they are more difficult for the host regulators to monitor and discipline. Host country regulators are thus likely to rely heavily on the home countries' regulators for monitoring and disciplining. A subsidiary is, at least in theory, separate from its parent and stands on its own feet with its own capital. It is subject to the same capital standards and the same insolvency resolution process as the host regulator applies to domestic banks. Its financial health should reflect primarily the health of the host country.

Foreign branches introduce another problem for the host country, if the home country has depositor preference legislation that gives priority to deposits at domestic over foreign offices of failed banks. Such legislation is in effect both in the U.S and, more importantly for New Zealand, in Australia. To depositors in these home countries, deposits in branches in foreign countries provide an additional layer of protection above a bank's capital. Moreover, home regulators may be incentised to resolve home banks more slowly as any additional losses would be borne first by depositors in other countries. To protect against this, the Reserve Bank is exploring whether domestic deposits at large branches of foreign banks could be matched or effectively collateralized by domestic assets. Currently, New Zealand depositors at branches of Australian and U.S. banks in New Zealand

appear to assume greater risk than depositors at these banks in home offices and should receive a corresponding higher interest rate.

On the other hand, it may be argued that regulators in some home countries may support their insolvent large, systemic banks through liquidity or other assistance so that the host depositors are protected via spillover. But one may wonder whether the home country's taxpayers may not be even more reluctant to bailout depositors in foreign countries than in their own. Likewise, it is sometimes argued that parent holding companies in home countries are likely to recapitalise their sick subs in other countries in order to avoid reputational damage. However, this likely would involve a careful weighing by the holding company of the costs of such recapitalisation versus the potential reputational harm of walking away from the sub. This is likely to be done on a case-by-case basis rather than by a general, once-and-for-all rule.

A sub may also be somewhat weaker than it appears. Although fund transfers to the parent are restricted, once done, it might be difficult to reclaim the assets from another country and legal jurisdiction even though they were transferred illegally, say, in anticipation of insolvency. In addition, any financial difficulties experienced by the parent bank may have adverse reputational spillover to the sub. Adverse reputational spillover effects may be more important for subs in relatively small countries as large, third country suppliers of funds may view the country too minor to expend significant resources on differentiating between the foreign parent and the domestic sub and even among domestic subs of different parents.

Perhaps most important is the issue of functionality for either a sub or branch. Most banking organisations, whether they involve branch or holding company subsidiaries, are managed on a centralised and integrated basis. Major decision-makers, technical personnel, records and computer and telecommunications facilities are physically located at the home office or tightly under the control of the home office. From the point of view of the sub, these services are effectively "outsourced". Thus, without access to these facilities, it may not be easy for the regulators to continue to operate a solvent sub office of an insolvent foreign parent as a stand alone facility or to resolve an insolvent sub and either maintain it in operation or liquidate it, as discussed earlier. A branch would be even more

difficult to operate. I suspect no country is more aware of these problems than is New Zealand. Although no easy solution is evident, agreements to house some facilities that are nowadays required for redundancy purposes anyway in the host country or where host regulators have immediate and guaranteed legal access appear doable and appropriate.

I would also wonder whether having 85 percent of bank assets in banks owned by banks in only one other country that is considerably larger may not open the host country both to excessive potential spill-over effects from problems in that country and excessive political leverage that could impinge on the host country's regulatory independence and induce it to defer to the home country regulators more than otherwise. At the same time, the host country is tempted to rely even more on the competency of that country's regulators to maintain the financial health of the banking organisations headquartered there.

It is obvious that I have only scratched the surface of these last issues. In part, this reflects the fact that I come from a country in which these issues are not as pressing and thus not as much analysed. The issues are complex and require greater quantification. Greater certainty regarding the rules of the game would benefit all participants over the long run - - bankers, regulators, and the taxpayers. I plan to examine these issues more carefully in my remaining stay here. I am happy to note that they have received and are continuing to receive serious attention at the Reserve Bank. The Bank, for example, is in the process of developing a strategy for resolving bank insolvencies that it refers to as "bank creditor recapitalisation" or BCR that includes many of the features that I spelled out in my four point programme above. The Bank is also involved in exploring ways of improving its ability to resolve foreign branch insolvencies as well as subs and to obtain the necessary functionality facilities. I hope that my thoughts expressed here will be of help to the Bank in perfecting these strategies. Some of the ideas may require some rethinking of long-held views, but my reading in the few weeks that I have been here is that New Zealand does not shy away from bold ideas or measures.