

# BANKING SUPERVISION - DEFINING THE PUBLIC SECTOR ROLE

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The Reserve Bank of New Zealand has been reviewing the role it plays in supervising registered banks. The review was initiated because it is now five years since the Bank assumed formal responsibility for the role and considered timely to review policies and practice in the light of experience. Such reviews are a normal part of the Bank's approach to its functions. As part of the review, which is still continuing, the Bank participated in a seminar on banking supervision, held in Wellington in August and organised by the Institute of Policy Studies. Representatives of banks, accountancy and legal firms, economists and academics attended the seminar. The following was one of the papers delivered at the seminar. In this paper, Dr Brash explains the rationale for a public sector interest in banking, and the options [this raises] for public sector involvement.

On behalf of the Bank, I would like to thank you for setting time aside to participate in this seminar. For our part, we are aware that there is considerable interest in the way we have been developing our banking supervision policies, and we welcome this opportunity to discuss some of the issues.

Also, as most of you are no doubt aware, a number of us at the Bank have this year been reviewing our role in banking supervision. I would like to bring you up to date with where that review has so far brought us.

Before doing that, however, I would like to put the subject in its recent historical context.

Up until the early 1980s, most financial institutions were regulated under a variety of regulatory policies, directed at monetary policy and safety and soundness objectives, often simultaneously and rarely coherently.

Most of you will still recall the various reserve asset and public sector security investment ratios which were applied to trading banks, savings banks, finance companies and building societies. The Trustee and the Post Office savings banks were closely supervised by the Reserve Bank and the Treasury respectively, and dealers in foreign exchange were supervised by the Reserve Bank.

The trading banks, while not subject to much direct 'supervision', enjoyed a relatively protected position. They were free from competition from new entrants, and relatively insulated from economic disturbances, to the extent that industry, and thus their customer base, was protected and subsidised.

Between 1984 and 1987, most of these arrangements were dismantled, to be replaced in 1987 with a formal framework of supervision. This was intended to be a light-handed regime, based mainly on qualitative considerations, rather than financial or prudential standards.

The regime was modified in the Reserve Bank Act of 1989 to facilitate adoption of supervision policies along the lines of those being developed by the Basle Committee on Banking and Supervision.

Given that it is now five years since the framework was first adopted, it seems timely to review our policies and practices in the light of our experience, and consider whether there is anything we can do to improve on current practice.

## Some Fundamentals

Before examining issues of banking supervision it is important to understand the nature of banks: what are banks and what do they do?

Banks are in the business of taking deposits and providing credit. To do that they must process information. Put very simply, firms and households approach banks for debt funding to supplement their existing equity in order to finance intended projects. Banks analyse information concerning the projects and the financial soundness of the borrower, and decide whether the lending risk is acceptable, relative to the return they receive.

Much of this information must remain confidential so that a firm's competitors do not receive commercially valuable information, and in the case of household borrowers, personal privacy is protected.

Provided the bank decides that the risk is acceptable, it provides credit to the applicant. This credit can take a variety of forms, including provision of revolving credit lines for working capital, or loan guarantees and acceptance lines.

Provision of working capital represents one aspect of a liquidity role for banks. Firms and individuals can thereby acquire temporary loan finance as required to finance immediate purchase needs without delay.

Another aspect of a bank's liquidity role is the liquidity of their deposit liabilities. A substantial proportion of most banks' liabilities are repayable or transferable on demand, which enables depositors to mobilise their funds immediately for expenditure.

A large proportion of deposits in banks are of this liquid form, while many loans have a longer maturity. Thus banks play an important maturity transformation role, funding their operations predominantly through short-term deposits and providing longer-term loans.

Banks also provide many other financial services to their customers, such as derivatives for risk management purposes, insurance services and funds management services. However, they are generally not unique in performing these roles.

One aspect of banking business which should, however, be highlighted is the role of banks in the payments system. Bank customers can efficiently make payments by having their bank transfer deposit balances to the account of the person to whom they are making payment. This is facilitated by complex interbank networks for sending and confirming payments instructions.

Clearly many of these roles are vitally important to the functioning of the economy. A modern economy could not operate without the provision of bank loans and without an effective payments system. Policy-makers will therefore wish to be satisfied that the banking system is operating soundly and efficiently.

Nevertheless, the strategic importance of this sector does not necessarily mean that public policy intervention is warranted.

Policy interventions can be justified only if they are likely to improve the soundness and efficiency of the system compared with a situation where there is no policy intrusion.

What aspects should we look at in ascertaining whether this is likely to be the case? A number of issues arise here.

The very nature of a bank's loan activities, which involves the analysis of confidential client-specific information, creates problems for depositors in monitoring a bank's soundness by directly monitoring its loan assets.

A depositor does not, and cannot, have access to a considerable amount of relevant information in this regard. Also, a depositor cannot have unrestricted access to information about the bank, for example, information about its intended money market trading strategies, since this would compromise the bank's competitive position.

There are a number of ways of reacting to this problem, as exhibited by different industries. The reactions can range from a pure market solution to the setting of mandatory standards with associated public sector supervision.

For instance, car owners regularly take their car to the garage to have it serviced.

The Government does not supervise the work garages do in this regard, even though many of us do not know much about what goes on under the bonnet.

In this, and many other, markets where information is incomplete or even one-sided in favour of the merchant, the maxim is 'caveat emptor' and there is seen to be no role for public policy. Instead, what we see is private agents making their own assessments of the competence of competing service stations - largely on the basis of previous experience, what they pick up from the experience of others, and the garage's reputation.

At the other end of the spectrum are a number of health and safety standards. For instance, the Government sets standards for food hygiene, work-place safety and lifts. It also monitors compliance with these standards. Presumably this approach is regarded as an efficient response where agents cannot individually assess the safety of the undertakings, except perhaps at significant cost.

In other cases, the Government may set standards but private sector monitors may be used. The granting of motor vehicle warrants of fitness is an example.

Thus the existence of an information problem does not automatically call for public sector intervention. But it is also not clear that private sector solutions are necessarily best.

Individual industry circumstances and, in particular, the nature of the information problem will be important in determining the appropriate regime.

One important consideration will be the degree to which individual reputations can be an effective information indicator. For instance, in the banking world, a reputation for sound and efficient management is invaluable to a bank in attracting deposits. The greater is its reputation, the greater is its incentive to act prudently in order to maintain its reputation, and so continue to be able to attract deposits on favourable terms.

Having said that, where depositors place heavy reliance on a bank's reputation, and undertake little monitoring, the scope for banks to engage in imprudent risk-taking is correspondingly greater.

## Systematic Aspects

What I have discussed so far has focused on the micro-foundations of the banking industry. But there is another dimension - the systemic picture.

An issue that arises here, in large part because of imperfect depositor information, is the risk of contagious bank runs.

If one bank becomes insolvent, depositors in other banks, who may be poorly informed of their own bank's true situation, and aware that their deposits are unsecured, may choose to withdraw their deposits.

They may choose to hold their funds in cash or with another bank, at least until the state of their bank's soundness is verified. This process is exacerbated by banks' maturity transformation role and hence their role as a haven for liquid deposits.

Where a contagious run takes the form of a flight to cash, there is a sensible public sector reaction to this potential problem. The run to cash represents an increase in the demand for base money and the central bank can, and should, respond by increasing the provision of base money in these circumstances. This is the classic lender of last resort role of a central bank, in which the central bank increases cash to the banking system in response to a crisis demand.

This role should not be confused with providing liquidity to, or statements of support for, an individual institution, for example, where there is a loss of confidence in one bank and deposits are re-deposited with other banks.

Failure of a significant bank (or a combination of smaller banks) may also have real economy effects. One problem is the resultant freezing of transaction balances.

Similar problems arise from withdrawal of credit lines to many firms and individuals.

The latter issue is again information related. A firm and a bank may have expended considerable resources in establishing the bank-customer relationship.

Having done so, the firm is able to obtain credit facilities from the bank to finance its business. If the bank fails and, as is the convention, all deposits are unsecured, then under current insolvency law the bank proceeds to liquidation.

This means that firms with undrawn credit lines and in need of access to working capital will be unable to obtain the agreed credit. Time and resources must be spent to establish a relationship with another bank, which may well be cautious about providing credit to customers from a failed bank.

This is a case where public policy can be effective in providing bankruptcy arrangements - or 'failure management' - for banks, which are suited to the nature of the banking industry.

Such a system should enable control of the failed bank to pass to its creditors (in practice an agent acting for its creditors) and should provide for flexibility in dealing with the affairs of the failed bank.

For example, there may need to be scope for the bank to allow draw-downs under approved credit facilities where this helps to protect the value of existing loan assets.

The failure of a bank may also have a disruptive effect on the payments system. Our current payments system, like those in many other countries, may not cope well with a bank failure. This matter is now receiving close policy attention in many countries, including New Zealand.

## Policy Issues

Many of the information problems that I have discussed may be exacerbated if depositors fail to heed the government's often repeated statements that it does not stand behind deposits in banks.

The fact that depositors cannot monitor banks closely does not mean that they should not monitor them at all. If they engage in too little monitoring then the incentives for banks to behave prudently will be weakened.

Ideally the solution to this problem is to convince depositors that the government means what it says in this respect. But this may be difficult when experience shows some governments acting otherwise. For instance, it may be difficult to explain to depositors that some authorities provide depositor protection as an explicit aim of their banking supervision regime, where there is no such explicit aim in New Zealand.

The optimal public policy response to this dilemma is not clear. One option is to require disclosure of information, so that people have a better chance to monitor their bank's soundness.

Generally, transparency also heightens the incentive for banks to act prudently, because of the greater likelihood that imprudent actions will be noticed. This is a role for a mandated disclosure regime. The details of such a regime could involve release of key financial and prudential data and/or compulsory credit ratings for banks.

Another option, where depositor monitoring is insufficient, is to promote greater shareholder monitoring. This can be achieved by requiring shareholders to have a material stake in a bank.

This is the role played by a regime of minimum capital ratios.

Also, to the extent that minimum capital ratios decrease the probability of bank failure by providing a buffer to absorb losses, they decrease the probability of costs associated with such failures, such as those arising from potential contagion effects, payments system problems and the withdrawal of credit lines. Thus, minimum capital ratios may well be a valid response also to these types of problems.

In order to make these capital ratios meaningful, it is likely that some recognition of different categories and levels of risk is needed. The ratios are also more meaningful if the risks of a bank are reasonably well spread.

For this reason limits on large credit and position exposures (relative to capital), or at least disclosure of large exposures, would be an important adjunct to such a regime. Credit exposures to related parties, for example, the bank's shareholders, warrant particular attention.

If standards are to be imposed on banks in this manner, some form of mandated third-party oversight is required. Possibilities here include monitoring by auditors, credit rating agencies and trustee companies within the private sector, or by a public sector supervision agency, such as the Reserve Bank, or a combination of these.

The best configuration of monitoring arrangements is likely to be one which takes account of the different incentives, capacities and responsibilities of the alternative candidates.

Within both private and public sector options, the degree of oversight can vary significantly. For instance, within the private sector options, the nature and degree of monitoring may well differ as between auditors and credit rating agencies. Also so far as public sector monitoring is concerned, a choice can be made between more or less intensive arrangements.

Having taken into account all of these various issues, what conclusions have we reached? Within the Reserve Bank we are agreed that the issues regarding information, the payments system, the potential withdrawal of credit lines, the freezing of transaction balances, and contagion, lead to a role for public policy intervention in the banking system.

Whatever the details of that intervention, there is an underlying principle that primary responsibility for prudent management of the bank rests with shareholders, directors and management themselves.

Beyond that, we are agreed that there should be a *registration* regime which informs potential depositors and borrowers that a 'registered bank' meets certain soundness criteria.

As one of these soundness criteria, the desirability of mandating a *minimum capital ratio* is accepted.

We consider that a *disclosure* regime should be mandated for banks.

We are agreed that there should be a particular focus on *large exposures* and *credit exposures to related parties*.

The corollary to a registration process is the need to have a capacity to enforce maintenance of the registration standards, or failing that, to initiate *deregistration*. In turn, this calls for compliance with standards to be monitored.

We are therefore convinced that some form of *third-party oversight* of banks is needed.

We see a need for a regime, such as the current statutory management arrangement, to *manage a bank failure*.

Our agreed framework also includes an explicit commitment on the part of the Reserve Bank to provide *liquidity to the system* - secured against appropriate security or assets. This would be in the event of a flight to cash.

Public sector policy-makers must also take into account important considerations in the *payments system*, in particular how to minimise the disruption that would be caused by a bank failure. These issues are currently being addressed by the Bankers' Association and the Reserve Bank and more will emerge from this work in due course.

We believe that a policy framework based on these broad principles should be capable of delivering a sound banking system, without reducing its efficiency through overly intense regulation.

However, some of the more specific aspects of the regime, and an assessment of the costs and benefits of alternative techniques, are still being considered. In particular, the respective roles of potential third-party monitors is an important issue: how much monitoring should be carried out in the public sector and how much should be left to the private sector; in the latter case, which private sector monitor or monitors? For instance, should the role of banks' auditors be formally extended to include provision of a "true and fair" audit opinion on compliance with prudential standards?

Details of various proposed regimes are also important. For instance, with a deregistration process: does experience indicate that under discretionary arrangements regulators exhibit too much forbearance so that automatic sanctions would be preferable? Are automatic sanctions feasible?

Should credit ratings be made compulsory, and/or should banks be required to publish most or all of the prudential information they currently and routinely provide to the Reserve Bank? Would such disclosure reduce the need for public sector monitoring?

Would disclosure of information on individual credit exposures above a certain threshold be a practical and acceptable alternative to maximum exposure limits?

These details, and the broader principles, are topics on which we welcome contributions and debate today. I look forward to your input.

