THE DFC FAILURE - LESSONS FOR BANKING SUPERVISION

This speech was delivered to the South Pacific Regional Convention of Internal Auditors on 5 March 1991 by Dr Donald T. Brash, Governor of the Reserve Bank of New Zealand.

I am pleased to have the opportunity to speak to you today. My pleasure is all the greater given that this convention celebrates the 50th anniversary of the establishment of the Institute of Internal Auditors.

I have no doubt that the last fifty years have seen enormous changes in the internal auditing profession. I suspect many of these changes have taken place in the last five or six years. In New Zealand, this has been a period of rapid change throughout the economy, and particularly in the financial sector. These changes have certainly had an influence on banking supervision; and I don't doubt that the internal auditing profession has also been significantly affected.

With these changes in mind I would like to talk about the failure of what was one of New Zealand's significant financial institutions, DFC, and the lessons the Reserve Bank, as the supervisor of banks, has learned. These lessons relate both to the causes of DFC's failure, and to our handling of that failure. I believe that the DFC story has lessons not only for the banking supervisor, but also for the senior management of banks and for internal auditors.

At the time of its collapse in October 1989, DFC was New Zealand's seventh largest financial institution in terms of assets. In March 1989, its assets stood at approximately NZ$2,900 million. DFC was a key player in the local foreign exchange market, and indeed, a leader in the development of the swap and option markets in New Zealand.

DFC was established in 1964 as a development bank jointly owned by private banks, the Reserve Bank and the Government. Created to assist the development of New Zealand industry, particularly export sectors, DFC became fully Government owned in 1973 and, for a period, enjoyed the benefit of a government guarantee. This guarantee was removed with respect to all debt issued after 1977.

DFC adopted a more aggressively commercial approach to its lending from the mid 1980s. In part, this reflected the changed policy environment and the encouragement of state-owned enterprises to perform in accordance with commercial criteria. As part of the Labour Government's privatisation programme, DFC was sold in 1988. National Provident Fund bought 80 per cent while Salomon Brothers of New York bought 20 per cent.

Severe deterioration in asset prices during the late 1980s caused DFC to review its loan book in August and September 1989. As a result of this review, it became evident that

DFC needed to make heavy provisioning against loan losses. The board of DFC advised me on 2 October 1989 that DFC was technically insolvent, and had limited liquidity. Following discussion with NPF and the Government, it became clear that neither of DFC's shareholders nor the Government were prepared to support DFC. Accordingly, in the absence of support from shareholders or from other sources, the directors took the view that it was not prudent for DFC to continue to trade.

After considering all the options, the Reserve Bank decided to appoint two statutory managers, drawn from a large chartered accounting firm. At the end of their term in April 1990, Mr Sandy Maier, former Chief Executive of Citibank's New Zealand operations, took over as statutory manager.

Statutory management allows the Reserve Bank to take action over the acute distress or failure of a supervised institution. A statutory manager has all the powers of the board of directors and shareholders of the institution in question. These wide management powers are constrained only by the need to comply with the Reserve Bank Act and with directions from the Reserve Bank. Of course, the actions of a statutory manager are subject to review by the Courts, as are the actions of the Reserve Bank itself.

A statutory manager would only be appointed in order to maintain the soundness and stability of the financial system. Reflecting this, the Reserve Bank Act effectively requires a statutory manager to put the interests of the financial system before the interests of creditors. While this can have the effect of disadvantaging creditors, there is generally significant overlap between the interests of creditors and the interests of the financial system. This was certainly the case with DFC.

We wanted to resolve the DFC situation in a timely but orderly manner, demonstrating to DFC's creditors that the situation was being handled responsibly. This was especially important as around 90 per cent of DFC's debt was held by major overseas banks and other institutions. The reputation of New Zealand and its financial system was very much at stake. Resolving the DFC situation was a complicated and, at times, tortuous process.

One of the first decisions facing the statutory managers and the Bank was how to handle DFC's voluminous off-balance sheet business. Most of this was in the form of swaps, which amounted to \$3.9 billion in notional principal value. We decided that DFC should continue to meet its obligations on these contracts. Had DFC defaulted on its off-balance sheet contracts, particularly the swaps, this could have disrupted the foreign exchange market. Furthermore it would have foregone large mark- to-market assets on its swap book. While this would have advantaged some swap counterparties, it would have been to the detriment of most of DFC's creditors.

Despite initial settlement difficulties, the decision to continue to meet DFC's obligations on its swaps and other off- balance sheet contracts proved correct. Losses of up to \$180 million were avoided and most of the swap book was sold to another bank. I have no doubt the successful sale of the swaps was a critical factor towards winning the confidence of overseas creditors in the statutory management process.

While tackling the off-balance sheet problems, we also needed to assess the size of the deficit in DFC's balance sheet. Assessment of loan losses required a comprehensive review of DFC's loan book which stood at more than $2 billion. That review was conducted by both the statutory managers and J P Morgan, the New York based bank brought in as advisers to the statutory managers. In the event, it transpired that the total provisioning required over the March 1990 year was more than $900 million, representing about 45 per cent of DFC's loan book as at March 1990.

It quickly became apparent that the DFC situation could best be solved through negotiated settlement involving DFC's shareholders and the Government. The objective was to reduce the gap between what DFC owed to its creditors and what its assets were worth. In March 1990 this gap amounted to more than $800 million. For the deal to be acceptable to DFC's creditors, the gap had to be closed quite considerably. Yet for various reasons, DFC's shareholders, and the Government as the former shareholder, were not willing to close that gap completely.

For commercial and prudential reasons, NPF's board considered it was inappropriate for NPF to inject further capital into DFC. The Government too,considered that for both policy and commercial reasons, it was inappropriate for the taxpayer to rescue DFC. In particular, the Government was concerned that a full bail-out could have undermined the Government's policy requiring state-owned enterprises to function in a strictly commercial environment, without the benefit of a government guarantee.

Finding an acceptable solution was therefore quite a balancing act.

After several months of negotiations, a deal was struck. The main elements were:

- an injection of funds from NPF, Salomon and the Government;

- the offer of new debt to DFC's creditors. It will provide a strong degree of certainty that, not later than 1997, senior creditors will recover 100 per cent of their debt. Subordinated creditors will recover 100 per cent of their debt by 2005. In addition, some interest, albeit at concessional rates, will be paid on the senior debt;

- in order to structure the debt in this way, the Government issued zero coupon instruments to securitise some of the new debt. In addition, the Government wrote swaps to enable some of the new debt to be denominated and serviced in foreign currency;

- as a condition of accepting the new debt, creditors had to agree to waive any claims against DFC, its shareholders, the Government and others.

The deal proved an outstanding success. It was sent to creditors in October 1990 and by December, creditors holding more than 99 per cent of DFC's debt had agreed to the proposal.

In the end, I believe the DFC situation was resolved satisfactorily. Creditors appear generally satisfied with the result; damage to New Zealand's financial reputation has been reduced to the extent possible; and we have avoided bitter and protracted litigation. Overall, I believe the outcome vindicates the use of statutory management.

The Reserve Bank has learned a great deal from handling the DFC failure. Although DFC was not a registered bank, it was nonetheless the first institutional failure the Reserve Bank had handled, and we therefore had to scale a very steep learning curve. While the outcome was successful, I have to say the curve was slippery in places, and I am the first to acknowledge that we did not do everything as quickly or as well as we might have.

The DFC experience taught us how crucial it is to be prepared for a crisis. While we hope we will never have another failure of a supervised institution, we need to be prepared to handle one. We are therefore currently reviewing our experience with DFC and as a result of that review we will update and improve our procedures for handling a financial distress or failure situation.

Among other matters, the DFC review will stress the need for a structured decision making process; the need for pre-developed strategies for handling particular crisis situations; and the ability to obtain the right resources for the job at very short notice. The DFC experience has confirmed the importance of differentiating clearly between the roles of the respective participants in a statutory management, and of setting clear objectives for each. It has also confirmed the need to incorporate, in a clear and methodical way, the financial system "soundness" considerations into the decision-making process.

The DFC experience has also demonstrated the importance of communication. In particular, there is need to make clear as early as possible what statutory management means, what it involves and what its objectives are. Creditors must be kept well briefed on developments and on future direction.

If there is ever a "next time", I am confident we will be better placed to handle it.

Although it is very important for the Reserve Bank to be able to effectively manage the failure of a bank, it is clearly preferable to reduce the risk of such a failure. That is the main purpose of banking supervision. No supervision regime can entirely prevent bank failure, but it can reduce the risk of failure to a very low level. The Reserve Bank's supervision does this in a number of ways.

We regularly and closely monitor the financial condition of each bank. We regularly consult with the banks and jointly discuss their future strategies, risk management systems, and other matters of prudential relevance. An increasingly important aspect of supervision is implementation of minimum prudential standards and guidelines. Perhaps the most well known is that banks hold a minimum level of capital in relation to risk adjusted exposures. Banks are currently required to have qualifying capital representing not less than 7.25 per cent of risk adjusted exposures. By the end of 1992 this minimum requirement moves to 8.0 per cent.

We are also in the process of introducing a number of other prudential standards and guidelines. These measures will improve the soundness of banks by reducing the impact and extent of particular risks, and by encouraging banks to manage their risks in a prudent way.

Looking back, it seems clear that the DFC's collapse was attributable to a complex web of causes, many aspects of which relate to its origins as a development bank, to the controls to which it was subject and to the DFC's development over time. Aside from these, there are a number of more general factors which help to explain its failure. Each relates to risk management, and I think they reveal some useful lessons for banks in general.

- DFC had large sectoral exposures, mainly to horticulture, tourism and, more recently, to commercial property. In part, this reflected its historical role as a development bank. Compared with other institutions, DFC had a very large proportion of its balance sheet tied up in these three sectors. Since much of the security underlying the tourism exposures was commercial property, effective exposure to commercial property was very high indeed. It was largely because of these high sectoral exposures that DFC fell victim to the substantial fall in asset prices that occurred in the late 1980s.

- DFC also had a number of very large single and grouped counterparty exposures.

- In many cases, the quality of DFC's assets was low, being inadequately secured, and ranking in a subordinated position.

- In a number of respects, DFC's credit assessment procedures were unsatisfactory.

- Too little attention was paid to the status of loans. In some cases, non-performing loans were restructured, with interest being zero rated or capitalised. This tended to understate the true loan arrears situation. It also meant that some loans were not given the attention they should have received, delaying corrective action.

- The discovery of the extent of DFC's problems was also hindered by the tendency for the loan reviews to be conducted by the persons responsible for the lending. In some cases, reviews were not conducted as rigorously or frequently as they should have been.

- Until 1988, DFC's management information system was deficient, impeding the board's and senior management's ability to manage DFC's affairs.

There are obvious lessons here for the banking supervisor, other banks, and the internal auditing profession. The DFC experience clearly demonstrates the need for an institution to have sound risk management systems and internal control procedures.

I believe that in any financial institution there should generally be an adequate level of high quality capital suitable to the riskiness of the institution's balance sheet and off-balance sheet exposures. The <u>minimum</u> capital requirements laid down by the Reserve Bank should not necessarily be regarded as adequate. These minimum requirements are the <u>minimum</u> level acceptable. A higher level of capital is clearly desirable for banks with a narrowly diversified asset portfolio, with a high concentration of large exposures, and with other features which raise its implicit riskiness.

Institutions should also have:

- reliable, comprehensive and timely management information systems;
- well developed guidelines for the assessment of a lending proposition;
- clear delegations of lending authority;
- a clearly prescribed set of objectives and responsibilities for each position within the institution;
- prudent lending proposal assessment procedures. Recommendations for lending proposals should be subject to an appropriate degree of scrutiny;
- a separation between lending and loan review;
- a system of regular loan review, with the intensity and frequency depending on the size and quality of the exposure;
- prudently set internal policies on maximum counterparty exposures, and on sectoral exposures;
- sound knowledge of the sector to which a loan is made;
- a comprehensive training programme for lending and loan review analysts;
- clear, concise reports to senior management and directors, focusing on the economic substance and risk dimensions of a proposal;
- a regular assessment that internal control procedures are being adhered to and that the procedures are adequate. This clearly suggests the need for an internal audit function.

The task of the banking supervisor is to ensure minimum prudential standards are adhered to. That is why we have minimum levels for risk adjusted capital. And it is why we will shortly introduce limits on the maximum level of exposure a bank can have to a single or grouped counterparty. Some time ago we signalled our intention to introduce large exposure constraints, and last year we released discussion papers to banks for their consideration. I am pleased that there has been a trend recently for the number of very large exposures reported by banks to decline.

It is increasingly clear that we also need to specify guidelines for risk management systems and internal controls. Appropriate risk management measures will hopefully reduce the chance that banks might make inappropriate lending decisions, and should generally promote a more prudent management of banks. We will also consider the adequacy of existing audit requirements in respect of prudential information provided to the Bank.

More broadly, we will need to assess the merit of augmenting the rigour and scope of the audit of banks' asset quality and risk management systems. We feel it desirable, both for the soundness of the financial system and for depositors, if greater reliance could be placed on the audit of a bank's business.

Given that the directors of a bank must take ultimate responsibility for sound management, we seek to bring greater focus on their role.

The DFC experience has also demonstrated the importance of an appropriate ownership structure for banks. From a supervisor's perspective, we place emphasis on a shareholder who is likely and able to provide support to a bank when needed; who will display ongoing commitment to the bank; and who is well equipped to carefully monitor the management of the bank. We have had particular regard to these factors when considering applications for bank registration. The DFC experience confirms the wisdom of this approach.

Banking supervision can only go so far. It can put in place minimum standards and hopefully reduce the risk of bank distress or failure. I am confident the policies we are putting in place will achieve that objective. However, it is the responsibility of directors and management of a bank to ensure that their bank's prudential policies not only comply with the minimum requirements, but are adequate in all respects. The public needs to understand that the ultimate responsibility for sound running of a bank rests with directors and management.

So it is perhaps fitting that I end by stressing the importance which the internal auditing profession plays in the sound management of a bank. An independent, well resourced internal audit function is a most important part of any bank, integral to the adoption and maintenance of sound internal controls, risk management systems and management information systems. As a supervisor of banks, the Reserve Bank places importance on a strong internal audit presence in each bank. As a result of the DFC experience, we will be placing greater emphasis on the importance of your role.

I wish your profession well for the future. I am sure the next 50 years will prove to be as eventful as the last.