BANKING SUPERVISION POLICY IN NEW ZEALAND

An article by Bruce White explains how banks are supervised in New Zealand. This follows an article in the Bulletin Vol 53 No.4 1990 on why banks are supervised.

SCOPE OF BANKING SUPERVISION

Banking supervision policy in New Zealand is directed at promoting a sound and efficient financial system and at avoiding significant damage to the financial system which could result from the failure of a registered bank.

While supervision of registered banks by the Reserve Bank is only one of a number of elements of an overall policy framework directed at achieving this objective, it is a particularly important part. This reflects the key role that banks play in the economy, in terms of their overall share of borrowing and lending activity, and their pivotal role as providers of liquidity and as providers of the major means of payment.

The bank registration and supervision provisions in the Reserve Bank Act 1989 allow for quite a broad range of financial institutions to come within the ambit of the Reserve Bank’s supervision. Any financial institution whose business substantially comprises the borrowing and lending of money, or the provision of other financial services, can apply to be registered as a registered bank. While, strictly speaking, no financial institution is required by law to be registered as a registered bank, all the major ‘monetary’ institutions in the New Zealand financial system are. That is, all the major deposit taking institutions, including all members of the cheque payments system, are registered banks and, in consequence, are subject to Reserve Bank supervision.

Why should banks want to choose voluntarily to be registered and supervised? There are several reasons. First, they generally wish to be able to carry on business under a bank title. In New Zealand only registered banks can include the word ‘bank’ in their name.

Secondly, banks which wish to carry on business internationally generally find that they need to be supervised by a banking supervisor. In most countries the banking authorities are generally reluctant to allow entry for foreign banks if they are not supervised at ‘home’. Additionally, some authorities discourage or prohibit banks under their jurisdiction from establishing in other countries without being supervised by the authorities in those countries. Thus, international banks generally find that there is a need to be supervised, both at home and abroad.

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1 Registered banks, as at March 1991, accounted for 92 per cent of the liabilities of the institutions covered by the Reserve Bank’s broad monetary aggregate (M3) survey.
Thirdly, non-bank institutions have little if any access to the finely priced ‘interbank’ funds market. Institutions with significant short term funding requirements and without access to this market can be placed at a competitive disadvantage.

Finally, maintenance of a supervisory relationship with the Reserve Bank provides a better basis for enabling the Reserve Bank to assist in resolving the sorts of problems which institutions can encounter in an industry which is crucially dependent on the maintenance of confidence. Even though the fundamental principle is always that prudent management is the first and major line of defence against a loss of confidence, and there are limitations on the nature and extent of the role that the Reserve Bank can play, this is another consideration which explains why major deposit taking financial institutions see a need to be supervised.

Taken together, the above considerations represent quite strong incentives for financial institutions to become registered banks, and this has been borne out by experience to date under the Reserve Bank Act 1989.

At the same time, the framework provided in the Reserve Bank Act does not create major regulatory barriers to entry to the ‘banking’ sector. Rather, it leaves open the possibility of different sorts of financial institution, with different emphases in the business they conduct, becoming registered banks. This reflects a desire to allow banks, and the financial system more generally, to continue to evolve in a way which primarily reflects commercial and customer needs rather than regulatory requirements and barriers. A supervisory framework which provides scope for this sort of evolution is considered more likely to contribute to the long run soundness and efficiency of the financial system.

**THE ELEMENTS OF BANKING SUPERVISION**

Key elements in most banking supervision regimes are:

- an initial licensing or registration requirement;
- application of on-going financial requirements and constraints;
- a non-quantitative ‘supervisory’ element;
- monitoring arrangements;
- failure intervention powers.

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2 This has been reinforced by the move by banking supervisors internationally to structure capital adequacy requirements for banks in a way which favours lending by banks to other banks (which are risk weighted at 20 per cent) over lending to other financial institutions (which are risk weighted at 100 per cent). The framework of capital requirements for registered banks is outlined later in this article.
The nature of these different aspects of banking supervision, as conducted in New Zealand, is outlined in the remainder of this article.

REGISTRATION REQUIREMENTS

Before a financial institution can carry on business in New Zealand under a bank title, it must be registered by the Reserve Bank as a registered bank. In considering an application for registration the Bank is required to have regard to:

(a) the incorporation and ownership structure of the applicant;

(b) the size of the applicant;

(c) the ability of the applicant to carry on its business in a prudent manner;

(d) the standing of the applicant in the financial market;

(e) in the case of banks incorporated overseas, or owned by overseas interests, the laws and regulatory requirements of the relevant overseas banking authorities.

Under the first of these criteria the Bank normally looks for the applicant to be incorporated as a company, either in New Zealand or overseas. However, unincorporated entities, such as partnerships, are not completely ruled out. An important element of what the Bank looks for is an incorporation and ownership structure which has clear stake holder(s) in the bank (normally shareholders), who would be responsible for the bank, and who would have an incentive to oversee the management of the bank. This will generally be the case where those responsible for the bank have a proprietorship and risk capital interest in it.

In the case of overseas applicants, the Bank does not insist on a registered bank being incorporated in New Zealand, i.e. it will register a branch of an overseas bank. From the Reserve Bank’s standpoint, in one respect, this is a preferred ownership structure for an overseas based bank. Where an overseas bank operates in New Zealand as a branch of the global bank, the overseas bank is directly liable for all the obligations incurred by its branch in New Zealand. It is also a structure preferred by some overseas banks, since it enables them to trade in New Zealand on the strength of their global balance sheet, rather than on just the financial resources of the bank in New Zealand. On the other hand, it needs to be recognised that the New Zealand branch of a foreign bank is directly exposed to, and fully shares in, any problems encountered by the bank wherever in the world they may arise. For this reason, when an overseas bank applies to be registered as a branch in New Zealand, the Reserve Bank has regard to the international standing of the overseas bank, and to the nature and scope of the supervision of that bank as conducted by the overseas banking supervisor. Where the Bank has cause to hold any material reservations in these regards, it reserves the right to require the applicant to form, and conduct its New Zealand banking operation out of, a New Zealand incorporated company.
In having regard to the size of an applicant, the Bank looks for a minimum quantum (at least $15 million) of capital. In the case of applicants which have not already established an obviously viable banking business, this evidences the applicant’s ‘wherewithal’ and its commitment to the banking venture, and provides the initial critical mass of capital essential for the development of a successful banking operation.

The “ability to carry on business in a prudent manner” criterion is given statutory definition in terms of:

- capital in relation to the size and nature of the business;
- loan concentration and risk exposures;
- separation of the business from other business and from other interests of any person owning or controlling the applicant;
- internal control and accounting systems.

These factors are at the core of the Bank’s on-going supervision and are elaborated on in the next section of this article.

The Bank is also required to have regard to the standing in the financial market of an applicant for registration. Evidence of good standing might be provided, for example, through the applicant having conducted a reputable and successful business venture to date, or through the support of an owner which itself has good standing in the financial market. In the case of an overseas applicant, comments on its standing are sought from the relevant overseas banking supervisor. This practice reflects an allocation of supervisory responsibilities for international banks which has been drawn up by the Basle Committee on Banking Supervision3 and which is codified in an understanding known as the ‘Basle Concordat’. The Concordat provides that the banking supervisor in the country where an international bank is headquartered (the ‘parent’ supervisor) has overall responsibility for supervising the bank on a global basis. The supervisors in the different countries in which an international bank carries on business (the ‘host’ supervisors) also have supervisory responsibilities, but these are focused more narrowly on the local banking operation.

Finally, the Bank is required to have regard to the law and regulations governing the licensing, authorisation or registration of banks in a foreign applicant’s home country. Under this requirement, regard is had to any elements of the overseas country’s banking law or regulations which could prejudice the stability of the applicant’s banking business in New Zealand.

Overall, the purpose of the registration procedure is twofold. First, it provides the Reserve Bank with an opportunity to assess whether the applicant would be likely to operate in a sound and prudent manner. Secondly, the registration procedures represent the beginning of an on-going banking supervision relationship. This on-going relation-

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3 The Basle Committee on Banking Supervision comprises representatives of the Governors of the central banks of the G10 countries (plus Switzerland and Luxembourg) and is based at the Bank for International Settlements, Basle, Switzerland.
ship is secured through registrations being made subject to compliance with certain conditions which define on-going prudential requirements.

FINANCIAL REGULATION

The areas of banks’ prudential conduct which the Bank ‘regulates’ or intends to ‘regulate’ by imposing conditions of registration are:

- capital in relation to the size and nature of the business;
- exposure concentration (credit exposures and other risk exposures);
- separation of the banking business from other business and from the other business interests of the owner;
- internal control and accounting systems.

This list of prudential ‘dimensions’ represents those considered fundamental to prudent banking and (perhaps with the exception of internal control and accounting systems) which lend themselves to prescription of simple quantitative standards or requirements. Other aspects of banks’ prudential management (e.g. management of liquidity) are no less critical but do not lend themselves to the same sort of supervisory treatment, at least not without the supervisor intruding into the management of the bank to an undue degree. Banks manage liquidity in a diversity of ways. Depending on the nature of the banking business being conducted, different degrees of emphasis tend to be placed on, *inter alia*, maintaining a precautionary stock of high quality liquid assets, and managing asset and liability maturity mismatches. This diversity of practice makes banks’ liquidity management less amenable to simple and direct regulation. But it does not detract from the importance of effective and prudent liquidity management by banks themselves. In relation to this, and other aspects of banks’ prudential management, the Reserve Bank maintains an involvement by conducting periodic consultations with banks.

Where the Bank has prescribed minimum standards, emphasis is given to the fact that these standards are minimum requirements. They represent a floor, or ‘bottom line’ standard, for a registered bank: anything less would be regarded as being inconsistent with the institution’s status as a registered bank. Accordingly, it is expected that many banks will wish to maintain standards which are more prudent than the minima prescribed by the Reserve Bank.

To date the Reserve Bank has implemented, or is in the process of implementing, minimum quantitative requirements or maximum limits in the areas of capital adequacy, individual borrower exposures, open positions in foreign exchange, and exposures to borrowers which are connected to the bank.4

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4 These requirements are applied only to banks which are incorporated in New Zealand. Comparable requirements are not applied to those banks which carry on business in New Zealand as a branch of an overseas bank. Regulation of the New Zealand business of these banks comes within the direct ambit of the overseas banking supervisor.
(a) Capital Requirements

The minimum capital requirements follow closely a framework developed for international application by the Basle Committee on Banking Supervision. This framework defines capital, the exposures that capital is to be held against (weighted according to different degrees of risk inherent in different categories of exposure) and a minimum ratio of one to the other.

Capital is divided into core capital - shareholders’ equity and retained profits - and supplementary capital, which includes subordinated debt and some other forms of reserve. Core capital represents that part of a bank’s funding which is free from any servicing obligations. In other words, it is the amount by which a bank’s assets exceed its obligations to depositors and other creditors, and which is available to absorb losses without the bank becoming insolvent.

The exposures against which capital is required to be held are principally credit exposures i.e. the risk of loss should a borrowing customer default. These credit risks include credit contracts recorded ‘off-balance sheet’ (e.g. guarantees written, undrawn lending commitments and forward foreign exchange and interest rate contracts) as well as the loans and investments actually funded by the bank and recorded on its balance sheet. In the case of off-balance sheet contracts, factors are applied to convert the face value of the contract to a balance sheet exposure equivalent. For example, a guarantee provided by a bank in respect of a customer’s borrowings from other sources exposes the bank to essentially the same risk of loss as if the bank itself had lent to the customer. Thus, guarantees provided by a bank are converted to balance sheet equivalents by applying a factor of one. Commitments to lend, which have not been drawn down but could be, are also taken into account, but on the basis of a lower conversion factor, recognising that many commitments may never be drawn down.

The framework also makes some allowance for the different levels of risk a bank is exposed to in lending to different categories of customer. Borrowers are divided into broad categories of risk and the greater the overall amount of risk in a bank’s business, the greater the amount of capital it must have. The risk weights for different categories of credit exposure are summarised in the box.

<table>
<thead>
<tr>
<th>Credit Risk Categories (and Risk Weights)</th>
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<tbody>
<tr>
<td>Nil: Cash and short term Government security investments;</td>
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<tr>
<td>10 per cent: Other lending to central governments;</td>
</tr>
<tr>
<td>20 per cent: Lending to other banks, to local authorities and to other public sector entities;</td>
</tr>
<tr>
<td>50 per cent: Loans secured by mortgage over a residence;</td>
</tr>
<tr>
<td>100 per cent: All other exposures to the private sector (including to non-bank financial institutions);</td>
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By applying these ‘risk weights’ to the credit exposures for each category of counterparty and aggregating across the different categories, a risk weighted measure of aggregate credit exposures is arrived at. Minimum ratios of capital to risk weighted exposures, of 4 per cent for core capital and 7.25 per cent (8 per cent from end of 1992) for total capital, are applied to determine the minimum levels of capital which banks must at least maintain.

(b) Exposure Limits

The Reserve Bank has established minimum standards which banks are required to comply with in two areas of risk concentration. These are large credit exposures to single borrowers and large foreign exchange open positions. These additional constraints on banks’ business are necessary to validate one of the basic assumptions which lies behind the unusually low capital ratios maintained by banks compared with most other firms. That assumption is that banks’ portfolios are very well diversified and well hedged against risk. In other words, banks are expected to keep tight control over their risks and spread those risks widely.

A ‘single borrower’ large exposures limit has been set at the equivalent of 35 per cent of a bank’s capital. In applying this limit, allowance is made for the amount of risk which a bank has ‘sold down’ to a syndicate of other banks, or to a parent bank. Again exposures are broadly defined to include off-balance sheet facilities, such as guarantees and lending commitments, as well as actual loans outstanding. A ‘single borrower’ is deemed to encompass a group of borrowers who are, or could become, a single lending risk. This situation is often encountered where companies are related through ownership in such a way that they comprise a group of companies.

The Bank has set a limit, at 40 per cent of capital, on foreign exchange open positions i.e. mismatches between a bank’s obligations in foreign currency (foreign currency liabilities and forward contracts to sell foreign currency) and foreign currency claims (foreign currency assets and forward contracts to buy foreign currency). This is to protect the bank’s capital from adverse movements in exchange rates. More generally, the limits serve to counter any tendency by banks to speculate excessively in foreign exchange and in particular, the temptation to attempt to recover losses arising from adverse currency movements by taking new and larger currency positions.

(c) Connected Lending

Limits on lending by banks to connected borrowers, that is, to their owners and to other interests of their owners, are imposed for two related reasons. First, there is always a risk that lending to connected parties will not be on arms length terms and secondly, where the lending is, either directly or indirectly, back to the bank’s shareholders, the capital base of the bank can be undermined. If, in effect, capital is lent back to the shareholders, then the bank is directly exposed to any financial difficulties which those shareholders might experience. Connected lending limits are intended to protect against these dangers.
Connected lending limits have been set at the equivalent of 75 per cent of a bank’s capital in respect of lending to a parent which itself is a bank, but otherwise at 15 per cent of capital. The higher limit for ‘inter-bank’ connected lending is intended to facilitate normal inter-bank business. The lower limit which applies to all other connected parties reflects a view, widely shared by banking supervisors internationally, that lending by a bank to non-bank commercial interests connected to itself may not always be provided on arms length terms. The risk here is that the terms of the lending will be weighted, possibly substantially so, in favour of the borrower and against the interests of the lending bank.

THE NON-QUANTITATIVE ELEMENT OF SUPERVISION

There is more to banking supervision than prescription of minimum financial standards to be maintained in key areas. For one thing, those standards, as already emphasised, are baseline standards only, and they address only a limited number of rather specific matters. The Bank also maintains a relationship with the banks it supervises through periodic consultations, and in these consultations takes a broader view of banks’ situations and policies.

Also, in formulating the prudential requirements outlined in the section on Financial Regulation earlier in this article, careful consideration has been given to complementing direct financial requirements and constraints with requirements which reinforce effective management of risks within banks themselves. For example, where non-bank commercial interests have a significant interest in a bank, the Reserve Bank requires that the bank’s board of directors must have a majority of independent directors. This requirement for independent board oversight of the bank’s affairs in these cases adds credibility to the connected lending limit and reinforces the general principle that the affairs of the bank should be kept separate from the other commercial interests of its owners. Also, as a matter of policy for all banks subject to the single borrower exposure limits, the Bank proposes to require confirmation from the bank that exposures which exceed 20 per cent of the bank’s capital - a threshold below the maximum allowable figure - were approved, before they were committed, by the bank’s board of directors or, where applicable, in the head office of the bank’s parent bank. Another area where banks’ directors have important responsibilities is in signing off the financial and prudential reports they are required to publish, in fulfilment of the requirements of the Securities Act (and prospectively the Reserve Bank Act). Directors are required, after making due enquiry, to satisfy themselves that the information contained in these reports is not false or misleading.

One area singled out in the Reserve Bank Act for specific attention, but where specification of precise quantitative requirements is not feasible, is that relating to banks’ internal control and accounting systems. The Bank is developing a framework

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5 Where a bank has exposures to a bank parent and also to other non-bank shareholders who have a significant ownership interest in the bank, the total amount of exposure to both shareholders must not exceed 75 per cent of the bank’s capital.
of internal control principles which it proposes to require registered banks to adhere to. The Act also provides for the Bank to be able to require banks’ internal control and accounting systems to be subject to independent external review. It is intended to use this provision in the Act as the basis for requiring independent reports to be provided to the Reserve Bank on whether banks’ control and accounting systems comply with the prescribed principles.

MONITORING ARRANGEMENTS

The banking supervision arrangements contained in the Reserve Bank Act include an array of provisions designed to facilitate monitoring of a bank by a number of different parties. These include:

- Public disclosure requirements under which banks must disclose financial and certain prudential information to the market, thereby enabling market participants to monitor the financial and prudential condition of banks. The Reserve Bank Act includes empowering provisions which, on being brought into force, would remove registered banks from the disclosure requirements of the Securities Act (which apply to all institutions which borrow from the public) and put in place a new set of public reporting requirements for registered banks which would be tailored to banking business. These alternative arrangements are currently being developed.

- Requirements for registered banks to make regular reports to the Reserve Bank on matters prescribed by the Bank. These currently include requirements to provide information on the overall financial position and profitability of the bank, and information which the Reserve Bank uses to monitor banks’ compliance with their conditions of registration. Also, the Act contains powers to enable the Reserve Bank to appoint a person to undertake an investigation of a bank’s affairs where the Bank is satisfied that this would be necessary or desirable for the purpose of determining whether to exercise formal intervention powers provided for in the Act.

- An ability to require banks to undergo independent credit assessments and to publish the results of those assessments. Under this provision it would be possible to require some, or all, registered banks to be ‘rated’ by a recognised rating agency.

This array of monitoring arrangements is in many respects central to the whole supervision process. One of the central reasons why banks need to be supervised is because banks’ customers, left to themselves, are unlikely to be able to monitor a bank’s affairs in a cost effective manner. A point to be emphasised, though, is that the arrangements in place in New Zealand give monitoring roles to a number of parties. While the Reserve Bank, as the official banking supervisor, has an important monitoring role, so also do banks’ boards of directors, auditors and market participants. This multi-pronged approach is intended to generate the sorts of disciplines over banks’ management which banks’ depositors would impose themselves if they had a better monitoring capacity.
The monitoring responsibilities of parties other than the banking supervisor are of some importance in the New Zealand context, given that the prudential requirements laid down by the Reserve Bank represent minimum standards only and that the Reserve Bank is not directly responsible for protecting depositors' funds. It is envisaged that under the new disclosure arrangements provided for in the Reserve Bank Act, banks will be required to disclose information designed to enable market participants to better gauge for themselves where different banks have positioned themselves in relation to the minimum prudential requirements prescribed by the Bank.

FAILURE MANAGEMENT

New Zealand banking supervision policy leaves banks with a significant amount of freedom to conduct their businesses as a commercial enterprise, albeit subject to certain minimum standards. In these circumstances, it remains possible, however unlikely, that a bank might fail.

Part of the Reserve Bank's responsibilities is to use the powers available to it under the Reserve Bank Act to limit the damage to the financial system likely to be caused by the failure of a registered bank. Where a bank becomes insolvent, or is likely to become insolvent, or where it has suspended or is about to suspend payment of its obligations, the Reserve Bank can recommend to the Minister of Finance that a statutory manager should be appointed. A statutory manager takes full control of the bank and has wide ranging powers to manage the bank's affairs, but is subject to the overriding requirement that those powers must be exercised for the purpose of limiting damage to the financial system. These powers include the ability to sell the bank, to sell part or all of its assets and liabilities and/or to negotiate with creditors an arrangement under which some compromise of claims would be involved, but which would secure a better outcome than if the bank were placed in liquidation. An important element of statutory management is that a 'moratorium' applies at the commencement. This provides the breathing space required in order for the situation to be assessed, for options to be evaluated and for negotiations with affected parties to be conducted without the bank's affairs falling into a state of uncontrolled disorder.

Statutory management is, however, the last resort option for dealing with a failing bank. Alternative solutions, not involving a suspension of payment, are to be preferred where they are available. Recapitalisation of the bank will often be the preferred option of the bank's owners, particularly where the bank has value as a going concern which would be lost in a winding up, or where the owner's commercial reputation would be severely damaged if the bank were to default on its obligations. Alternatively, it may be possible to organise the sale of the bank to another, stronger party. This will sometimes be a feasible option where the failing bank has a market franchise of value to competing institutions.

One aspect of managing a bank failure which is attracting increased attention internationally is the impact that a bank failure would have on the payments system. While the primary emphasis in banking supervision is to reduce the risk of bank failures occurring, it is important that the banking system have a capacity to cope with a failure should one ever occur. In New Zealand, proposals are being developed by the banking industry to enable the payments system to handle a bank failure without serious disruption.

occurring. The main concern in this regard is the domino effects which could be caused by defaults on large value payment obligations - if one bank fails to make payments, then this event could jeopardise the ability of other participants in the system to meet their payments obligations, and so on. To guard against consequences of this sort, proposals have been developed in a number of countries to restructure payments systems in ways which will reduce risks, to improve monitoring of the risks that remain, and to provide for a predetermined set of procedures to be followed if a failure should occur. Within the Reserve Bank a task force has been established to address these issues, and the Bank is participating in a Committee of the New Zealand Bankers' Association which is also working on the subject.

CONCLUSION

Banking supervision policy in New Zealand comprises a number of strands. There is a registration requirement: banks are subject to on-going prudential requirements, including some minimum financial standards; mechanisms have been developed under which the financial and prudential positions of banks can be monitored (by the Reserve Bank and others, including market participants), and provision has been made for control of a bank which has failed to pass to a statutory manager.

The Bank has not, however, attempted to put in place banking supervision arrangements which will ensure that no bank ever gets into financial difficulty. To have formulated banking supervision requirements with the aim of excluding the possibility of banks encountering difficulties would have required more extensive and stringent regulation, and even this would not have ensured that bank failures would never occur. It would also have involved unacceptable costs because very stringent regulation would in many situations have impeded banks from meeting the reasonable needs of their customers at a reasonable cost. In the long run such a strategy would not have promoted long-run soundness or efficiency in the financial system. This approach was therefore rejected.

The framework contained in the Reserve Bank Act requires a balance to be struck between imposing constraints on the risk taking behaviour of banks and allowing them scope to competitively service the needs of their customers and respond to changing commercial circumstances. By placing some outer constraints on risk taking behaviour in key areas, significant protection is provided against banks operating at an excessive level of risk. But it would be a mistake to conclude that these regulatory constraints make banks fail-safe. In the final analysis the safety of a bank rests in the hands of those who control it - its board of directors and its management team. The Reserve Bank can and does play a role in encouraging sound and prudent management practices by banks, including through the periodic consultations which the Reserve Bank conducts with each bank. Additionally though, the market place within which banks operate has an important role to play - in many respects, the disciplines imposed on banks by their customers remain the most important element of the various forces which maintain stability in the banking system.