Introduction and Executive Summary

Over 1991 and 1992, a review of banking supervision was undertaken by the Reserve Bank to assess whether existing supervision arrangements represented the most effective means of promoting a sound and efficient banking system. In particular, the review sought to identify arrangements which best meet the following objectives:

- Ensuring that policies are directed at strengthening the incentives which banks face to manage their affairs prudently.
- Ensuring that policies constructively reinforce, and do not undermine, those incentives; are cost effective; and leave banks with scope to be responsive to the needs of their customers.
- Maintaining policies which minimise disruption to the financial system which would result from the failure of a registered bank.
- Reducing the perception that the government underwrites the prudential soundness of banks.

The review culminated in the release, in June this year, of a set of proposed changes to the supervision framework. The main proposals, at a general level, are:

(a) Strengthened disclosure requirements for registered banks;
(b) Mandatory credit rating of banks;
(c) Reduced role for prudential rules;
(d) A changed approach to the official monitoring of banks;
(e) A standardised approach to addressing breaches of capital requirements.

The Reserve Bank has invited comment from interested parties on these proposals, and intends to prepare a further paper setting out more detailed proposals in light of comments received.
Background

The Reserve Bank sees a need to retain a specialist public policy interest in banks and the banking system, at least until existing payment systems and insolvency law are reformed. This recognises that, under existing payment systems, the failure of one bank has the potential to cause widespread disruption to the functioning of the banking system, and that current insolvency law is not sufficiently flexible to cater [in any adequate way] for the failure of a bank. These considerations underscore the importance we attach to current efforts to reform the structure of payment systems in New Zealand.

Looking to the longer term, when these matters have been addressed, it might be possible to achieve banking system stability objectives with banks being covered by the same regulatory arrangements as apply to other issuers of debt securities. The proposals set out in this paper should, therefore, be seen as part of an evolutionary process, which is aimed at ensuring that the regulatory requirements applicable to banks are effective, but no more burdensome than is required.

At this stage in the evolution of the banking system, we consider that Reserve Bank oversight of the banking system broadly along current lines should be retained. However, we see scope to shift the emphasis towards more market scrutiny and away from direct prudential regulation. We consider that regular scrutiny of registered banks by the market place can, and should, play an important role in promoting prudent banking practices. The maintenance of prudent banking practices can also be enhanced by increasing the involvement of private sector monitoring agents, such as external auditors and rating agencies. Prudential regulation and official monitoring have complementary roles to play, but are not the principal mechanism, nor substitutes for market based private mechanisms. Our general thinking is that a re-balancing of policy which brings market based mechanisms a little more to the fore would enhance the overall soundness of the banking system, and at the same time afford banks greater scope to prudently respond to customer needs.

Summary of Proposed Changes

The main proposals, at a general level, are:

(a) **Strengthened disclosure requirements for registered banks.** We see the programme of implementing new disclosure requirements for registered banks under the Reserve Bank Act as continuing and as having a more central role. The new requirements would replace existing prospectus and advertising regulations under the Securities Act1. We are thinking in terms of quarterly disclosures, with those disclosures being subject to full external audit six monthly. Banks operating in New Zealand but incorporated overseas would also be subject to disclosure requirements, but in general, the requirement in these cases would be for the bank to disclose the information reported in the jurisdiction in which it is incorporated.

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1 Note that the Securities Act requirements do not apply to non-public issues, whereas the disclosure requirements provided for in the Reserve Bank Act would apply to all registered banks.
The disclosure regime would serve three main purposes:

- to enhance existing market disciplines by better facilitating market scrutiny of the bank;
- to increase the ability of creditors and others to protect their interests by providing them with improved information on a bank's affairs;
- to increase the level of scrutiny by external auditors.

(b) **Mandatory credit rating of banks.** We propose that all registered banks should be required to have a credit rating and to display the credit rating in a manner which enables retail depositors and other creditors to be readily informed of the rating. The Reserve Bank Act already makes provision for this proposal.

(c) **Reduced role for prudential rules.** The introduction of more comprehensive disclosure requirements, including in respect of prudential matters, will enable a reduction in the extent to which prudential rules are used to achieve system soundness objectives. Accordingly, it is proposed that there should be fewer conditions of registration than is currently the case, with at least the existing limits on large exposures and foreign currency open positions being removed. We propose to retain the minimum capital ratio requirement.

(d) **A changed approach to the official monitoring of banks.** It is proposed that existing prudential returns, as a routine means of monitoring banks, would be discontinued. Rather, our monitoring would be primarily based on banks’ public disclosure statements and other publicly available information. The Bank would monitor banks’ compliance with disclosure requirements and with conditions of registration, and their general prudential soundness. It is proposed that regular consultations would continue to be held with banks in order to provide the Bank with a sound understanding of the operation of the banking system.

(e) **More standardised approach to addressing breaches of capital requirements.** It is proposed that breaches of capital requirements would be addressed in a less discretionary manner than current policy provides for. Although the Bank would necessarily have regard to the circumstances in each particular case, we see merit in general rules being established, which we would follow unless there were compelling reasons to adopt an alternative course of action. The precise formulation of those responses has yet to be developed, but an indicative structure is outlined later in this paper.

### Registration

The registration criteria would remain as under existing policy (as prescribed in the Reserve Bank Act). That is, registered banks must be substantially involved in the business of borrowing and lending money and/or providing other financial services. In reviewing applications, the Reserve Bank would have regard for the matters prescribed in the Act. Those matters are:
• the standing of the applicant;
• prudential policies (as referred to in section 78);
• form of incorporation and parentage;
• size of the applicant; and
• in the case of foreign applicants, overseas regulatory matters which could impinge on the bank’s New Zealand operations.

The registration criteria would continue to provide a meaningful hurdle to entry to registered bank status. However, in practice, there would be few impediments to registration of subsidiaries of major international banks, and, subject to the following paragraph, of branches of major international banks from countries with stable banking and regulatory systems.

International experience indicates that managing the failure of a bank established in one country as a branch of a bank incorporated in another country can be complicated by national laws which interfere with the ranking of the failed bank’s obligations. These laws can result in the creditors of a bank in one country gaining preferential access to the assets of the bank, to the disadvantage of the creditors in other countries. Where such laws exist, and it is considered that they could be prejudicial to the interests of New Zealand creditors, the Reserve Bank will consider whether the overseas bank should be required to conduct its New Zealand business through a New Zealand incorporated subsidiary, rather than through a branch of the overseas bank.

Conditions of Registration

Given that locally incorporated banks and branches in New Zealand of banks incorporated overseas are necessarily treated differently in terms of conditions of registration, the discussion below on conditions of registration is divided into two sections: the first, dealing with locally incorporated banks; and the second, dealing with branches of overseas incorporated banks.

Conditions of Registration for Banks Incorporated in New Zealand

For registered banks which are incorporated in New Zealand, registration would normally be conditional on:

• the bank remaining in the business of borrowing and lending money, or providing other financial services (or both);
• the bank obtaining Reserve Bank consent before a change in control of the bank occurs;
• the bank maintaining a level of capital which meets or exceeds the international standard prescribed by the Basle Committee on Banking Supervision (as applied
by the Reserve Bank). The existing minimum absolute dollar amount of capital requirement ($15 million) will also be retained.

The Bank proposes to remove existing conditions dealing with large exposures, boards of directors (for those banks whose registrations are subject to a condition dealing with board membership), internal controls and, possibly, connected lending. These requirements would be replaced by the disclosure arrangements and other aspects of the proposed regime. The Bank considers that, in most cases, the objectives which these conditions of registration are designed to meet could be achieved as effectively, but more flexibly, under a disclosure regime.

The Bank would retain the right to apply additional conditions of registration, as provided for under section 74 of the Reserve Bank Act. In this context, we have yet to carefully review the Companies Bill (as reported back to the House of Representatives), as regards its implications for banks. It may be necessary to apply some conditions of registration dealing with banks' constitutions, in the light of the more permissive regime proposed in the new Bill (e.g., the new Bill allows the directors of a company to act in the interests of its holding company even where this may be inconsistent with the interests of their own company, where the constitution of the company so provides).

The “Basle” Capital Ratio
Since this regime was introduced, there has been considerable market comment, within New Zealand and internationally, about its appropriateness and the effects it has had on banks' lending behaviour. The Bank has given preliminary consideration to the following modifications to the capital regime:

- The minimum ratio for banks incorporated in New Zealand should be higher than the 8 percent minimum international standard, given the narrowness of the New Zealand economy, the degree of concentration in the New Zealand corporate sector, and the relative absence of a public sector "safety net" for New Zealand banks (or for their depositors) compared with those provided by the governments of many other countries. It is also noted that the authorities in many countries either implicitly or explicitly require the banks under their supervision to maintain capital at some margin above the internationally agreed minimum ratio.

- The Basle standard makes too much allowance for “quasi-equity” and subordinated debt (i.e., tier two capital). Although the initiative taken by the Basle Committee has raised levels of capital adequacy overall, it may have facilitated a deterioration in the quality of bank capital. According to this view, there would be merit in re-emphasising the role for proprietors' equity, either by raising the tier one minimum requirement (e.g., to 6 percent with the total capital requirement rising to 10 percent), or by progressively phasing out the tier two eligibility, thereby requiring all of the current 8 percent minimum requirement to be held in the form of tier one capital.

- The system of counterparty risk weights used in the regime may have encouraged banks to shift the balance of their credit portfolios towards residential mortgages, government and bank exposures, and away from commercial lending, to a greater degree than can be explained by an analysis of the relative risks and rewards. On this view, distortions in lending behaviour might be reduced or avoided by
reducing the spread in the risk weight levels, reducing the number of risk weight categories, or removing them from the framework altogether.

**Connected Exposures**

The Bank is reviewing the current policy under which limits are applied to exposures to connected parties (principally shareholders and shareholder affiliates). At present these exposures (in aggregate) are limited to not more than 75 percent of capital, with a sub-limit of 15 percent of capital for exposure to “non-bank” connected parties. Where risk is laid off to a parent bank, the resultant exposure to the parent is captured within the framework used to apply these limits, although, in practice, we have generally agreed to exclusion of these exposures. The objectives of the connected lending limit are to reduce the extent to which the registered bank in New Zealand can be destabilised by difficulties being faced by its parent, and to reduce the potential for credit decisions being made by the local bank on other than arm’s length terms.

We have re-examined these arrangements, with a view to increasing the level of protection achieved. In particular, we are not comfortable with that aspect of the current policy which permits a bank to take on credit exposures to a shareholder (or its affiliates) up to the equivalent of 75 percent of the bank’s capital. In addressing this concern, we have identified the following menu of alternatives:

- Introduce a requirement, under the capital adequacy provisions, for exposures (other than those arising from risk lay-offs) to connected parties to be deducted from the bank’s capital.

- Introduce more rigorous disclosure requirements with respect to exposure to connected parties. These could require disclosure of certain details on the nature and purpose of the exposure, and, for example, whether regulatory provisions exist which could affect the ranking of the claim on the connected party.

- Retain a limit based approach, but with a lower limit for at least some categories of connected exposure (eg. exposure arising from provision of funding to a connected party).

**Conditions of Registration for Banks Incorporated Overseas**

For banks which are incorporated overseas, registrations normally would be made conditional on:

- The business of the bank in New Zealand continuing to comprise the borrowing and lending of money, or the provision of other financial services, or both.

- Positive net assets being held “in New Zealand”. We have yet to work through the details of the “in New Zealand” concept, but our preliminary thinking is that it would refer to assets and liabilities recoverable and payable in New Zealand and/or subject to New Zealand law.

- The business of the bank in New Zealand remaining insubstantial relative to the business of the global bank. This condition would be directed at avoiding a
situation where, for the purposes of avoiding requirements applicable to locally incorporated banks, a bank incorporates overseas but maintains most of its business in New Zealand.

- The bank, on a global basis, complying with the requirements imposed by the supervisory authority in the jurisdiction of incorporation.

Disclosure

The Bank considers that one of the most effective ways it can promote soundness in the banking system is to introduce an improved disclosure regime for banks. The aim would be to align the required scope and content of New Zealand registered banks’ financial reports with international “best practice” and, more specifically, to facilitate scrutiny by the market place of a number of specific prudential matters. We consider that such a regime would strengthen existing incentives to maintain prudent banking practices, and for directors, in signing off disclosure statements, to exercise appropriate scrutiny of management. In addition, enhanced disclosure would provide depositors and other creditors of banks with a better basis for protecting their own interests.

It is intended that the disclosure proposals we are currently developing, with assistance from a working group drawn from banks, the accounting profession and the Securities Commission, will be completed as soon as possible and broadly in line with what has already been proposed. These would include requirements to disclose:

- The bank’s capital ratio (including information on how it has been arrived at and on the different components of capital).

- The degree of credit risk concentration. We see this as including a requirement to disclose the number of exposures in prescribed exposure “size” bands, eg, 10 percent - under 20 percent of capital; 20 percent - under 30 percent of capital; and 30 percent of capital and over (with the dollar amount of each exposure in the last mentioned band to also be disclosed). We are also considering requirements to disclose credit exposures on a sectoral basis (recognising the need for flexibility given the classification difficulties associated with a proposal of this nature).

- Information about credit exposure to related parties, ie, major shareholders and their affiliates, and others in a position to influence the bank’s lending policies. (See above for discussion of more detailed possibilities.)

We make two new proposals concerning frequency and audit of disclosures:

- that disclosure statements should be published quarterly (previously six monthly reporting had been proposed); and

- that the financial statements, including the “prudential” information to be contained in those statements, should be subject to a full “true and fair view” external audit six monthly.

It is recognised that branches of banks incorporated overseas may not be able to comply with all of the specific requirements of the proposed disclosure regime, given that the

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banks of which they are part are already subject to disclosure regimes which may differ in some respects from the requirements proposed for New Zealand. In such cases, as a general rule, provision would be made in the disclosure requirements to allow branches of banks incorporated overseas to comply with the requirements by making disclosures on the same basis as in the jurisdiction where the bank is incorporated. In this context, where the home jurisdiction of a bank incorporated overseas does not require quarterly financial reporting or six monthly audit of financial disclosures, those requirements would not apply.

However, should the proposed requirement that branches maintain positive net assets in New Zealand be implemented, then it would seem appropriate that the branch should be required to publish quarterly statements showing assets and liabilities in New Zealand, and that these statements should be subject to six monthly external audit.

The disclosures made in a disclosure statement would be required to be signed by all of a bank's directors, or by their duly authorised agent. Subject to this requirement, provision would be made for information published elsewhere to be incorporated in the Disclosure Statement “by reference”, provided that the information so incorporated was made available with the disclosure statement.

**Credit Rating Requirement**

Our thinking at this stage is that registered banks should be required to obtain and maintain a credit rating, and to display that rating in each of its branch premises. This would be to promote additional market scrutiny of a bank's prudential position. A credit rating requirement would also enhance the ability of depositors and other parties to protect their interests in dealing with a bank.

Details of precisely which of a bank’s obligations would be required to be rated have yet to be fully developed. A preliminary view is that it is a bank’s senior, long-term unsecured obligations payable in New Zealand which the rating should apply to.

**Reserve Bank Monitoring**

We propose to continue our own monitoring of registered banks. However, unlike at present where most of the information we receive is either not publicly available, or is in a different form from that which is publicly available, we would monitor primarily on the basis of banks' published disclosure statements and other publicly available information. Once the disclosure and audit arrangements for banks are in place, we would cease requiring banks to routinely provide us with the information they presently forward by way of prudential returns. Regular consultations with banks' senior managements would be held for the purpose of maintaining a sound understanding of the operation of the banking system.

Our monitoring would have the following principal purposes:

- checking whether conditions of registration have been complied with;
- checking whether the matters on which disclosures are required have been addressed in the published disclosure statement;
• assessing the general prudential condition of a bank.

We would seek further details on a bank where:

• material elements of the published information were unclear;

• we were concerned about the veracity of the published information;

• we had cause to believe that possible grounds existed for exercising powers under the Reserve Bank Act, including where capital adequacy had fallen, or was in prospect of falling, below the minimum standard.

Seeking further details could involve discussions with management, directors, auditors, shareholders and overseas supervisors.

For registered banks which are not incorporated in New Zealand, we would keep ourselves informed about the financial condition of the bank as a whole on the basis of published information and through our contacts with overseas central banks. We would also place some focus on the net assets in the New Zealand position of the bank.

The Reserve Bank Act gives the Bank the power to require a disclosure statement to be corrected where we consider the information published is false or misleading, or does not comply with the disclosure requirements. If we had cause to believe that a disclosure statement was false or misleading, or unclear, or if we had concerns about the bank, we would discuss the situation with the bank’s management in the first instance. If we were not satisfied with management’s explanations, we would raise the matter with the bank’s directors, auditors or shareholders, as appropriate. In extreme situations, we could require the bank to engage an auditor (probably an auditor other than the bank’s usual auditor), or we could appoint an investigator, to investigate the affairs of the bank and report to us.

We envisage that banks, from time to time, will wish to discuss how they should comply with the disclosure requirements and conditions of registration. We see value in maintaining arrangements under which new situations can be discussed in general terms, but would see it as being clearly each bank’s responsibility to ensure that the information they disclose is not false and misleading.

Existing prudential guidelines will be reviewed. It is likely that guidelines, in suitably modified form, will remain to assist banks and auditors to determine compliance with the capital adequacy requirements and certain disclosure requirements. The guidelines on internal controls would be withdrawn.

**Crisis Management**

We propose to retain our present crisis management role and powers. This role potentially includes the Bank in assisting in the formulation and implementation of solutions to serious banking problems (outside of recommending the appointment of a statutory manager, if feasible), and in recommending, and overseeing, statutory management where that is required.
We propose to codify the way in which we would expect to respond to situations where capital adequacy requirements were not being complied with. Where a bank’s capital adequacy ratio falls below the minimum required level (and is not immediately restored) it generally is not appropriate to proceed straight to the cancellation of registration option. However, not recommending deregistration of a bank in this situation exposes the Reserve Bank to potential risk if it turns out that the circumstances of the bank are worse than they appeared, and the bank fails.

Our thinking is that codification of how the Bank would respond in these sorts of situations would be helpful. Such an approach could entail establishing a series of predetermined steps, which we would follow unless there were compelling reasons to adopt an alternative course of action. Although we have not finalised our view on the nature of the steps that would be involved, an indicative structure might be as follows:

- Where a bank’s published capital ratio falls below 8 percent, but is still above 6 percent, the bank would be required to suspend distributions to all shareholders, constrain exposure to shareholders at the then prevailing level, and submit a binding plan to restore capital to at least the 8 percent level within a specified period.

- A capital ratio below 6 percent but above 3 percent would require, in addition to the requirements in the preceding paragraph, an immediate curtailment of new “lending”, including off-balance sheet “lending” (with the proviso that existing contractual obligations would be permitted to be honoured), and a binding undertaking to restore capital to at least 8 percent within a specified period.

- A capital ratio below 3 percent would result in the Bank recommending that the bank in question be placed into statutory management. (This step would be taken subject to having regard to the particular circumstances of the bank and being satisfied that the requirements of the Reserve Bank Act with respect to recommending statutory management were fully complied with.)

The Bank favours this type of more standardised and pre-defined approach to dealing with situations where a bank is not in compliance with conditions of registration, because it would provide banks with clear guidance, before the event, of the actions required in particular circumstances. It would also lessen the risk to the Reserve Bank from exercising inappropriate regulatory forbearance. The sort of framework outlined above could be implemented within the present Reserve Bank Act, provided that we had regard to the particular circumstances in each case, which would be our intention.

**Lender of Last Resort**

The Bank will continue to be responsible for managing the availability of “cash” to the financial system, through open market operations. This responsibility extends to providing the system with the additional cash required when there is a market “flight to cash”, by purchasing high quality assets through competitive tenders.

However, we wish to review the existing “emergency liquidity support arrangements” developed with the Bankers’ Association in 1989. Under those arrangements, the Bank has acknowledged the possibility of providing liquidity to a single institution, in
conjunction with other banks, on the basis of confidential information supplied by the bank in difficulty. The arrangements are intended to address liquidity or public confidence difficulties being experienced by a bank which is otherwise in a sound prudential condition.

Fees

The annual fee paid by registered banks to the Reserve Bank, to cover part of the cost to the Bank of performing the banking supervision function, is being reviewed. We recognise that the proposed disclosure regime would impose additional costs on banks, due to the increased frequency of disclosure and additional audit requirements. The proposed mandatory rating requirement may also impose additional costs on some banks. More generally, retention of the present fee structure may not sit comfortably with the proposed shift in emphasis to market scrutiny of banks. These considerations suggest that if banking supervision arrangements are to be revised along the lines proposed in this paper, then the current fees should be substantially reduced or eliminated.

Related Issues

During the course of the review of banking supervision, some longer term issues have been identified. These include:

- The appropriate regulatory framework for financial “conglomerates” (eg, provision of banking, insurance and funds management services by a single group, or entity), coordination of supervision activities by the different authorities, and whether the central bank should be one of those authorities.

- The relationship between Reserve Bank supervision and the Securities Act in the medium term. We wonder whether banks, and other financial institutions, are evolving in a way as to make the bank/non-bank distinction (and the separate regulatory frameworks for each) less relevant. It is recognised that, while the payments system is in its present form, separate regulatory treatment of banks is appropriate. However, in the longer term, once the payments system restructuring has been completed and a more flexible insolvency law has been implemented, further consideration might usefully be given to whether banks should remain subject to a separate regulatory regime. Consideration of this issue would likely involve an assessment of the need for some form of deposit insurance or “safe haven” for “small” deposits.

These issues have not been addressed in the current banking supervision review, but have been identified as issues which will likely require attention at some future stage. They are referred to here only as a medium term backdrop to the proposals outlined above, not as proposals which are being advanced at this stage.

Conclusion

The main proposals being put forward by the Bank, and on which comments have been sought are as follows.
Disclosure
• a quarterly disclosure requirement;
• a six monthly audit requirement;
• mandatory credit ratings, and a requirement that each registered bank publish/display its credit rating;
• disclosure of large exposures (in bands, no names of counterparties);

Overseas Incorporated Banks
• overseas banks’ disclosure requirements to be aligned with what they disclose in their home jurisdiction, but to include quarterly publication (and six monthly audit) of branch accounts showing net assets in New Zealand;
• branches of banks incorporated overseas to be required to maintain net assets in New Zealand;
• a requirement for an overseas bank to incorporate in New Zealand where foreign laws could interfere with the ranking of New Zealand creditors in a winding up of the bank;

Prudential Regulation
• retention of the Basle capital standard;
• a review of what comprises eligible capital (in particular the balance between tier 1 and tier 2 capital) and of the exposure risk weights;
• removal of limits on large exposures, foreign exchange open positions and withdrawal of the guidelines on internal controls;
• a review of connected lending limits (leading, possibly, to some reduction in the limits, or to a requirement for certain connected exposures to be deducted from capital);
• less discretion by Reserve Bank in responding to breaches of the minimum capital adequacy standard, and codification of the intended responses;
• phase out of prudential returns to the Reserve Bank;

Other
• a review of existing RBNZ/NZBA “emergency liquidity support arrangements”;
• a substantial reduction in, or abolition of, the banking supervision annual fees.

We propose to issue further papers on a number of the above issues, as a basis for further consultation on detailed proposals. Also, work is in train on the disclosure requirements, involving a working group drawn from the Reserve Bank, registered banks, the accounting profession and the Securities Commission, and, in due course, we will make available to all banks a revised set of disclosure proposals which take account of the proposals outlined in this paper.