Adrian Orr: Bank capital, risk management and the economy

Speech by Mr Adrian Orr, Deputy Governor of the Reserve Bank of New Zealand, to the Retail Financial Services Forum, Auckland, 10 April 2006.

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Thank you for the opportunity to speak to you today. The bulk of my comments will be focused on one of the major banking regulation initiatives the Reserve Bank is currently undertaking - the implementation of the new Basel II capital adequacy framework for banks. But first, I'll explain some of the context to this initiative, to try to give a sense of why this work is a priority for us.

As I'm sure this audience will know, the Reserve Bank has important duties and functions regarding financial stability in New Zealand. These include the issue of notes and coins, the prudential supervision of banks, the operation and oversight of payments systems, the provision of liquidity to the financial system, and the role of lender of last resort to the financial system. As well as being critical for the effective conduct of monetary policy - the Reserve Bank's primary function, and the one for which we are perhaps most often in the headlines - financial stability is also crucial for the transactions supporting economic activity to be efficiently facilitated, for savings to be channeled efficiently to the most productive investment destinations, and for risk to be transformed and borne by the parties best able to manage it. When all of these things happen, the financial system makes its maximum contribution to sustainable growth in the economy and to the welfare of New Zealanders.

Financial stability exists when the financial system is resilient to a wide range of economic and financial shocks, and able to absorb financial crisis losses with least disruption. There are obviously a number of dimensions to this proposition, that I and other Reserve Bank staffers have talked about at length in recent speeches and articles. I don't intend to rehearse that material here, but commend it to you if you are interested. It's all on our website. Suffice it to say for now that the Reserve Bank focuses its energies in the financial stability space on *risk*. For most of us, risk is a bad thing. However, financial activity is as much about risk as return, and as everyone knows there is no such thing as a free lunch. Our job in a nutshell is to do the best we can, using the best balance of the means at our disposal, to ensure that lunch generally does not cost too much. If we are successful, then by implication risk will have been *identified* by all parties it affects, *priced* by those able freely to choose to bear it, *allocated* to those who are best placed to bear it, and *managed* by those parties in the most efficient manner. These are the preconditions for financial stability to which we at the Reserve Bank generally refer when assessing the performance of the financial system and our own performance in promoting financial stability.

I know this is all, to this point, somewhat abstract. The financial system is, after all, more recognisable as a collection of financial institutions, financial markets, and payment and settlement systems. Financial institutions include banks, insurance companies, fund managers and so on. Financial markets are arrangements whereby shares, bonds and other types of securities are issued and traded. Payment and settlement systems - also called "plumbing", a term that is evocative if nothing else - enable the transfer of funds and claims from one person to another.

In New Zealand, the first element of the three, financial institutions, is the most familiar to the most people. Among the OECD countries, New Zealand is currently one of the more heavily "banked" countries, meaning that a relatively large proportion of financial activity involves banks, as opposed to, say, direct investment and trading in shares or debt securities. For the bulk of the population, banks provide a place to park savings, the primary means of making day-to-day payments, and the main source of loans for such things as home-buying and business investment. As a crude measure of the importance of banks, about three quarters of all financial assets held in New Zealand are held in banks. The comparable number for Australia, for example, is about half.

Moreover, New Zealand has a heavy reliance on foreign funding, and banks are the primary conduit by which domestic borrowing needs are met by foreign lenders. Over half of New Zealand's foreign borrowings come in via banks' balance sheets, and the vast majority (98 percent) of bank lending is done by banks that are owned by, or part of, foreign banks. 85 percent of all bank lending is done by banks owned by Australian parent banks.

The strong presence of banks that are parts of (much) larger international banking groups brings both benefits and risks to New Zealand. On the benefit side, it has enhanced risk-management capacity within the banking system, facilitated the entry of new banking products and services, and provided a source of financial strength to weather domestic economic shocks. Against these benefits are increased exposure to adverse events or mismanagement in the parent banking systems, which is accentuated by the high industry concentration and the dominant position of banks from a single foreign country.

In light of these facts, it should probably be undoubted that the soundness and efficiency of banks matters a lot for financial stability. Banks play a central role in identifying, pricing, and managing risk, and are in the business of allocating risk among their various customers. Indeed, the strength and resilience of New Zealand's banks are crucial to the ability of the New Zealand economy to endure the range of adverse macroeconomic situations in which we now and then find ourselves due to our particular economic circumstances. These circumstances include being a small, open economy with strong dependence on the vagaries of international commodity markets, and one with a high level of foreign funding of New Zealand economic activity. We have spoken recently about growing household indebtedness and the vulnerabilities that creates in economic performance. Going along with these vulnerabilities are an increase in the risk of foreign lenders becoming unwilling to continue to provide funding, and a concern about how that unwillingness might play out in the New Zealand financial markets and in the exposures of banks in New Zealand. These factors are amplified in our consciousness when we reflect on the small size and fairly narrow diversification of bank assets in New Zealand, compared to most other developed countries.

I should emphasise at this point that there is no doubt that the New Zealand banking system is currently in robust health. Bank balance sheets continue to grow and that growth has not, to date, seen any rise in asset impairment. Loan default rates remain very low and bank profitability strong.

We would obviously be remiss, however, and probably in the wrong jobs, if we were simply to rest on our laurels and hope that the risks do not eventuate or that trouble does not happen. The Reserve Bank of New Zealand Act requires us to use our banking regulation and supervision powers to promote the soundness and efficiency of the New Zealand financial system, and to avoid significant damage to the financial system that could be caused by the failure of a registered bank. For some time now the Reserve Bank has pursued these objectives using a mix of policies that promote effective governance by banks' boards of directors, that strengthen market scrutiny of banks, and that set certain minimum standards of risk management by banks.

We continue to believe that effective governance and market scrutiny will go a long way towards delivering our financial stability objectives. However, these approaches generally work best under normal economic circumstances, and in some cases weaken considerably under conditions of severe economic stress or shock. One purpose of minimum risk management standards is to fill that gap in anticipation of stress, and reduce the adverse consequences of those circumstances - including the possibility of bank failure and its wider and potentially severe costs in financial system stability and economic performance.

The cornerstone of effective risk management by banks is capital. Consequently, capital adequacy is at the core of prudential regulation, not just for the Reserve Bank but banking supervisors worldwide. We, along with our peer supervisors, are currently engaged in the implementation in New Zealand of the new international framework for bank capital adequacy, otherwise known as Basel II.[1]

Individual banks need to hold adequate levels of capital so that they can absorb unexpected losses, so that their shareholders have a sufficient stake in the business to care about its ongoing viability, and so that they have a sound platform for medium-term growth and innovation. From the point of view of the banking and financial system as a whole, adequate capital is essential for the system to be able to withstand the stresses that arise from the ups and downs of the economy, including extreme stresses - such as the failure of one or more financial institutions - that may be associated with large and widespread unexpected losses.

Basel II brings together improvements in the regulation of bank capital distilled from many years of experience under Basel I, the first international Accord on capital adequacy agreed by the G10

[1] The Basel II framework has been promoted internationally by the Basel Committee on Banking Supervision (BCBS), a committee of senior banking supervisors from the G10 countries. See "Basel II: A New Capital Framework", Reserve Bank of New Zealand Bulletin, September 2005, Vol 68 No 3, for an introduction to Basel II and the Reserve Bank's approach to implementing it.

countries in 1988. Basel II also takes account of advances in the measurement of risk, and a widespread and lengthy development and public consultation process since 1998. Basel I set in place two basic principles about capital regulation that continue to be relevant today: that banks should hold capital of a certain quality and above certain levels at all times, and that those levels should take account of the risks banks face. The major innovations in Basel II are that a bank's minimum capital requirements should be better aligned to the risks that the bank is taking, and that supervisors should allow banks optionally to use their own internal statistical models and processes to calculate their minimum capital requirements - provided that the internal models and processes meet certain minimum quality requirements.

Basel II explicitly does *not* seek to change settings for the minimum level of capital in the banking system overall - only to make the minimum level for an individual bank more sensitive to the risk of unexpected loss faced by that bank. At this stage, I know of no supervisor who thinks there should be large reductions in bank capital in their jurisdiction upon the introduction of Basel II. Indeed, concerns that Basel II might lead to stability-threatening reductions in bank capital have led supervisors worldwide to scrutinise very carefully the quantitative calibration of the Basel II, and to put in place arrangements for a cautious transition from Basel I to Basel II. In New Zealand, the question of whether our requirements for the overall minimum level and quality of bank capital should be higher or lower is an ongoing workstream for us, quite aside from Basel II and considerations of risk sensitivity.

Regulatory capital requirements for banks incorporated in New Zealand will be calculated under Basel II from January 2008. In New Zealand, banks will not be required to use internal models approaches, and those that do not will use "standardised" approaches, which link minimum capital requirements to external measures of risk.

Banks applying to be "accredited" to use internal models to calculate minimum capital requirements will need to submit their applications to the Reserve Bank by July this year. Information requirements for accreditation submissions have been disseminated. Among other things, the requirements ask banks to support their applications with reference to loss data relevant to New Zealand risk circumstances wherever possible, to support any case made that the internal models are appropriate for use in New Zealand.

A key focus for the Reserve Bank in assessing accreditation applications will be on how a bank's proposed internal models approach addresses the bank's credit risk exposure to losses on housing loans. This focus reflects that housing loans make up the largest part of banks' exposures in New Zealand. New Zealand banks are, through the extension of housing loans, potentially vulnerable to fluctuations in household income, interest rates, and the level of household debt. With the economy's strong performance over recent years, there has not been stress due to these factors on the ability of households to service their mortgages, hence the experience of default on housing loans has been minimal. However, as noted earlier, the focus of capital adequacy is not on favourable or benign economic conditions, or on the "expected" losses that occur as a normal part of banking business - those matters should be addressed through provisioning. Rather, the focus is on unexpected loss associated with severe downturns in the economy's performance. "Stress testing" for such scenarios is required under Basel II, and the scenarios need to account fully for the behaviour of systematic risk. For example, stress scenarios should address the risk of a downturn leading borrowers' risks to correlate more closely, undermining the diversification strategies rightfully adopted by banks to manage risk in normal times.

Experience shows that downturns in the housing market do happen and can cause significant losses to banks and to the financial system as a whole when they do. The Reserve Bank will be working to ensure that any internal models used by an accredited bank produce capital estimates that are based on "through the cycle" loss experience - that is, after adjustment for the peaks and troughs in observed losses that occur over the business cycle in New Zealand.

Notwithstanding this emphasis on through-the-cycle loss experience for the purposes of internal modelling, it will also be important to ensure that capital management processes *in practice* deliver fairly stable capital outcomes through the business cycle. For example, a failure to adjust fully for the business cycle when incorporating loss experience into modelling processes could lead to capital falling during upturns in the cycle and rising during downturns, which would exacerbate the cycle through promoting lending growth during upturns and lending contraction during downturns. Capital settings should be for the long haul, and need to be robust over many business cycles and through a range of economic circumstances. An important outcome we will be seeking from our Basel II implementation is that the capital management processes within banks (both those using internal models and those using standardised approaches) ensure that adequate "buffer" capital is always held in anticipation of any need to manage any residual "procyclicality" in the outputs of internal modelling processes.

As well as making minimum capital requirements more risk-sensitive, Basel II also includes the principle of sharpening the focus of engagement between supervisors and banks on ensuring that a bank's capital management process adequately accounts for the risk of unexpected loss. The quality of this process and the manner in which the outputs from internal models are used within the bank's governance and risk management more generally will be a key part of the assessment for a bank wishing to be accredited to use the internal models approaches. The bank will need to satisfy the Reserve Bank both that its internal models and processes are of adequate quality, and that the use of internal models is incorporated into the bank's risk management framework with appropriate knowledge and oversight, to be accredited.

Our programme of engagement with banks on Basel II is well underway, focusing in particular on the banks intending to apply to use the internal models approaches, because of all the reasons set out earlier. Such banks are themselves devoting a large amount of resources to their applications, and to planning for the use of the internal models approaches, should they be accredited to do so. These large resources devoted to Basel II implementation, as well as the significance of the banks applying to use the internal models approaches, both reflect and underscore the need to get it right.

This should not be taken to mean that we are leaving aside those banks that expect to be on the standardised approaches. As well as working on the internal models approaches, we are also well underway with proposals for the implementation of the standardised approaches and will be enter into discussions with the industry on these also over this year and next. In this part of the work, a key outcome we will seek is the preservation of competitive neutrality between banks using internal models and those using standardised approaches.

Because most banks in New Zealand are parts of international banking groups, we will be communicating and coordinating the New Zealand implementation closely with relevant foreign supervisors. Also, it is only natural that banks owned by foreign parent banks should seek to base any internal models for New Zealand capital on models developed within their parent banks. However, where this is the approach taken, the New Zealand banks will still need to satisfy the Reserve Bank that those models are appropriate for New Zealand circumstances.

In our coordination with foreign supervisors, engagement with the Australian Prudential Regulation Authority (APRA) will clearly be particularly important, because of the significant place in New Zealand's banking system of banks (including the four major banks) owned by Australian parent banks. Already, we and APRA have put in place Terms of Engagement to ensure that communication flows well between us. For banks with operations in both New Zealand and Australia, under the Terms of Engagement we will work with APRA to ensure that in meeting our responsibilities to set capital requirements for the New Zealand subsidiaries, we will keep compliance costs to the minimum necessary, consistent with New Zealand capital requirements being tuned to New Zealand conditions. We will do this by making use of APRA's and the Reserve Bank's comparative advantages and knowledge bases, by seeking to optimise the use of overall supervisory resources, and by sharing any assessments and other information needed.

What is the Reserve Bank trying to achieve with Basel II overall? Observance of the principles I noted earlier on, of greater risk-sensitivity in capital requirements and of the need for levels of bank capital to be held stably and sustainably at sufficient levels to account for unexpected loss, should I hope not be remarkable. What is more the focus of our implementation work at the next level down, particularly for the banks seeking to use the internal models approaches, is to ensure that the more intensive supervisory attention is paid to the accuracy with which those banks' internal models capture and appropriately account for the particular characteristics of the New Zealand economy and financial system.

I do not want to leave you with the impression that Basel II is all we are doing on the front of improving financial regulation. To come back to the themes I introduced at the outset, although our Basel II implementation effort is a major one, we are in addition pursuing a range of other initiatives and completing work on earlier projects directed towards enhancing the soundness and efficiency of the New Zealand financial system. These projects include the implementation of the outsourcing and local incorporation policies for large banks, both of which were finalised recently. Also, the Reserve Bank is working with other agencies to advance the legislative changes proposed by the Trans-Tasman Council on Banking Supervision, which New Zealand Minister of Finance Michael Cullen and

Australian Treasurer Peter Costello recently agreed to promote. We are actively working with other New Zealand regulatory agencies to develop reforms to the regulation and supervision of the non-bank financial sector, and with the industry to improve the resilience of the payment and settlement system. And we are working with the banking industry and others to establish an appropriate state of readiness in New Zealand for a pandemic.

I hope this brief rundown of one important aspect of the Reserve Bank's regulatory activity as it affects banks gives you a flavour of the approach we are taking, and why. The Reserve Bank will work to ensure that the implementation of Basel II in New Zealand, among our other regulatory activities, fits well with and supports the Reserve Bank's primary function of maintaining price stability through monetary policy - and the benefits in economic stability that that provides. Financial stability and economic stability are strongly connected - and this is why we believe that our roles as prudential regulator and as central bank in New Zealand are strongly complementary.