Donald T Brash: Promoting financial stability: the New Zealand approach

Address by Dr Donald T Brash, Governor of the Reserve Bank of New Zealand, to the Conference for Commonwealth Central Banks on Corporate Governance for the Banking Sector, London, 6 June 2001.

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Introduction

It is a great pleasure to have the opportunity to speak to you today.

The theme of this conference – Corporate Governance in the Banking Sector – is a subject that has been an important element in the Commonwealth Secretariat's financial sector work in recent years. It has also been a notable feature of other international initiatives, including those of the International Monetary Fund and World Bank, in their efforts to address the causes of financial crises and to promote greater financial stability. Appropriately, improving corporate governance is seen as a significant way of encouraging banks to strengthen their capacity to manage risks. And it has rightly been viewed as an important element in the management of central banks.

Today, I want to discuss the role that corporate governance plays in the New Zealand banking supervision framework and to relate this to the importance we attach to strengthening market discipline in the financial system. But before doing this, let me briefly recap the main points made in the report issued by the Commonwealth Secretariat last year on the causes of financial instability and the policies for promoting stable financial systems. This provides a useful context within which to discuss the New Zealand approach to financial sector regulation.

Causes of financial instability

As indicated in the Commonwealth Secretariat's paper *Corporate Governance in the Financial Sector*, financial instability is caused by a combination of factors. These include:

- rapid financial sector liberalisation unsupported by measures to encourage prudent risk management in the financial sector;
- unsustainable macroeconomic policies, such as loose monetary policy and excessive fiscal spending – such policies can contribute to asset price volatility and a subsequent erosion of asset quality in the financial system;
- exchange rate arrangements that lack credibility, including unsustainable exchange rate pegs – this is particularly important where financial institutions and corporations have come to rely on an exchange rate peg, and fail to hedge their currency risk, only to sustain currency losses when the peg collapses;
- protection against imports and other policies that impede the efficient allocation of resources in the economy;
- poor banking supervision;
- inadequate financial disclosure arrangements, including poor quality accounting and auditing standards; and
- weak market disciplines in the banking and corporate sectors, reducing the incentives for high quality risk management by banks.

Policies for promoting stable financial systems

The broad range of factors that can contribute to financial crises suggests the need for an equally broad set of policy responses. Of course, the particular policies will vary from country to country, depending on a country's stage of development, the nature of its economy and the structure of its financial system. There is no single "right" policy prescription. Each country must develop policies that suit its own particular circumstances. However, at a general level, it can safely be said that the following types of policies will be needed in order to promote financial stability:

- sound, sustainable and credible macroeconomic policies, including a monetary policy aimed at promoting price stability;
- microeconomic policies that minimise distortions to relative prices and that encourage efficient allocation of resources;
- exchange rate policy that is seen as credible by all market participants, that facilitates macroeconomic adjustment and that builds in incentives for financial institutions to hedge against currency risk;
- an effective legal and judicial system, facilitating the enforcement of legal contracts;
- policies to encourage banks to manage their risks prudently, including corporate governance and financial disclosure;
- policies to encourage effective market disciplines in the financial sector, thereby strengthening the incentives for banks to manage their risks prudently;
- policies to promote robust payment systems and minimise inter-bank contagion, such as netting arrangements, real time gross settlement and failure-to-settle structures within the payment system; and
- effective and well-enforced banking supervision arrangements.

It would be tempting to discuss each of these policy areas, given their importance to the promotion of sound and efficient financial systems. But we would need a great deal longer than one day to do justice to such a broad range of complicated policy issues. Instead, I want to focus on the main theme of this conference – corporate governance in the financial sector.

Corporate governance in the financial sector

As noted in the Commonwealth Secretariat's report, improving corporate governance is an important way to promote financial stability. The effectiveness of a bank's internal governance arrangements has a very substantial effect on the ability of a bank to identify, monitor and control its risks. Although banking crises are caused by many factors, some of which are beyond the control of bank management, almost every bank failure is at least partially the result of poor risk management within the bank itself. And poor risk management is ultimately a failure of internal governance.

Although banking supervision and the regulation of banks' risk positions can go some way towards countering the effects of poor governance, supervision by some external official agency is not a substitute for sound corporate governance practices. Ultimately, banking system risks are most likely to be reduced to acceptable levels by fostering sound risk management practices within individual banks. Instilling sound corporate governance practices within banks is a crucial element of achieving this.

As the Commonwealth Secretariat's report notes, there are a number of ways in which corporate governance in the financial sector can be strengthened. These include:

- having a well designed and enforced company law;
- having codes of principles developed by professional or industry associations, setting out desired attributes of corporate governance, and associated educational and consciousness-raising initiatives;
- maintaining high quality disclosure requirements for banks and other companies, based on robust accounting and auditing standards;
- adopting measures to strengthen market disciplines in the banking sector, including by promoting a contestable and competitive banking system and seeking to ensure that bank creditors are not fully insulated from loss in a bank failure;
- effective banking supervision arrangements, with particular emphasis on policies that encourage sound governance and risk management practices; and
- leadership by example, including the adoption of sound governance, accountability and transparency practices by central banks and regulatory agencies.

New Zealand's approach to financial stability

Against this background, let me briefly summarise the New Zealand approach to promoting financial stability. This has three main strands:

- promoting self discipline by banks in the management of their risks;
- fostering effective market discipline on the banking system; and
- supervising banks for the purpose of promoting financial stability, but seeking to avoid supervisory practices that might erode market discipline and weaken the incentives for bank directors to take ultimate responsibility for the management of risks.

Let me elaborate on each of these in turn.

Banks' self discipline in managing risks

Banking supervision in New Zealand places considerable emphasis on encouraging banks' self discipline in managing risks, primarily by reinforcing the role of bank directors in taking ultimate responsibility for the stewardship of their banks. Since the mid 1990s, when a new public disclosure framework was introduced for banks, a key mechanism for encouraging banks to manage risks prudently has been the need for banks to issue public disclosure statements each quarter.

The disclosure statements are in two forms: a brief Key Information Summary, which is aimed at the ordinary depositor; and a more comprehensive General Disclosure Statement, which is aimed principally at the professional analyst.

The Key Information Summary contains a short summary of information on the bank, including:

- the bank's credit rating;
- the bank's capital ratio, measured using the Basel framework; and
- information on exposure concentration, exposures to connected parties, asset quality and profitability.

The Key Information Summary must be displayed prominently in, and be available on demand from, every bank branch.

The General Disclosure Statement contains wider-ranging and much more detailed information on the bank and its banking group, including:

- comprehensive financial statements;
- credit rating information;
- detailed information on capital adequacy, asset quality and various risk exposures; and
- information on the bank's exposure to market risk.

One of the most important features of this disclosure framework is the role it accords bank directors. Each director is required to sign and make certain attestations in the disclosure statements, including:

- whether the bank is complying with the prudential requirements imposed on it by the Reserve Bank;
- whether the bank has systems in place to adequately monitor and control its banking risks and whether those systems are being properly applied;
- whether the bank's exposure to connected parties is contrary to the interests of the bank; and
- whether the disclosure statement contains all the required disclosures and is not false or misleading.

Directors face potentially severe criminal penalties and civil liability where a disclosure statement is held to be false or misleading.

Complementing the disclosure requirements, banks incorporated in New Zealand are required to have a minimum of two independent directors (who must also be independent of any parent company) and a non-executive chairman. These requirements are intended to increase the board's capacity to scrutinise the performance of the management team. In addition, independent directors provide some assurance that the bank's dealings with its parent or other related parties are not in conflict with the interests of the bank in New Zealand.

The disclosure requirements have increased the accountability of bank directors and, indirectly, the accountability of various levels of management within the banks. As a result of the disclosure arrangements, we have seen directors taking greater care than might otherwise have been the case to ensure that they are adequately discharging their obligations. In so doing, directors have strong incentives to ensure that there are appropriate accountability mechanisms within the management hierarchy.