Vigilance and reinvigoration

The New Zealand economy has experienced a very good period of growth over the last ten or so years, averaging 3.4 per cent GDP growth per annum. In the last five years, with growth averaging 3.8 per cent per annum, New Zealand has been one of the fastest growing economies in the OECD even ahead of Australia. New Zealand's unemployment rate is now at a multi year low of 3.6 per cent.

The banking sector has played a significant role in this economic growth, being the main intermediator of peoples' savings into investment and gateway for foreign investment funds. At around 74 per cent, banks account for the lion's share of financial system assets in New Zealand. In comparison, banks account for about 50 per cent of financial system assets in Australia.

Bank balance sheet growth has been exceptional for several years, dominated by lending to households. What is pleasing to date is that the soundness of the banking sector has also remained intact. Banks are experiencing a period of very low loan default and strong profitability.

However, it should never be forgotten that despite our impressive growth, New Zealand remains a small, open, and indebted economy. We have also been benefiting from a strong terms of trade upswing, and a structural rise in households' debt appetite, neither of which will be sustained forever.

The potential vulnerabilities of our economy are reflected in the banking sector. Over half of New Zealand's foreign borrowings are sitting on banks' balance sheets, with New Zealand's private sector relative indebtedness the highest in the OECD. What's more, our banking sector displays amongst the highest levels of foreign ownership in the world - foreign banks own 98 per cent of New Zealand banking system assets, with 85 per cent being Australian-owned.

Despite the benefits that foreign ownership and capital bring, these features mean that any banking crisis New Zealand faces is as likely to be caused by external influences as it is internal. The New Zealand financial system is vulnerable to shocks within the banking system (such as the mismanagement of a local bank), outside of the banking system (such as a wider economic threat), as well as shocks in other countries, especially Australia, that may be transmitted through our banking system. The serious mismanagement of an Australian bank, or a major shock to the Australian economy, could have serious negative repercussions for the New Zealand banking sector and financial system.

It is awareness of these potential vulnerabilities that motivates the RBNZ's vigilance, and that has led to a particular focus over the last couple of years in assessing and reinvigorating how we go about regulating and supervising banks, as well as driving trans-Tasman policy harmonisation.

The RBNZ's responsibility to supervise banks in New Zealand is prescribed in the Reserve Bank of New Zealand Act. This Act requires us to use the powers it gives to the Bank 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 RBNZ has taken a three pillars approach, based on a regulatory culture of self, market and regulatory discipline. This approach places risk management largely in the hands of those closest to it, and lays responsibility for outcomes with boards of directors, management, and creditors - that is, those who have the most to lose from a mismanaged bank.

The first pillar is self-regulation. This is all about the policies and structures that promote effective governance by banks' boards of directors, including effective oversight by local boards of the local banks' managements. We expect high standards of corporate governance from the boards of New Zealand banks, and this expectation is reinforced by some quite severe penalties that could apply

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1 According to IIP data as at September 2004.
should a bank’s directors fail to properly discharge their responsibilities. In the wake of the Enron-type corporate governance scandals and subsequent numerous reviews, the importance of good self-regulation has gained a lot more recognition recently with the passing of such legislation as the Sarbanes Oxley Act. In its Basel II recommendations, the Basel committee has also put a lot more weight on the importance of good self-regulation for ensuring bank stability than it did previously.

The second pillar is market discipline. For many years, banks in New Zealand have been subject to obligations to make quite comprehensive quarterly financial and prudential disclosures to the marketplace. These disclosures, combined with a policy of not bailing out failed institutions, help to strengthen market scrutiny of banks, and the market disciplines that go with that.

The third pillar consists of our regulatory and supervisory requirements. Although our regulatory framework is somewhat less intrusive than that of many countries, it nonetheless contains most of the standard features, the centre-piece of which is the requirement that banks in New Zealand be adequately capitalised.

In its Financial Sector Assessment Programme (FSAP) review of the New Zealand financial system last year, the IMF confirmed that we have a good model for host country supervision.

Fulfilling the second element of our statutory responsibilities - to avoid significant damage to the financial system that could be caused by the failure of a registered bank - requires the Reserve Bank to have a crisis management strategy. That is, we must be ready with a range of tools and options that would enable us to step in should a bank get into serious difficulties.

What has reinvigoration involved?
The Bank has been reassessing and testing each of the pillars described above, and at the same time putting a lot of effort into developing its crisis management capabilities.

Maintaining and encouraging soundness and efficiency

We strengthened the first pillar of self discipline, in the middle of last year, by implementing a policy of “fit and proper” review of appointees to positions as senior managers or directors of registered banks. Recruitment into these positions is still the sole responsibility of the banks’ respective boards. The “fit and proper” policy simply means that the Reserve Bank seeks a “negative assurance” when appointments to senior management or boards are made. In no way does this relieve boards of their responsibilities.

Our outsourcing and local incorporation policies also reinforce that a bank’s board must act in the interest of the New Zealand bank. The use of parent-bank systems, tools and techniques is of course permitted, but only with the full understanding and ownership of the local bank and board. The local bank board is responsible and accountable for all aspects of bank operations

Some minor changes to the second pillar will take place at the end of March when several amendments to our disclosure requirements come into force. The amendments will facilitate banks’ adoption of international financial reporting standards and make a number of other changes relating to earlier changes to banking supervision policy and the disclosure regime.

Basel II capital requirements have led to us reassessing aspects of the third pillar. We have decided to increase our emphasis on harmonisation with APRA when implementing the capital requirements of Basel II. Banks operating in New Zealand, and meeting certain criteria, will have the option to use the Internal Ratings Based and Advanced Measurement Approaches to calculating regulatory capital.

The Reserve Bank is also developing a framework that will help it understand in more detail how banks are fulfilling their regulatory and supervisory requirements. Section 95 of the RBNZ Act gives the Reserve Bank the power to require a bank to provide us with a report by a Reserve Bank-approved, independent person. These reviews, the cost of which will be met by the banks themselves, are likely to investigate such issues as risk management, operational systems, and the nature of outsourcing. We have already exercised our section 95 powers in relation to one bank’s outsourcing arrangements.
Crisis management

It is very important that, when dealing with a troubled bank, the New Zealand authorities should have a range of options available that can prevent a wider systemic crisis. These can range from the power to give directions, through statutory management, through to liquidation or a full-blown rescue. To exercise any of these options, it is essential that the bank in question have the records, people and systems it needs to operate on a stand-alone basis - that is, it must be a bank, not a shell of a bank.

We are putting a considerable amount of effort into securing our ability to manage a crisis, both by developing the Reserve Bank’s crisis management capabilities, and by ensuring that there exists the legal and practical ability to continue to operate a failed bank via our local incorporation and outsourcing policies.

Simply stated, our local incorporation and outsourcing policies require that systemically-important banks in New Zealand be incorporated locally, and that they maintain the capacity to function on a stand-alone basis, if required. Without that capacity, there is a material risk of the banking system becoming dysfunctional in a banking crisis. The measures we are introducing to counter that risk have recently been affirmed by Standard and Poor’s, who noted that they “could well enhance the strength of the New Zealand banking sector and its ability to withstand a period of financial stress”.

Outsourcing is a reality in today’s world, where national borders are permeable and the business environment highly specialised. However, where systemically important banks are concerned, the Reserve Bank needs to be satisfied that any outsourcing undertaken does not compromise their legal, operational, or financial ability to meet their obligations. Although it has not been an issue to date, outsourcing could well become more of an issue for Australia over the next few years.

In November last year we released a paper for consultation, setting out the RBNZ’s proposed outsourcing policy. We had already established principles for our proposed outsourcing policy and applied those to ANZ National Bank upon approval of its merger. The consultation paper formalised these principles and set out a policy framework for application to all systemic banks and some other categories of banks. Submissions on the discussion paper closed at the end of February and bank staff are currently working their way through those submissions.

The outsourcing policy is very much outcomes-focussed, so individual banks can tailor a solution that best suits their situation and needs, while meeting our requirements. In this way costs can be minimised and a level playing field maintained. We intend to work closely with banks as they go about implementing the policy.

There is no doubt that banks will incur some operational costs due to the outsourcing policy. However, we think these costs will be small and manageable, especially relative to Australian banks’ annual gross revenue, profits, and the potential costs of a bank failure, despite the claims in the media to the contrary.

Much of the public debate around the outsourcing policy has focussed on direct operational costs and thus the relatively small loss in productive efficiency that may occur. However, there are other aspects to efficiency to consider also, including allocative and dynamic responses. For example, our outsourcing policy could lead to better capital allocation due to more local decision making capacity, as well as systems that are more flexible and responsive to local needs. These aspects are especially important for the growth of small to medium size enterprises that dominate the New Zealand business landscape. Such benefits could accrue to bank shareholders and customers, as well as the wider New Zealand economy.

At the heart of the Reserve Bank’s crisis management work is the development of a crisis management toolkit that will provide tools, policies and procedures to guide the high-stakes decisions supervisors would have to make under very tight time frames.

Crisis management can be thought of as having two phases. Phase one is the very short period, perhaps a day or two, immediately following the discovery that a bank is in severe distress. It involves decisions around whether and how to get the bank solvent and operating again. Phase two is the potentially lengthy subsequent period, during which it must be decided what to do with the bank over

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the long term. It involves decisions around the bank's value and long term ownership. It is important to have options for the initial phase that avoid destroying future economic value or squandering tax-payer money, or that ultimately reduce the options in phase two.

Perhaps the most original of the tools we have been exploring for phase one is Bank Creditor Recapitalisation or BCR, which could enable the Reserve Bank to respond to a bank failure in a way that avoided or minimised costs to the taxpayer, while still maintaining systemic stability. Essentially, it involves applying a "haircut" to depositors and other creditors to recapitalise the bank, and then quickly making available to depositors the non-haircut portion of their deposits.

BCR addresses some of the same issues as deposit insurance, which is currently receiving attention in Australia, in that it quickly restores liquidity for depositors. However, with BCR the costs of imprudent risk management and monitoring are borne by depositors, management and shareholders, thus reinforcing the market and self-discipline that underpins our regulatory culture.

Much has been done to advance this project, including pilot testing of some IT prepositioning at one of the major banks. We are confident that, from an IT technical perspective, a BCR approach is likely to be feasible. However, substantial work remains to be done and no decision has yet been taken to formally adopt it as a crisis management tool.

Regarding the bank `work out' phase, we are developing our thinking on other failure management options, such as good bank/bad bank split, partial sale of failed banks' assets and liabilities, government bail-out, and industry support. Although these are well known, almost garden variety, options for dealing with a bank failure, putting in place the decision-making frameworks, policies and procedures that will facilitate effective, low cost management of a bank crisis is a big job.

**The trans-Tasman dimension**

As I made mention of at the beginning, New Zealand is very dependent on foreign capital, and the bulk of this foreign capital is intermediated through a predominantly Australian-owned banking sector. This industry and geographic concentration of foreign ownership in one country makes the New Zealand banking sector quite unique.

As you will be aware, home and host countries undertake their banking supervision roles and responsibilities within the framework of home-host supervision set out in the Basel Concordat. The Concordat emphasises the general responsibility of home country authorities to supervise banks' worldwide consolidated activities, as well as the host country responsibility to supervise foreign bank establishments in their territories as individual institutions.

Our emphasis on market and self discipline and our less prescriptive regulation has led to New Zealand's supervisory and regulatory activity neatly complementing that of APRA and the other home supervisors with whom we share banks. In fact, we feel that New Zealand leads the world in home/host dovetailing from the host viewpoint within the very general framework provided by the Basel concordat.

When it is done well, both home and host supervisors can benefit in obvious ways from each other's supervision. In New Zealand, we openly acknowledge the benefit that our financial system derives from the role played by APRA, and the other home-country regulators. However, we are also keenly aware that the interests of home and host supervisors can and do diverge, and that these divergences lead to differences in the style and substance of supervision and regulation. Moreover, these differences are likely to manifest themselves most sharply in the very pressured circumstances that a distressed bank brings. Such differences include:

- Different statutory objectives. For example some supervisors have depositor protection as their main objective, while others have soundness and stability.
- How capital should be allocated. Each supervisory authority would like to see as much capital reside within its own jurisdiction as possible.
- How risk should be allocated. Each supervisory authority would prefer that the risk resides outside its own system.
- Each supervisory authority is only responsible for financial stability in its own system. The effects on the financial systems of other jurisdictions of any actions taken to manage a bank failure in one's own jurisdiction are likely to be considered second order.
Different views on appropriate techniques for responding to bank stress.
Different perceptions of when a crisis is systemic – a particular risk when the subsidiary plays a much larger role in the host system than the parent plays in the home system.
Each system may also be subject to different destabilising influences.

These differences are not straightforward to resolve when there is a largely bilateral relationship between home and host countries, of the kind faced by New Zealand. For these reasons, and in the absence of any fair and formalised, operationally and legally robust, international framework, a host authority would not purely rely on the home authority to protect the host financial system. All supervisors’ actions are ultimately bounded by the legislation under which they operate. And in the midst of a crisis situation there is no room to negotiate legal boundaries.

That said, we also recognise that the most effective response to a cross-border crisis would desirably involve very close cooperation and coordination between the home and host authorities. To this end the RBNZ has been active in pursuing closer cooperation with APRA. We have had for some time Memoranda of Understanding with APRA and the Financial Services Authority in the UK that allow for the sharing of supervisory information. However, a number of other cooperative measures have been undertaken recently:

- We have initiated a secondment strategy of senior staff members between APRA and the Bank. We believe that we can learn from one another.
- We have established a terms of engagement with APRA so that we can dovetail our Basel II implementation initiatives.
- We are assessing all of our requirements of banks under the Basel Core Principles (BCP) so as to best ensure we have a single set of regulatory ‘rules’ where possible and sensible.
- We have agreed to share visits to Australian-owned banks on either side of the Tasman with APRA staff.

The RBNZ has agreed with APRA a Terms of Engagement for Basel II implementation. The Terms of Engagement sets out the RBNZ’s and APRA’s intent to implement Basel II in such a way that each supervisor’s right to set its own minimum levels of capital is maintained, while at the same time seeking to reduce compliance costs where possible. It also requires that the RBNZ and APRA will conduct supervisory reviews of banks operating in both jurisdictions in a way that makes use of each supervisor’s comparative advantage. This will involve joint sharing of information on, and recognition of, supervisory tools used and reviews undertaken.

In February, New Zealand's Minister of Finance and the Australian Treasurer announced the formation of a Trans-Tasman Council on Banking Supervision to consist of the respective Reserve Banks and Treasuries, and APRA. This council will be represented at the highest level within the member institutions. Its main role will be the monitoring and coordinating of trans-Tasman home-host regulatory issues.

The council is not based on statute. Rather its role is that of monitoring and advice, with reporting duties to the relevant Ministers. A key goal for the Council is to promote the maximum coordination, cooperation and harmonisation of trans-Tasman bank regulation where sensible, so as to best minimise compliance costs.

Preliminary work is underway at the moment for the first meeting of the council, which is scheduled to happen soon. The first key output of the Council is to report to Ministers in late May on any legislative changes that may be required to ensure APRA and RBNZ can support each other in the performance of their current regulatory responsibilities at least regulatory cost.

There are other significant early gains that could be made for the Council over the coming year. For example, we anticipate good progress on the home-host coordinated implementation of Basel II that I outlined in the Terms of Engagement earlier. We also think good progress can be made on gaining a clearer understanding of trans-Tasman bank failure management strategies and coordination.

We look forward to building the trans-Tasman regulatory community based on the principles of cooperation and harmonisation. But, we will also work diligently to continue developing the capacity to preserve New Zealand's systemic financial interests.
**Conclusion**

Overall, the strong presence of foreign banks has brought many benefits to New Zealand in terms of soundness and efficiency. It has enhanced risk management capacity within the banking system, facilitated the entry of new banking products and services, and reduced the financial system’s vulnerability to domestic economic shocks. However, along with the many benefits it brings, having an open, foreign-owned banking system also increases the chances of our financial system being adversely impacted by off-shore developments.

The Reserve Bank of New Zealand is developing and maintaining the ability to deal with troubled banks in a way that is fiscally responsible, and that causes minimal disruption to real activity.

We are also actively engaging with our trans-Tasman counterparts, and are optimistic about the opportunities the trans-Tasman Council and further harmonisation might offer.