

## **Mr Brash gives an address on the development of international standards**

Opening address given by Dr Donald T Brash, Governor of the Reserve Bank of New Zealand, to the SEANZA Forum of Banking Supervisors' conference, held in Auckland on 11 November 1999.

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It's a great pleasure to welcome you all to New Zealand and to the SEANZA Forum of Banking Supervisors' Conference.

I would especially like to welcome our guest speakers: William Coen from the Basel Committee Secretariat, Roland Raskopf from the Financial Stability Institute, and Clive Briault from the Financial Services Authority. We very much appreciate their giving up valuable time to be with us, particularly given the long distances they have had to travel to get here. I am sure that they will make a very valuable contribution to our discussions over the next two days.

I would also like to extend a special welcome to the delegate from Macau. In the past, Macau has been an observer at these conferences. However, since the last meeting of the Forum it has become a full member of SEANZA.

As some of you will know, the SEANZA Group has a long history. It originally grew out of a 1956 meeting of central bank governors from British Commonwealth countries in the Asia Pacific region. The governors decided that the central banks in the region should pool their resources to provide an intensive and systematic training course for promising central bank staff. The first such course was held in Australia in 1957. These courses continue to be held once every two years. The last course was held in New Zealand last year, while the next one will be held next year in Sri Lanka.

The SEANZA Forum of Banking Supervisors was established in 1984 as an offshoot of the main SEANZA group. The objective was to provide a means for banking supervisors from the region to establish contact with each other, in order to exchange information on issues and problems of common interest. Initially only central banks were represented at the Forum. More recently, special purpose regulatory bodies like the Korean Financial Supervisory Service and APRA in Australia have joined.

Since SEANZA was first established, the number of countries in the SEANZA group has gradually expanded, to the extent that each country now gets the opportunity to host these conferences only once every 40 years. That probably means I won't get the chance to give the opening address at one of these conferences again, and that none of us here today will attend the next New Zealand conference! No doubt the issues under discussion at that conference will be quite a bit different from those being considered here, and the financial system will look radically different from the way it does today.

Already we are seeing rapid change in the financial sector. Over recent years, advances in computer and communications technology, and financial market liberalisation, have led to increasing globalisation of financial markets. At the same time, banks are under pressure to keep their costs down. As a result, many banks that operate in a number of different countries are choosing to centralise activities in one regional centre rather than duplicate services in each country. We are particularly aware of this trend in New Zealand as all of our banks except one are foreign owned. We are increasingly finding that these banks are using computer systems located in another country, or that parts of their New Zealand business are not in fact being conducted here at all. For example, a phone call to a bank's treasury may be answered by someone located in Sydney rather than in Wellington or Auckland. Or we find that particular types of transactions entered into with New Zealand-based customers are being booked through another jurisdiction and do not appear on the New Zealand balance sheet.

These trends make it more important than ever for supervisors in the region to get together and talk about matters of common interest, both in groups like this and on a one-to-one basis.

At the same time, boundaries between different types of financial institution are becoming increasingly blurred. Financial conglomerates offering a wide range of financial services are becoming increasingly common.

These developments are reflected in the three main themes of this conference: international standards, supervisory structures (and by that I mean the question of whether supervision is best conducted through a so-called “mega regulator” or through more traditional, functionally-based, supervisory structures), and the supervision of conglomerates. These are all very important and topical issues.

I would like to talk a little about one of these themes – the development of international standards. There are two main points I would like to make. First, while there is a definite role for international standards, it is very important that they are implemented in a way that takes into account the individual circumstances of each country. Secondly, it is possible to have too much of a good thing in this area. We will not necessarily be able to achieve our overall objective – a sound and efficient financial system – by adding further layers of complexity to our supervisory rule books. In fact we may weaken rather than strengthen the financial infrastructure if we go down this route.

The Basel Committee on Banking Supervision has been instrumental in producing a number of important international standards on the supervision of banks, including the Capital Accord and minimum standards governing the supervision of banks’ cross-border establishments. Similarly, other supervisors such as IOSCO and the International Association of Insurance Supervisors have pursued co-operation in their areas of responsibility. And in the early 1990s, in recognition of the emergence and growth of financial conglomerates, banking, securities and insurance supervisors from G10 countries began to work together to identify the problems that conglomerates can cause, and to consider ways to overcome them.

The Mexican crisis in 1995, in particular, and the widespread incidence and high cost of banking problems recently in this region have prompted calls for concerted international action to promote the soundness of financial systems. These calls have strengthened over the last couple of years, with the G7 countries calling for the adoption of strong prudential standards in emerging countries and encouraging the international financial institutions to increase their efforts to promote effective supervisory structures in those countries. The Basel Committee has been at the forefront of this effort with the release of the Core Principles. The IMF and the World Bank are also involved. The IMF is making evaluation of financial supervision and regulation part of its annual country reviews, and the World Bank is emphasising the strengthening of financial infrastructure as an important part of its structural assistance programmes.

These initiatives have many positive aspects. International harmonisation and co-operation are very important in what is rapidly becoming a “borderless” global financial system. Also, it is important that the risks that supervisors should take into account in their supervision are identified, and that benchmarks are established whereby countries can measure their progress in establishing appropriate supervisory regimes. As supervisors, we can derive a great deal of benefit from such an approach. Bank customers and banks themselves also benefit from the international comparability made possible by the use of common measurement and disclosure frameworks.

Nevertheless, I believe it is important not to assume that supervisory arrangements should be, or can be, the same in every country. In my view, they must be tailored to the individual circumstances of each country. What is appropriate for a small country like New Zealand may be totally inappropriate for a large country like the United States, and vice versa. To give just one example, non-bank financial institutions need not be licensed or supervised in order to take deposits in New Zealand. Here that does not cause any problems because the non-bank sector is tiny relative to the bank sector, and people are generally aware of the differences between banks and non-banks, and of the fact that non-banks may be more risky than banks. However, I would be the first to acknowledge that such an approach would not necessarily be the best for all other countries. In many countries, retail depositors typically use non-bank financial institutions rather than banks and it may therefore be important that those institutions are licensed and supervised. Similarly, in some countries where there are perhaps thousands of licensed financial institutions and a very large population – and generous deposit insurance or a strong implicit government guarantee of bank deposits – it may well be desirable for the

supervisor to check the bona fides of bank management. In New Zealand, with its relatively small population and absence of deposit insurance, we are satisfied that the public is well able to make its own assessment of the quality of bank management and has an incentive to do so, and in these circumstances there is no need for the supervisor to take on this role. Thus, while we strongly support the introduction of international standards in principle, we would not like to see a one-size-fits-all or checklist, tick-the-boxes, approach. International standards need to be interpreted with an appropriate degree of flexibility in order to adequately cater for the individual circumstances of each country.

Further, when devising supervisory policies we need to bear in mind not only the individual circumstances of our own countries but also the need to ensure that policies harness market forces to the extent possible, rather than undermine them. As Alan Greenspan said in 1997:

“As financial transactions become increasingly rapid and complex, I believe we have no choice but to harness market forces, as best we can, to reinforce our supervisory objectives. The appeal of market-led discipline lies not only in its cost effectiveness and flexibility but also in its limited intrusiveness and its greater adaptability to changing financial environments. Measures to enhance market discipline involve providing private investors the incentives and the means to reward good bank performance and penalise poor performance. Expanded risk management disclosures by financial institutions is a significant step in this direction.”<sup>1</sup>

Indeed, Mr Greenspan made the same point again exactly one month ago, when addressing the American Bankers Association in Phoenix, Arizona. In that speech he said:

“A one-size-fits-all approach to regulation and supervision is inefficient and, frankly, untenable in a world in which banks vary dramatically in terms of size, business mix, and appetite for risk ... Policymakers must be sensitive to the tradeoffs between more detailed supervision and regulation, on the one hand, and moral hazard and the smothering of innovation and competitive response, on the other. Heavier supervision and regulation designed to reduce systemic risk would likely lead to the virtual abdication of risk evaluation by creditors of such entities, who could – in such an environment – rely almost totally on the authorities to discipline and protect the bank. The resultant reduction in market discipline would, in turn, increase the risks in the banking system, quite the opposite of what is intended ... Supervisors have little choice but to try to rely more – not less – on market discipline – augmented by more effective public disclosures – to carry an increasing share of the oversight load ... The potential for oversight through market discipline is significant, and success in this area may well reduce the need to rely on more stringent governmental supervision and regulation.”<sup>2</sup>

I am pleased that the profound truth of this view is being recognised more widely and that international standards are increasingly reflective of this. The use of banks’ own models in the measurement of market risk is one example. Increased emphasis on the role of disclosure is another. These developments recognise that, as banks’ activities become increasingly complex and change occurs with ever greater rapidity, it becomes more and more difficult to place reliance on detailed rules. Often supervisors are dealing with yesterday’s problem rather than the one that is emerging today. What we should aim to do is to harness and reinforce market disciplines to achieve the outcome we are seeking – a sound and efficient financial system. Bank directors and management have a detailed knowledge of their bank’s business. We need to make sure that this knowledge is used in the measurement and management of risk. We also need to make sure that supervision is not carried out in a way that will reduce incentives for bank customers to monitor the performance and risk profile of their bank. To the extent that supervisors ensure that these things happen, we can expect banks to operate more prudently.

As supervisors, we need to be realistic about what supervision can achieve. It is certainly clear from the record that there have been significant weaknesses in some countries’ banking systems, and that

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<sup>1</sup> Speaking at the Conference on Bank Structure and Competition hosted by the Federal Reserve Bank of Chicago, 1 May 1997.

<sup>2</sup> Speaking at the American Bankers Association conference in Phoenix, Arizona, 11 October 1999.

these weaknesses have both contributed to the emergence and severity of financial crises and complicated the task of resolving them. However, I am myself somewhat dubious about the proposition that “poor supervision” was the primary cause of these weaknesses. There has been a tendency to give supervision the blame for problems that have originated elsewhere, or to seek supervisory remedies for problems that might be better solved in other ways. I would also note that supervision can sometimes be part of the “problem” rather than part of the solution – particularly when there has been excessive regulatory forbearance and/or excessive reliance on the public safety net.

I believe that supervision should be seen as only one of the factors influencing the health of the financial system. In this regard I am pleased to note that the Basel Core Principles recognise this by identifying the preconditions for effective banking supervision, including sound and sustainable macro-economic policies, a well developed public infrastructure, and effective market disciplines. I am sure that we can all agree that all of these factors are vital to the development of a sound financial system.

In conclusion, as financial markets become increasingly globalised, supervisory co-operation and harmonisation become increasingly important. Groups such as SEANZA play an important role in achieving these objectives, as do international supervisory standards. But I believe it is important that we don’t assume that international standards are the holy grail and that their adoption will necessarily lead to a sounder financial system. Supervision is only one of a number of factors impacting on the performance of the financial sector. It is important that we have good supervision, but we should not over-emphasise its importance.

I hope that you will find this conference stimulating and that you will enjoy your time in New Zealand.