Regulating Banks through Public Disclosure—The Case of New Zealand

Recently, the New Zealand government revised the regulation and supervision of its banking sector. The new regime retains elements of traditional prudential supervision—for example, bank registration, minimum capital requirements, limits on lending to related parties, and crisis management powers—but it adds a new framework of market-based regulation. The key ingredients of this market-based approach are public disclosure, enhanced responsibility for directors, and predetermined responses to banks’ breaches of prudential requirements. This new approach has much in common with earlier public sector reforms in New Zealand intended to make the objectives of government agencies more explicit, to sharpen incentives for good performance, and to mandate more transparent reporting (see Note 97). For the central bank, these reforms meant that monetary policy would be bound by an explicit price stability target for inflation and the bank would have to report regularly and publically on how well it was meeting this target. For the six years or so that this monetary policy model has been in effect, New Zealand has had very low inflation (1 to 2.5 percent), earning the central bank considerable international credibility.

The overall objective of this round of reform to the central bank’s responsibilities for banking regulation is to reduce the financial risk to government by reducing the moral hazard problem that besets more traditional approaches to banking supervision. There is a good body of evidence from a variety of regulatory regimes around the world showing that banking supervision has not prevented bank failures, and because of moral hazard, governments in many countries have met some or all of the costs of these failures. Often, the initial response to banking crises is to seek more regulation and more supervision. But along with this, of course, come more moral hazard and more financial risk to governments.

The Reserve Bank, New Zealand’s central bank, judged that an incentive-based system would promote the soundness and efficiency of the banking system as well as or better than conventional banking supervision while signifi-
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New Zealand's new regime has retained the following traditional banking supervision policies:

- A system of bank registration. The registration policy does not limit the number of banks in operation, but it does try to ensure that only institutions of appropriate standing with the ability to carry on business prudently are "registered banks."
- The Reserve Bank's statutory responsibility for maintaining the soundness of the banking system. In keeping with that responsibility, the Reserve Bank is reviewing the payment system to identify ways to reduce system risk, such as by shifting to real-time settlement for large transactions.
- The Reserve Bank's monitoring role—though the Reserve Bank now uses publicly disclosed statements, whereas previously it received private prudential returns. It retains crisis management powers, including the power to appoint an investigator, give directives to a bank, and recommend that a bank be placed under statutory management, a special bankruptcy code for banks. The power to appoint an investigator is preferred to regular on-site inspection because it is regarded as cheaper and more effective. The Reserve Bank also has powers for dealing with breaches of disclosure requirements and conditions of registration.
- Minimum capital requirements (based on the BIS Capital Accord) for locally incorporated banks. Although the Reserve Bank believes that disclosure alone should provide sufficient incentives for banks to at least meet the international norm of 8 percent, it also believes that the capital requirement offers benefits of international credibility at little if any marginal cost to banks.
- A limit on the amount a bank may lend to related parties (parties capable of controlling or exercising significant influence over a bank). Banks are required to publicly disclose their exposures to related parties, and directors are required to attest that the exposures are not contrary to the interests of the bank.

While it is early to draw conclusions from New Zealand's experience with market-based regulation (the disclosure provisions took effect only on January 1, 1996), the approach has attracted much attention. This Note reviews the new procedures and the underlying arguments.

New market-based elements

The market-based elements of New Zealand's supervisory regime have two essential strands: disclosure and incentives.

Disclosure

The regime requires all banks to issue quarterly public disclosure statements (box 1). Banks are required to make their full disclosure statements available on request, and to display a one- or two-page "key information summary" in all branches. The disclosure requirements are intended to be comprehensive and will include requirements for disclosing market risk—though these have not yet come into effect. The statements are subject to external audit twice a year. But because of the substantial costs that external audits can impose on banks, the audit at the half year is a limited review.

The disclosure arrangements are intended to serve several purposes. First, they should reinforce the incentives for bank management to adopt and maintain prudent risk positions. Second, they should highlight the fact that directors have ultimate responsibility for the management of their bank and focus the directors' attention on monitoring and managing risk. Third, they should provide depositors and their agents with better and more timely information for assessing the prudential condition of their banks and for comparing banks. Fourth, they should help reduce the government's risk from banking supervision by reducing the private information in the hands of the supervisor and giving depositors and others a greater ability to take responsibility for their investment decisions.

New Zealand also uses credit ratings as part of its disclosure regime. Banks with a credit rat-
When a bank’s tier-one capital falls to less than 4 percent of its risk-weighted exposures, or its total capital to less than 8 percent, the bank is required to submit to the Reserve Bank a plan for restoring its capital to at least the minimum required levels. The plan, which the bank is expected to describe in its public disclosure statement at the first practicable opportunity, must include the following elements:

- A statement that the bank would make no distributions to its shareholders until it has complied with the minimum capital requirements.
- A statement that the bank would not increase its exposure to a related party from the level at the time of the first occurrence of the breach. (If a reduction in capital results in a bank’s being in breach of the limit on exposure to related parties, the bank would be required to reduce its exposure to related parties to comply with the limit.)
- If the bank’s tier-one capital had fallen to less than 3 percent of its risk-weighted exposures, a statement that the bank would not increase its gross credit exposures from the level that prevailed at the time of the first occurrence of the breach.

Directors’ responsibilities

The second important feature of the new arrangements is a requirement that the directors of a bank (or their appointed agents) attest that the disclosure statements are not false or misleading. Producing a disclosure statement that is false or misleading can have serious consequences, including fines and imprisonment. Moreover, if creditors lose money as a result of reliance on a false or misleading disclosure statement, directors face potentially unlimited personal liability.

In addition, directors must attest that they are satisfied that their bank’s risk management systems are adequate for managing its risks and that the systems are properly applied. The Reserve Bank believes that this requirement sharpens the incentives for directors to ensure that their bank has appropriate systems in place to identify, monitor, and manage its business risks. The requirement also supports the Reserve Bank’s intention to ensure that responsibility for the management of a bank ultimately rests with its directors, not with the banking supervisor.

Response to breaches of capital requirements

The third main feature of the new banking supervision approach is the adoption of a more structured response to breaches of the minimum capital ratio requirements. This is intended to reduce the scope for regulatory forbearance by the banking supervisor and thus to reduce the risks associated with such forbearance.

Reactions

It is fair to say that the reactions to the new approach from bankers, supervisors, academics, politicians, and the general public have been mixed. In the main, academics, politicians, business commentators, and consumer lobby groups in New Zealand have been supportive. The Reserve Bank, believing that it was important to build widespread confidence in the new regime, spent considerable time explaining the new approach to these groups.

The reactions from New Zealand’s bankers and from overseas supervisors have been more hesitant. While most banks are supportive of the general direction of the reforms, many are uncomfortable with the transparency that the new disclosure regime brings to the banking system. Some of the comments and reactions of bankers suggest that they think a regime based on the judgments of the market is tougher than
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one centered on a supervisory authority. Many bank managers and directors are concerned about the likely depositor reaction if they have to publish “worrying” information. Their concern indicates their strong incentives to avoid having to do so. It also illustrates the moral hazard risk that existed when only the Reserve Bank and the banking supervisor had access to such “worrying” information.

Some doubts have been raised about the responsibility put on directors to ensure that their institutions are sound. Some commentators have said that it is difficult for independent directors to understand and monitor the risks, and they wonder why anyone would want to be a bank director now. These sentiments are not surprising. But the issue for banking supervisors is whether they are in a better position to understand and monitor these risks. It is doubtful that they are. And if the supervisors assume that they are, they increase the moral hazard and potential financial liability for their government.

The shift toward greater responsibility for banks’ directors is consistent with the general direction that director obligations have been moving in New Zealand. For example, the directors of other entities in New Zealand that issue securities to the public are subject to similar disciplines under the Securities Act, and the new Companies Act (1993) strengthens the requirements of and disciplines on company directors.

A second criticism is that New Zealand is essentially free-riding on overseas supervisors. That criticism has some validity. Just over 90 percent of the New Zealand banking system is now foreign-owned (about 66 percent by Australian banks). But it is highly likely that New Zealand would have proceeded with these changes even if the domestically owned share of the banking system was greater. Those analyzing the approach should focus on the approach itself, rather than simply dismiss it because adopting it was relatively easy for a country like New Zealand, with its well-established and primarily foreign-owned banking system.

A third criticism is that most depositors will either ignore or misunderstand the disclosed information. The Reserve Bank does not expect the majority of bank depositors to study the disclosure documents. But financial advisers, business journalists, and other professionals will study them—and they will convey the information to depositors. It is possible that analysts or depositors will misinterpret the information and start an unwarranted panic. But that risk existed in the past too. The banks and the authorities had to decide whether to dispel market rumors that started and, if necessary, support the institution. With more information in the marketplace under the new disclosure policy, there should be less risk of unfounded rumors, not more.

Conclusion

The New Zealand approach will reduce the moral hazard problem. But will it improve the prudential soundness of the banking system? That will depend on whether bank directors are in a better position than supervisors to understand their bank and whether the incentives lead directors to act prudently—or at least more prudently than supervisors did in the past. The Reserve Bank believes that bank directors are in a better position.

Is the model exportable? That is hard to judge. But its major elements—public disclosure, director responsibility, predetermined responses to breaches—could certainly play a role in the banking supervision regimes of other countries.

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