A More Market Based Approach to Maintaining Systemic Stability

David Mayes

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FSA OCCASIONAL PAPERS IN FINANCIAL REGULATION

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Authors wishing to contribute to this series should contact Clive Briault or Paul Johnson at:

The Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London  
E14 5HS

Telephone: (0)20 7676 3100 or 3120

e-mail: clive.briault@fsa.gov.uk or paul.johnson@fsa.gov.uk

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Biographical Note

David G Mayes is Professor of Economics at South Bank University and Adviser to the Board of the Bank of Finland. He was previously Chief Manager and Chief Economist at the Reserve Bank of New Zealand. He writes here in a personal capacity and the views expressed are not necessarily those of either the Financial Services Authority, the Bank of Finland, or the Reserve Bank of New Zealand.

Abstract

This paper explains how banking supervision within the EU could be improved by the implementation of greater market discipline and related changes. It draws heavily on the experience of New Zealand, where there was a major shift in this direction in the mid-1990s. Although existing EU law, institutions, market structures and practices of corporate governance restrict the scope for change, substantial improvements could be introduced in the current framework. Such changes would be particularly easy to introduce in the UK as its systems are more similar to New Zealand’s. While New Zealand has many special features which make the new regime particularly suitable there, all the main principles could be applied in the context of current EU legislation. These include: ensuring the quality of corporate governance of those financial institutions wishing to be registered as banks, with high accounting and independent auditing standards; public disclosure of substantial information about the risks individual banks face so that market disciplines can be applied – including extending Value at Risk measurement to the whole of the bank’s activities; placing the responsibility of the prudential operation of each bank on its directors and management, with penalties and financial liability for false statements; and avoiding putting taxpayer funds at risk, by making it clear that no bank is too big to fail and focusing the role of supervisors on ensuring that they have the power to step in and prevent adverse consequences to the system as a whole when a bank gets into difficulty. By these means, the moral hazard inherent in bank supervision and the costs of supervision could be significantly reduced.

Greater market discipline, in the form of a regime of quarterly public disclosure by banks of their capital adequacy, peak exposures and risk management systems, along with improved incentives, could help to improve the prudential management of banks, enable supervisors to focus on systemic risks and help customers determine the risks they face. Banking inherently involves the taking of risks, but transparency and improved public information about them would help all concerned manage the risks more effectively and reduce the chance that the taxpayer will again be called upon to help rescue the banking system.
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Executive summary

In 1996 New Zealand implemented a new system of banking supervision following a four year period of review. This new system has attracted considerable international interest as it represents a major step away from the prescriptive and intrusive systems that have normally been implemented elsewhere. It is an innovative response to the unfortunate fact that in recent years there have been substantial bank failures in the Nordic countries, Japan, the United States and the United Kingdom, among many others.

The principal feature of the new system is that it puts the responsibility for the prudent management of banks firmly on the directors and management of the banks themselves. It makes it the responsibility of the supervisor to concentrate on the stability of the financial system as a whole, not on the viability of any individual bank. Under this view, the ‘moral hazard’ present in banking systems should be reduced and taxpayers’ money should not be put at risk. Individual banks should expect to fail if they become insolvent, whatever their size.

This system therefore entails a network of incentives to ensure that appropriate attention is paid to the management of risk by bank shareholders, directors, management, depositors, analysts and competitors. These incentives are applied by an extensive regime of quarterly disclosure of the banks’ assets, liabilities and exposure to risks, backed up by an attestation by all the directors including the non-executive directors which each bank is required to have, that the bank is applying appropriate risk management procedures. Directors are liable to stiff fines and periods of imprisonment for false or misleading statements and have unlimited personal civil liability for losses incurred by others as a result of these statements. While the Reserve Bank has set out a basis it finds acceptable for measurement of Value at Risk, the registered banks are allowed to implement adequate schemes better adjusted to their specific businesses. The pressure on banks to run themselves well will come from depositors, who can take their funds elsewhere, from analysts, and from competitors, who will be eager to point out items of relative weakness.

However, the system does not rest on disclosure alone. It has three principal pillars, of which disclosure so that market disciplines can be applied is only one. The second is that the structure, ownership and management of the banks should be such as to encourage prudential behaviour. There is thus a series of wide-ranging prior conditions that have to be met before a bank can be registered, relating to capital adequacy as
laid down by the Basel criteria, size, standing and corporate governance. Lastly the Reserve Bank has extensive powers to act swiftly and effectively in a crisis, including the ability to place an insolvent bank under statutory management.

New Zealand, being a small country with a small number of banks, almost all of which are foreign-owned and undertake only limited business overseas, is not typical of many of the other OECD countries. In particular it is unusual in having no deposit insurance. However, while having deposit insurance may limit the bite of the market discipline it does not invalidate the applicability of any of the main principles. These principles can be readily applied in the EU countries, consistent with their existing directives, including those on capital adequacy and protection of depositors. Indeed the idea that market discipline can place a substantial incentive on banks to run themselves prudently will have a significant appeal as regulators struggle to keep pace with the rapid internationalisation of banking operations and the rapid rate of innovation of financial products and IT systems.

This paper, therefore, appraises the New Zealand regime, suggests improvements and indicates how it might be introduced to European Union countries.
1 Introduction

In recent years there has been increasing discontent with traditional methods of banking supervision. On the one hand banking crises and failures have continued, with substantial difficulties in the Nordic countries, the US and Japan among others before the latest problems in Asia. The difficulties have included countrywide problems as well as some specific problems due to fraud as with BCCI and Barings. On the other hand, rapid improvements in technology and products and increasing operation across national borders have meant that the operations to be supervised are developing at an increasing rate. Supervisors can respond by seeking more information from banks, investing more effort in keeping pace with innovation and technology, and by cooperating more with each other. No doubt this helps, but the costs of supervision rise and those who seek to run excessive risks in the hope of greater returns will still tend to remain one step ahead of an external supervisor.

At the same time, new ideas (or, more accurately, new versions of ideas) have been emerging which involve setting up better incentives for banks to want to run themselves in a way which avoids excess risk-taking and reduces the chance of failure or distress. There is a danger in the traditional system that risk-taking will actually be encouraged, first, because the mere existence of close supervision can appear to be a guarantee in itself and, second, because there are implicit and explicit guarantees that depositors will be protected and that banks, particularly the larger ones, will not be allowed to fail. If shareholders, managers and depositors feel themselves more at risk, both financially and for their reputations, they will tend to want to manage risk rather better.

Furthermore, many banks have sought to generate their reputation behind a cloak of secrecy, avoiding disclosures for fear that such disclosures will reveal weaknesses. In most other markets, suppliers go far more out of their way to demonstrate their superiority over their competitors by revealing their strengths and adopting voluntary procedures such as quality standards which seek to demonstrate a commitment to excellence. There is no reason why banks should be different in this regard.

Several supervisory authorities have started to revise their procedures in the light of these new ideas and others are contemplating them. In an effort to assist these developments, this discussion paper explains the rationale for the new system and how it operates in the country which has gone furthest in this regard, New Zealand.
In some respects New Zealand has more freedom to act than other OECD countries, so it may not be possible for others to follow some of the detail of the measures that have been implemented. EU countries are bound by directives on capital adequacy and deposit insurance, for example. However, all the principles are applicable to other OECD countries and New Zealand’s experience shows they can indeed be applied in practice. Examining what has happened in New Zealand indicates that there is an opportunity for other financial supervisors to increase the role of incentives and market disciplines to help reduce the risks both to the banks themselves and to the financial system as a whole. This paper therefore focuses on the transferable lessons in the hope that others will wish to pursue them further and, indeed, adopt them in the future. It focuses on the changes that can be made now within the current framework of EU law and institutions rather than treating these ideas as something for the long term.

The structure of the rest of the paper is as follows. Sections 2 and 3 explain the role of more market discipline and how it might improve the incentives towards greater systemic stability. Section 4 sets out the framework for bank regulation in New Zealand and section 5 then goes on to explain in the light of this what the key ingredients of effective market-based regimes appear to be. Section 6 asks how far the New Zealand regime is transferable and considers barriers that have to be overcome for successful implementation of a similar regime in the EEA. Section 7 then goes on to consider how that implementation might be structured and Section 8 concludes. The relevant legislation is not discussed in detail in the paper but links to the main relevant websites are given.

2 The role of incentives and market discipline in reducing systemic risks

Following ten years altogether of discussion and consultation, in 1996 the Reserve Bank of New Zealand introduced a new system of banking supervision designed to improve the prudential operation of banks and the soundness of the financial system. The Reserve Bank sought, by imposing requirements for the public quarterly disclosure statements of their health on registered banks, to obtain much more discipline from
the market on banks to run their businesses prudentially. Secondly, by heightening the
role and accountability of the directors of the registered banks in attesting to the
veracity of these disclosures, it hoped to improve the management of banks, in
particular, their identification, monitoring and management of risks.

As by-products the Reserve Bank expected to reduce compliance costs for the
registered banks and improve their business freedom. Furthermore it expected that
this regime would reduce the risk to the taxpayer of ever being called upon to rescue
a bank. By eliminating the traditional monopoly of information that supervisors have
on banks’ financial condition, this should both heighten the public perception that the
management and directors of a bank have the sole responsibility for the management
of their bank’s affairs and assist future governments in resisting the pressures to
rescue a bank in distress or insulate its creditors from losses.

2.1 The need for banking supervision

The changes to the system of banking supervision stem from an extended period of
revision of the regulation of the company sector and financial institutions in
particular. Although the detailed changes resulted from a four year review of banking
supervision, which began in late 1991, the basis for change was set out in the mid-
1980s and the enabling legislation incorporated in the Reserve Bank Act of 1989. The
review and the wholesale changes were motivated by the fact that traditional banking
supervision arrangements in other countries, while costly, have not been very effective
in forestalling banking crises or identifying banks in difficulty.

While by and large the Reserve Bank would prefer that banks be regulated like other
trading bodies, there are some respects in which banks have a special position and
hence require more explicit supervision. These include the traditional feature, that
banks play a special role in the working of the economy by accepting short-run and
very liquid deposits and providing business stability by lending long and hence
creating assets which cannot readily be liquidated (George 1996). As a result they are
vulnerable in a crisis; yet removing the vulnerability by changing their role would
greatly reduce the value of banks to the economy.

Furthermore, banking crises tend to occur at times of overall difficulty for the
economy, exacerbated by the fact that, compared to some other financial institutions,
the assets underpinning banks’ balance sheets, such as property, can be subject to
wider swings in value. The appropriate valuation of assets relating to businesses, particularly small businesses, will depend upon private information held by the bank and will be difficult to establish rapidly in a crisis.

There are also particularly large externalities from bank failures. Not only is there the domino effect where a failure in one bank can cause problems for others and undermine the public’s confidence in the banking system as a whole but failures in the banking sector will knock on to the rest of the productive economy, reducing activity (Goodhart, 1996b).

It is thus important to understand that in making the changes to the system of banking supervision in New Zealand, the Reserve Bank was not washing its hands of its responsibilities for the soundness of the financial system but seeking to exercise them more effectively. The Reserve Bank continues to regulate the system and increase the chance of soundness for the system by:

- regulating entry;
- insisting on internationally accepted capital adequacy standards; and
- requiring bank structures that create incentives for a bank’s management to ensure that their bank has good risk management systems.

Disclosure alone is not enough. There is also continuing consultation with the senior management of the registered banks, both in order to understand the information better and to convey the Reserve Bank’s concerns. The Reserve Bank also retains a wide-ranging capacity to respond to bank distress or failure where the stability of the banking system is threatened.

At the same time the Reserve Bank has continued to reduce the risks inherent in the operation of the financial system, for example, through introducing RTGS, which covers over 90 percent of transactions by value. Improved arrangements on netting (Zodgekar, 1996) have also been implemented. Taken together, these measures should lessen the exposure for other banks should any particular bank fail or get into difficulties.

However, as explained in Section 5.3, although the supervision arrangements are more detailed and comprehensive for banks, the same principles regarding the importance of disclosure apply to legislation relating to all trading companies and to other financial institutions in particular. Some parts of the regime are still being developed, such as that for insurance companies.
2.2 Assigning responsibility and reducing moral hazard

One of the Reserve Bank’s concerns with the traditional system has been that it blurs the responsibility of the management of the registered bank and that of the supervisor in ensuring that the bank is well run. With intrusive supervision, including site visits, there will be an expectation, among both directors and the public, that if there is something wrong it will be picked up by the supervisors. Furthermore there will be a greater expectation that if, despite the close supervision, a bank fails or gets into difficulty the government will have an obligation to intervene, as in some sense this would imply failure by a public authority in its duty. This introduces a ‘moral hazard’ that both depositors and those running banks will tend to take greater risks because there is a safety net limiting the adverse consequences of their actions for them.

The more that depositors and bank directors have at risk the more effective are market disciplines likely to be. With the absence of deposit insurance in New Zealand those incentives for the depositor may be rather greater than in most other OECD countries. However, it is not possible, even in these circumstances, to eliminate moral hazard altogether. If the central bank stands ready to prevent a spill-over into the rest of the financial system and retail depositors also form a significant portion of the country’s electors, there will always be the expectation that some form of safety net exists, however strong the words denying it are. Even so, the new regime in New Zealand should clearly reduce any moral hazard that did exist. The Reserve Bank has seen itself as having an important role in public ‘education’, not just in terms of trying to persuade people that there will be no bail-outs, but in emphasising the existence and nature of risks and the extent to which interest rates will reflect them.

The OECD (1997) in their summary of the issues facing the financial sector put the point very clearly: ‘A key and recurrent question is what induced banks to lend so heavily on the basis of real estate collateral particularly in the late stages of booms when prices had reached historically unprecedented levels. The experiences suggest that ‘moral hazard’ incentives arising from deposit insurance or the implicit insurance afforded by the likelihood of state support in the event of failure of a large institution
(‘too big to fail’) encouraged institutions to assume excessive risks (relative to returns that could reasonably have been expected) while lowering incentives for depositors to adequately monitor the risks of banks in which their funds were placed.’ (p. 27). One of the key problems is to try to place responsibility individually on banks even if many banks chose to make similar risky decisions at the same time. There may appear to be inherent safety in such collective action or ‘herd behaviour’, as the results will lead to a reaction by the authorities to limit the systemic consequences.

The OECD comes to a similar conclusion as the Reserve Bank about the appropriate way forward for supervision: ‘Financial reform also necessitates fundamental changes in prudential policies, in particular to foster effective market discipline and adequate risk management by financial institutions including strong corporate governance regimes; to improve disclosure and transparency; and to harmonise oversight policies in similar market segments.’ (pp. 37-38).

2.3 Market discipline through disclosure of information

The quotation from the OECD makes it clear that the appropriate system for reducing risk includes not just disclosure but good corporate governance. However, if there are to be effective pressures from the market they can only come about if the individual bank’s actions are transparent and the relevant information is readily available.

Naturally there will be some who view such a change with apprehension. Indeed there may be circumstances where a scheme of open disclosure could pose a disadvantage, for example, when a bank is in temporary difficulties. Under a more closed system the problem would be known only to the supervisor (let us assume) and to the bank itself. The bank might then have time to sort the problem out before the difficulty became publicly known. With public knowledge, depositors and creditors will attempt to protect themselves and that action in itself will worsen the problem, possibly turning a difficulty into failure. The knowledge that a safety net exists might reduce the chance of a ‘run’ on a bank, as all insured depositors would expect not to lose their money and there would be no need to try to rush to get to the front of the queue.

It is not quite clear whether there is in practice a net disadvantage in these circumstances. There might well be more disadvantages from a system where public knowledge was more limited and hence rumour and misinformation were more prevalent. This could harm banks that did not in fact have difficulties but had disclosed
insufficient information to satisfy market fears. The New Zealand approach creates incentives for the bank to present solutions at an early stage and hence reduce the risk of a run on the bank.

In any case the sheer knowledge that disclosure means that the opportunity to cover up problems is very limited may in itself lead the management of banks to act much earlier to head off problems or to implement more effective systems which will prevent such problems emerging in the first place. This in itself will tend to reduce the cost of finance for banks.

It is not of course realistic to expect that every ordinary depositor will be rushing into the nearest branch of every bank, reading the various disclosure statements with enormous care and then making wise and well informed decisions about where to place their funds. It is the financial news media, financial analysts, investment advisers, major creditors and the competing banks who will digest and publish the results of their analysis. Most ordinary depositors will rely on this secondary information and the fact that it will be spread rapidly by word of mouth.

The ability to make comparisons across banks has several advantages. The banks themselves have a twofold interest in each other’s performance. First of all they have major transactions with each other through money markets and, second, they want their own positions to be compared favourably with those of competitors. The fear that banks might be able to take advantage of each other’s weakness as a result of disclosure does not appear to have been translated into a problem in practice, although their positions are more transparent.

It is already clear from initial experience (Brash 1997) that the financial media and, particularly, competing banks are scrutinising disclosure statements, and there has been some public comment about issues such as the breach of exposure limits.

In any case the point of the system is to have prudently run banks in the first place, and the main incentive structure and discipline lies firmly on directors and bank managers, whose livelihoods and reputations are at stake if a problem arises. Brash (1997) claims that there are already signs that directors of banks are exercising ‘greater scrutiny of their banks’ risk positions’ (p. 11). Signing-off procedures by management need to be rigorous and transparent if non-executive directors, in particular, are to be willing to sign the quarterly attestation. Furthermore the increased auditing requirement helps provide a greater independent confirmation of the banks’ performance.
3 The rationale for a more market-based regime

The successful implementation of a more market-based supervision regime is expected to offer benefits on a wide front (Ledingham, 1995). Gains are expected not only for banking supervisors in the effective and efficient execution of their tasks, but also for all the stakeholders in the banks themselves – owners, managers, depositors, borrowers and creditors. Most important, there are benefits to the public at large both as taxpayers and as employees and consumers through the reduced risk of banking crises and the consequent difficulties for the economy as a whole. Of course, no system of banking supervision is a panacea. Banking inherently involves taking risks but it is the prudent management of those risks that defines a successful bank. A successful supervision regime will provide effective incentives to keep the quality of management of risks by banks above the minimum acceptable level and should ensure that, in the event of difficulty in one or more individual banks, this does not spill over to the detriment of the banking system and economy as a whole.

In other words, it is the aim of a successful regime to focus supervisors and the supervised on the aspects of the task that they are best equipped to handle. Thus the responsibility for the prudent management of any individual bank should lie not with the supervisor but with the managers and directors of that bank themselves. They are the only people with the information and opportunity to run an individual bank well. An outsider, however well qualified and however good the information system, cannot hope to do as well. If one is not prepared to accord this responsibility to the banks’ management then the obvious alternative would be to opt for a publicly owned banking system and to reject the hypothesis that the disciplines and incentives of a well-operating market stand the best chance of maximising welfare for society.

It is the role of the supervisory authority, to quote the Reserve Bank of New Zealand’s Commitment to New Zealanders (RBNZ, 1998) ‘[to] do everything in our power to build national and international confidence in the stability and integrity of New Zealand’s money and monetary system by:

- operating monetary policy so as to maintain price stability;
- promoting the maintenance of a sound and efficient financial system; and
- meeting the currency needs of the public.’
where the italicised phrase provides the key remark. In this view it is not the job of the supervisor to support any individual bank. Indeed, if it were thought that the supervisor would provide such support, this would increase the moral hazard that bank managements might run greater risks, as owners and depositors would not have funds at risk.

A more market-based system operates by revealing publicly the sorts of information that would previously have been disclosed only to the supervisor and by providing a system of incentives that encourages banks to operate in a prudent, efficient and indeed profitable manner. Although the supervisor needs to lay down the minimum of information to be disclosed, the practice in New Zealand has been for banks to disclose more as they seek to demonstrate their strengths compared to their competitors to depositors, actual and potential shareholders, counterparties and other customers. There is a trend towards increasing voluntary disclosure as companies in the United States move towards quarterly accounts, and a trend among supervisors to encourage more disclosure both through the Basel Committee and within the EU.

Some people view public disclosure as a support to the traditional regime of the collection of detailed undisclosed information by the supervisor. However, this belt and braces approach is not advocated here and it is anticipated that the supervisor would follow the New Zealand approach of only seeking more information if the disclosure statement seemed inadequate or unclear or in the event of a difficulty emerging. Even in the event of difficulty the emphasis would be on openness and revelation as soon as possible of how the problem would be solved.

3.1 Increasing the effectiveness of supervision

Putting the emphasis on public disclosure and the forces of market discipline is not washing one’s hands of supervision in a difficult world of technical change and international business. It is an attempt to provide a system, in jurisdictions where the banks are strong and accounting and auditing rules adequate, which increases the chance of prudent behaviour.¹ It is clear from experience that current regimes of detailed supervision cannot ‘succeed’ in the sense of stopping banking crises, but then nothing can, because we are talking about managing risk prudently not eliminating it, which is impossible. There are downsides to any approach and detailed supervision can be costly and inhibit banks in undertaking profitable business. The advantage of this

¹ There is also a clear incentive for weak banks to become stronger if their position is disclosed.
arrangement is that it allows the supervisor to focus on the parts of the problem where it has a clear advantage:

- assessing the quality of new entrants;
- ensuring that banks comply with the disclosure rules and following up problems;
- oversight of the system as a whole – identifying potential problems which relate to banks as a whole, e.g. exposure to particular markets or sectors – considering social costs and risks;
- resolving problems when they emerge and ensuring that crisis resolution capabilities are in good shape; and
- advising banks that have not as yet managed to get to the stage where they can comply with a full disclosure regime.

These comments all relate to prudential supervision, corporate governance and disclosure but not to other aspects of conduct such as fair trading. It is an open question whether this last should be covered by a special financial sector or banking regulator. A variety of approaches to this can be seen in OECD countries.

There are three main sources of confusion in discussing financial supervision. The first is in the discussion of what such actions are intended to achieve, the second in the structures and methods used to achieve those objectives and the third is in the meaning attributed to the terms being used. The principal focus of this paper is on one specific means for achieving one of the objectives, namely the use of more market discipline rather than supervisor intervention to improve the prudential management of banks. However, implementing such a scheme successfully involves a much wider range of regulatory activity affecting banks, and this section of the paper seeks to set them out.

The objectives of public sector involvement are perhaps the easiest to disentangle, although in most jurisdictions they tend to be implicit and hence have to be inferred from what has been implemented. Normally the public sector has two objectives:

- Systemic stability
- Consumer protection

(Goodhart et al, 1998).
In what is probably the most comprehensive recent survey of the problems and how they might be tackled in an embracing framework, the Wallis Committee distinguished three main functions in its Report Australia, *The Financial System: Towards 2010*:

(i) the regulation of ‘conduct’ and ‘disclosure’ for financial institutions  
(ii) prudential regulation (financial safety) and  
(iii) systemic stability

and advocated the establishment of a regulator for each function (a recommendation that has since been implemented).

This approach effectively divides the consumer protection objective in two. An alternative approach which a few countries including the UK have adopted is to combine functions (i) and (ii) above in a single regulator. In the UK this has led to the prudential regulation of banks being transferred to the new single regulator, the Financial Services Authority. The case for having a single national financial services regulator is set out in Briault (1999). Under either approach, however, effective prudential regulation also contributes to making the task of maintaining systemic stability easier. So the items are interrelated.

The emphasis in the Wallis Committee discussion is on ‘regulation’. However, it is not necessary to view the way that the public sector involves itself in these issues just from that perspective. In a second recent comprehensive survey, Goodhart et al (1998, p. 189) cut the cake slightly differently, distinguishing the approaches of:

- *Regulation* (the establishment of specific rules of behaviour)  
- *Monitoring* (observing whether the rules are obeyed)  
- *Supervision* (the more general observation of the behaviour of financial firms)

as means of addressing the regulatory goal. There are other approaches. Merton (1995) suggests distinguishing between *functions* in the sense of financial services: financial intermediation, risk management, etc.

There is no simple paradigm for implementing such systems in practice. Structures of financial supervision vary considerably across countries, even within the European Union. The effectiveness of the system and the effectiveness of a more market-based regime are
affected by the structure chosen. The structure chosen often reflects decisions made in
the past, usually implicitly rather explicitly, about the purpose of regulation.

Attitudes towards what should be done and how it should be organised tend to be
heavily influenced by the prevailing regime and experience with it. There are several
fundamental questions:

• Are banks separately regulated from other financial institutions?
• Is there a distinction between responsibility for the stability of the financial
  system as a whole and the supervision of individual banks?
• What functions of banks are covered by the specific regulator and what by
  regulators of general business practice – advertising standards, consumer
  protection, etc?
• How far do the powers of responsibility for the stability of the financial system
  extend – into the degree of monopoly?
• What powers are there for crisis resolution?

It is unusual for all functions to be the prime responsibility of a single body and the
new structures in Australia and the UK are well towards the neater end of the
spectrum. In many jurisdictions, not only may different functions be assigned to
different bodies but responsibility for a single function may be shared. Normally, if
there is a ‘conduct and disclosure’ regulator much of that function will be to administer
rules set for the whole economy in the particular instance of the financial sector. As
the Wallis Report puts it, ‘[while as] a general principle, and to avoid regulatory
inconsistency, economy-wide regulation should not exclude the financial system ... the
complexity of financial products and the specialised nature of financial markets
has led most countries to establish specialised regulatory arrangements for the
financial sector.’ (p.17).
Table 1 cuts the functions of supervisors identified by Wallis in a slightly different way, in order to highlight seven aspects that affect the applicability and effectiveness of a more market-based regime.

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<td>2</td>
<td>Systemic stability – crisis resolution</td>
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<td>3</td>
<td>Supervision of other financial institutions – including payment and settlement systems</td>
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<td>Competition – regulation of entry</td>
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<td>5</td>
<td>Management of deposit insurance</td>
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<td>Fair trading</td>
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Table 1 may be somewhat more extensive than might be expected, as corporate governance is a key determinant of the effectiveness of more market-based supervisory regimes. If incentives are to work well there needs to be a clear identification of property rights and avoidance of conflicts of interest. However, the system of auditing and accounting needs to be such that market information is understandable, verifiable and comparable.

### 3.2 Reducing costs of banking supervision for the taxpayer, customers, banks and the supervisor

It is a relatively trivial consequence of a more market-based regime that the scale of supervision necessary will be reduced and hence its cost will be reduced. In most countries the cost is borne by the banks themselves, or more literally by their customers, rather than the taxpayer. Given the scale of other bank costs, the effect on
interest rates and other prices will be difficult to detect. Also, if it is more costly for
the banks to comply with the disclosure regime than it was with detailed supervision
then this gain will have been lost. However, the New Zealand approach tries to align
what is disclosed with what banks need to compute for internal purposes, both for
decision-making and monitoring. If this approach is followed, any extra costs are likely
to be small and not sufficient to offset the gains from reduced detailed supervision
costs. The New Zealand banks report that possibly one or two more staff may be
involved and that extra printing may be required. On the whole, however, the extra
printing replaces the costs that would otherwise have been incurred in printing
prospectuses and annual or other reports in order to inform potential investors or
depositors (Mayes, 1997).

Bigger gains from the new approach come because banks are now able to run their
businesses in a less constrained manner. Rather than having to conform to specific
ratios or limits to exposures in particular sectors laid down by the supervisory
authority, their requirement is simply to disclose the risks they have taken on. They are
therefore able to pursue opportunities for profit and to differentiate their business
from that of competitors as they think appropriate provided they can convince markets
that they are managing their risk satisfactorily when they do so. The New Zealand
banks reacted particularly well to this freedom (Mayes, 1997). They use the disclosure
documents as an opportunity to convince customers that they manage risk well.

Customers will also be able to benefit, not just because costs will be reduced but
because they can choose institutions whose business more closely reflects their own
needs. The efficient assessment of the quality of banks will then be largely assigned to
the market and to competing private sector analysts and rating agencies. The role of
the supervisor is to ensure compliance with the law. Disclosure thus tends to permit a
rather wider range of choice, instead of a clustering of bank behaviour close to, but
above, the minimum standards that the supervisor requires.

Finally, if the risk of bank failure is reduced through better incentives for prudential
management then the potential cost to the taxpayer is reduced in addition to any small
costs that could not be passed on by the supervisor to banks. Given the example of the
scale of the bailout in the Nordic banking crises at the beginning of the decade, this
could be the largest single source of gain, totally dwarfing those relating to
compliance costs.
3.3 Focusing supervision on systemic risk

This is the key point. Governments do not seek to protect people from all risks but they do wish to act where the public benefit and the private benefit diverge. If banks are in general well supervised, and there is insurance available, particularly for the small depositor, and there is a wide range of choice, then the main concern for the authorities is that a problem in a specific bank spills over into the rest of the system and causes a loss to society as a whole that could be reduced by public action. If the protection is complete and all banks are bailed out, then one set of individuals who have taken a specific risk are going to be bailed out by the community at large, who take a general risk over which they have little control.

3.4 Placing responsibility for the management of banks on the management of banks

The people who can ensure prudent management are the directors and managers of banks themselves. Disclosure will help achieve this because markets and customers will penalise banks that are not well run. The cost of raising capital will tend to rise and banks will have to cut margins in order to attract customers. This information on how the market views moves by banks will also help them in running their business. However, this information alone is not likely to be sufficient. Directors and managers need to be held accountable for their actions, both within the framework of the firm, for poor performance, and legally in the event of fraud or failure to conform with disclosure or corporate governance standards. The shareholder always faces a difficulty in knowing whether the management it has appointed is doing an adequate job. Disclosure assists this assessment because it is more readily possible to compare the performance of banks with their competitors, and indeed with banks in other jurisdictions. (Of course, with the exception of large shareholders, it will be analysts and market commentators who will provide much of the advice. If there are problems, then competitors will be only too keen to point out the difficulty and their own success in countering it.)

In the New Zealand system all bank directors, whether or not executives, have to sign an attestation on the accuracy of the accounts and on compliance with the rules for prudential management. Thus their attestation is not just that such rules are in place but that they are actually being followed.
3.5 Establishing incentives for all ‘stakeholders’ in banks

For this regime to work well there needs to be as comprehensive a set of incentives as possible. This comes not just from setting out regulations and having penalties for not following them. It is not possible to specify in sufficient detail what any individual organisation should do in order to manage its risk ‘properly’. It is, however, possible to lay down general principles and then get banks to disclose enough of what they are doing so that people can decide whether they like the specific risks involved. We do not expect banks to be identical. People are prepared to take different risks. The concern of supervisors is to limit the risk to the system as a whole, and for that reason they insist on minimum standards.

All those involved therefore need to have appropriate incentives: not just managers but owners – shareholders, depositors, borrowers and of course the supervisors themselves. The key ingredient of the disclosure system is that it provides the basis for people to take informed decisions – one requirement of an effective market-based regime is that there is a sufficiently large group of professional analysts crawling over the information to provide advice for the rest of customers and investors to act on. Clearly the message will be more limited if the shares in a particular bank are not actively traded or if shareholders do not have much say in the way the bank is run.

A feature of a disclosure regime is that it makes it easier for incentives to be progressive rather than there being simply penalties for stepping over a specific line.

3.6 Reducing moral hazard from implicit and actual guarantees

One of the main problems is that the public at large may feel that there is no risk from bank failure. Even if they know that banks can fail, they may have the expectation that the bank will be bailed out. Experience supports this view. As a result (Llewellyn, 1995) retail customers will tend to choose the banks that offer the most favourable terms, as they treat all the risks as being effectively zero, not recognising that higher returns are normally associated with higher risks. Worse still, this view can extend to creditors, shareholders, directors and managers. Bailing out a bank may mean for them that they do not lose as much financially as they would with a commercial company. It may mean that reputations and future employment are not expected to be harmed substantially by bad performance. One could scarcely give a worse signal than show that someone who has been held responsible for major losses by others in the past continues to prosper personally.
The moral hazard may extend to the banks themselves if they regard interbank risk as zero. They might, for example, prefer a ‘cheaper’ netting system to real-time gross settlement systems that effectively eliminate the exposure.

3.7 Precommitment – focusing supervision on banks with potential problems

In most circumstances bank failures are fairly isolated and in a well-regulated system only some institutions will have difficulties even for common risks associated with the macroeconomic cycle. There is a role for a supervisor to focus on those institutions and help see how the problems can be resolved. Here an extra step is required that was not a concern for the introduction of the New Zealand regime, because European countries are not starting with a clean slate. It is not a matter of being able to choose just strong banks for registration. Some banks have been in difficulty and may not yet be fully out of the wood. The decision to allow them to continue and work their way out of the problems has already been made. The supervisor may therefore want to keep an especially close eye on them until they are either closed, taken over or move into satisfactory performance. There will be a strong incentive for a bank to move as quickly as possible out of the problem category, if the position is public knowledge, as being there will affect its cost of capital and business adversely.

Section 6.4 suggests that within the group of ‘strong’ banks it could be possible for individual banks to make precommitments to avoid actual exposures to market risk exceeding a given level and to provide capital cover of at least that amount. This would enable them both to use their own risk assessment methods and to choose the appropriate level of cover, instead of following some predetermined rule applied to all banks irrespective of the particular characteristics of their business. It would be up to the market to judge the quality of these commitments ex ante and for the supervisor to decide if they were to be allowed to continue in future if either the commitment were violated or the standing of the bank fell.

It would be possible to invert this idea and allow banks to choose the level of supervision. In this case a bank might feel that it could enhance its standing by exposing itself to more vigorous inspection. However, if such inspections were thought to imply validation of the bank by the supervisory authority then it might be argued that the supervisor should bear some share of the responsibility if the bank subsequently fails. To some extent this choice can take place if the area of competition
from non-banks is increased, say, by permitting entry into e-money without a banking licence. However, the implication for the market discipline approach is that it is exposure to the full vigour of the market that gives the highest reputation. The decision to rely on direct supervision would, in these circumstances, be taken as a sign of weakness.

3.8 Comparability

The disclosure regime needs to require banks to report on a basis where they can be compared with a standard and with each other.

Somewhat ironically, disclosure means that there is much less incentive for banks to try to choose one supervisory regime rather than another as their position is clear and can be compared across borders wherever they are located. With the advent of the euro area, comparison is greatly facilitated.

4 The framework for bank regulation in New Zealand

The changes to bank regulation in New Zealand have been harmonised as part of much wider revision of the regulation of trading activities in the economy. Most importantly the Reserve Bank’s disclosure regime has been developed in tandem with the accounting standards for financial reporting (Financial Reporting Standard (FRS) 33). The Companies Office accepts the disclosure documents as meeting their requirements. Hence banks are spared multiple reporting standards within New Zealand. Similarly these standards apply to other institutions so that disclosure is becoming a feature for the rest of the financial sector as well.

Bank regulation in New Zealand is covered by a number of very simple principles, which were derived after an extensive review that took place in the early 1990s. (These principles are set out in RBNZ (1999).) The new regime came into full effect from the first quarter of 1996. However, the framework for the Reserve Bank’s regulation of the banking system is contained in Part V of the Reserve Bank Act 1989. Sections 67 to 156
cover the registration and prudential supervision of banks out of a total 192 sections in the Act. Indeed one of the main reasons why it has been possible to implement the new regime so successfully is that it has been introduced only after extensive consultation over many years.

The principles supporting the regime can be summarised as follows:

- Only financial institutions of appropriate standing and repute can become registered banks.
- Subject to this, impediments to entry of qualifying institutions are kept at a minimum in order to encourage competition in the banking system.
- The incentives in the system should encourage prudence on the part of registered banks and their customers and normal market disciplines should not be impeded.

Thus while outside interest has tended to focus on the disclosure regime which underpins the application of the third of these principles, an important precondition for its success is that there is a screening process to try to ensure that all participating banks are of a high calibre and likely to follow prudential behaviour (section 73 of the Act). Furthermore, these principles recognise that competition can bring significant benefits to users of the services provided by registered banks. New Zealand has lower margins and a higher quality and range of services than some other small countries, which may in part be due to competitive pressure. It is the combination of these three aspects which provides the full flavour of the New Zealand approach.

The series of criteria which the Reserve Bank applies in deciding whether to register a bank in the first place are straightforward but wide ranging. These are discussed further in Mayes (1997)2 but in brief they entail:

- that the Reserve Bank satisfy itself that the applicant’s business will substantially consist of the borrowing and lending of money, or the provision of financial services, or both;
- and that it have regard to:
  - incorporation and ownership structure

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2 Full details of the information that the Reserve Bank requires from the applicant can also be obtained from its website, www.rbnz.govt.nz/bsd/bs3.pdf
- size of business
- ability to carry on business in a prudent manner
- standing of the applicant in the financial market
- law and regulatory requirements in an overseas bank’s country of domicile
- any other matters prescribed in regulations.

It is worth emphasising that these provisions include compliance with the Basel criteria for capital adequacy, restriction of connected lending exposure, separation from the other interests of the owners and adequate internal and accounting controls.

The incentive system to encourage prudent behaviour has two main elements:

- a system of quarterly public disclosure statements and attestation by directors;
- the avoidance as far as possible of any implicit guarantees against bank failures or of the protection of creditors. Supervision is aimed at encouraging the soundness and efficiency of the financial system as a whole.

In the event that a bank should fail – and there have been no bank failures in New Zealand in ‘living memory’ (Ledingham, 1995) – the Reserve Bank will seek to minimise damage to the financial system, in a way that does not involve taxpayer funding. The Bank has extensive powers of crisis management under the Act, including the power to put registered banks under statutory management (a statutory manager has a broader set of powers than a receiver). Having a crisis management system which not only has strong powers but seeks to limit moral hazard is a key pillar in the system.

Furthermore, an open system of this form, with pre-commitment to respond in specified circumstances (as Goodhart (1996a) puts it), is likely to minimise any possible potential conflict of interest between the supervision and monetary policy functions of the Reserve Bank.
Section 5 of the paper (5.3-5.6) covers two main ingredients of the New Zealand system

- disclosure statements
- crisis management

as they have most to offer for changes in the European system. There are however important preconditions for a disclosure regime, the most important of which are fully functioning markets, a good system of corporate governance and the rule of law. Section 5 therefore starts (5.1 and 5.2) by reviewing the necessary conditions for a more market-based regime and their importance.

5 The ingredients of effective market-based regimes

5.1 A well-functioning market

The market itself needs to operate well, in the sense of there being

- an active share market,
- good market analysts,
- rating agencies,
- effective competition among banks and
- an effective market for corporate control,

if the disclosure is to mean something. Clearly if banks do not need to raise capital in the open market and if their customers have no effective choice the system will work poorly. However, most banks will have to rely on the interbank market or at least some other market sources for funds. Disclosure tries to overcome some of the problems of asymmetric information that may inhibit the effective operation of the market.

While most EU countries reflect these five characteristics to some extent, there are frequently limitations. Some banks are not actively traded. Setting aside those that are
actually private, there are substantial numbers of government-controlled banks. There are also savings and co-operative banks that face relatively inactive members, whose disciplining effect on the institutions has been relatively limited (as illustrated in the Nordic crises of the last decade, for example, where these banks got into serious trouble when they went outside their previous experience and expertise). The US has had similar difficulties with Savings and Loans. Lastly it is not clear how competitive the European market is in practice. Some banks have very large market shares to the extent that they can act as market leaders. Others have privileged positions, as the European Commission is alleging for the German Landesbanken, or have been the beneficiaries of substantial state injections of capital (Credit Lyonnais being a well-known case in point).

5.2 Good corporate governance

Establishing a structure for the governance of financial institutions which maximises the chance of good prudential management is clearly an important starting point for an effective supervision regime. The New Zealand system focuses on four key features:

- incorporation and ownership structure,
- size,
- ability to carry on business in prudent manner, and
- standing in the financial market

which between them cover the likely range of issues. However, much of the relevant legislation for ensuring good corporate governance is not in banking law but in company law. This is an area where the European Commission has had only limited success in ensuring convergence and considerable national diversity prevails.

Ownership structure

It is a simple starting point that the ownership structure needs to be transparent. This is particularly important in the case of conglomerates, where one might question the role of the bank compared to other parts of the company, and to international institutions where the network of ownership may be obscure. The BCCI debacle has been very helpful in sharpening the mind in this regard.
The principles that need to apply within an institution are fairly commonplace and include that the ownership structure needs to provide incentives for owners to monitor the performance of the bank closely and seek to ensure that it is managed prudently. If owners have a substantial stake in the business and are among the first to absorb the losses from poor performance then this will tend to be the case. However, owners and the board of directors need to be separated, as the interests of the bank and the interests of the owners may not always be identical.

Private banks and joint stock banks with dispersed ownership present contrasting difficulties. The worry in the case of the private bank is that activities could be run in the inappropriate interest of the owners, providing them or friends with cheap or inadequately collateralised loans. In the case of a diffuse ownership no single owner will be able to exert any effective control and the holding in the bank may only form a very small proportion of their total assets, thus tending to leave the company to the interests of the management and ineffectively monitored. In savings and co-operative banks the interests of owners and customers are not clearly separated and the position of the managers and directors vis-à-vis the owners may also be somewhat unclear in practice.

One of the key features of the New Zealand system is the role of independent directors. All banks are required to have at least two independent directors and an independent chairman. These will offer not only the benefit of experience from outside the bank but will tend to have a more independent and dispassionate view of the running of the business. Since they, like the rest of the board, will be personally liable for the accuracy of the disclosure statements, they will have a particular interest in being convinced that the bank is applying all the appropriate risk management measures. A common arrangement is for one of their number to chair the audit committee, for example (Goodhart 1996a, p. 64, sets out a similar suggestion). Their presence on the board will tend to give comfort to small shareholders, depositors, creditors and indeed the supervisory authority that the business is likely to be run prudently. This is very much the sort of banking system that is common across the Anglo-Saxon world.

The boards of some European banks have a somewhat different structure. They tend to be divided into two in a manner similar to that in Germany, with an executive board on which there are not normally independent outsiders and a supervisory board where the majority are outsiders. Clearly the members of the executive board would need to attest to the correctness of any disclosure statement. To mirror the role of external directors or to demonstrate the supervisory board’s confidence in the activities of the
executives, a matching action would be for the members of the supervisory board to sign the attestation.

Resolving the problem of the blurred distinction between owners and customers in co-operative and savings banks is also difficult. New Zealand faced this problem potentially with the trustee savings banks but they voluntarily changed their structure shortly before the introduction of the new regime (with the exception of the small Taranaki Savings Bank) and have since been acquired by one of the larger banks. However, while this was seen as a difficulty it was not viewed as being insurmountable. The main difficulty is a lack of any public quotation and hence clear expression of view by shareholders and the market as to the performance of management that is incorporated in a price. However, views would still be reflected in the action of depositors so market pressures, although perhaps a little weaker, would still exist. The worry would be that depositors might not be very well informed, particularly if they were largely individuals and not corporate entities. However, difficulties would be reflected in the costs of any market finance required by the bank.3

Accounting and auditing practice

Secondly, an essential feature of good corporate governance is independent verification of the accuracy of the accounts and statements made by the directors. This role of independent auditors is crucial both for reassuring the directors themselves and for external purposes. It was simultaneous developments in financial reporting standards that made the development of the New Zealand system possible. The innovations were already being made in the United States and the accounting profession in New Zealand based its changes on them. The Reserve Bank was a party to the discussions (through membership of the professional association) but implemented its proposals ahead of the final decisions of the association, as their progress was too slow. However, only very limited amendments had to be made when FRS 33 was actually published.

3 There can be specific difficulties in national structures that can blunt market incentives. One such example is given by the co-operative banks in Finland. They are effectively treated as a single unit as they operate their own ‘central bank’ and have to meet constraints such as capital adequacy jointly rather than individually. This structure is less than fully transparent and may mean that the incentives and responsibilities for individual entities are somewhat blunted. Raising market finance is an issue for the co-operative banks as a group so market signals will not tend to apply so clearly to the individual banks.
The key changes related to the frequency of the production of accounts – quarterly – and to the valuation of financial assets. There is already a trend towards quarterly accounting in Europe. Moreover, companies commonly produce considerable detail for even shorter frequencies for internal purposes. Valuation, however, does pose a clear problem, as there is some variety of opinion on the best way forward. Mark-to-market is becoming the accepted way of determining fair values in Europe and the discussions within the profession appear to be going in the same direction. At present, practice varies with use of historical cost, revaluation and mark-to-market. Revaluation to current prices proved one of the factors aiding the development of the banking crisis in the Nordic countries in the early 1990s. Some property portfolios were revalued to prevailing prices shortly before the asset price bubble was pricked (Bordes et al, 1993) and lending was increased on the back of it. The value of the liabilities incurred against those property assets did not fall with asset prices. Indeed, where they involved foreign currency borrowing the liability actually increased substantially, emphasising the solvency crisis in the banking system.

The passage of time since New Zealand’s implementation of the disclosure regime means that there is now a clear model to follow from international accounting standards, should others wish to adopt a similar approach. However, the IASB standards follow the ‘Anglo-Saxon’ approach to accounting, which many continental European countries do not, so adopting a more transparent valuation basis will involve a complication to the way in which accounts are presented. As things stand the additional information would need to be presented in the form of notes to the accounts. This is the same sort of procedure that is being followed in the agreement on accounting standards within the EU to which all member states will have to conform. There, although there is a general preference for the international standard, the pressure for the retention of the ‘continental tradition’ is sufficiently great that both systems will be permitted with an encouragement to follow the international standard in the form of notes to the accounts. Thus while the necessary standard will not be compelled, it will be permitted.

Of course, the accounting bodies are not the only relevant organisations, as others accepting accounts for official purposes, such as the tax authorities, would need to agree to the changes if the system were not to become unduly complex.
Size

In one sense size is an important issue. The minimum size for registration as a new bank in European countries is similar to that in New Zealand and follows the EU standards. There needs to be a reasonable minimum size in order to make sure that organisations really are going to operate as banks and are on a scale such that they can reasonably be expected to have the resources to operate proper risk management. In practice most new entrants lie well above the minimum and banks from elsewhere in the EEA opening branches in other member states are likely to have very substantial asset backing. The reservation comes from the large number of small savings and co-operative banks that already exist – not so much that their small size makes prudential behaviour more difficult but simply that their sheer number makes the process of analysis and comparison complex and less valuable, as the ordinary depositor or investor is not going to be considering the whole range of banks but just those that can readily operate in the relevant region. This immediately reduces the comparison to a small dimension, as the small banks are mainly regionally concentrated.

A problem not present in New Zealand is large size. Some of the European banks are very large indeed and with such complex operations it might be legitimate to question whether the limited disclosure proposed would be adequate for outsiders to form a view of the risks faced by the bank.

Prudential potential

Assessing the potential for the applicant to exercise prudence in management is a complex issue but one where there is considerable agreement among supervisors. The simplest is capital adequacy. Here there are accepted rules through the Basel criteria, which the EEA countries apply, so all banks operating in the EEA could be expected to meet these minima. However, it is a separate issue whether these criteria are adequate in all cases or indeed necessary in others (Mayes, 1997). For banks operating very cautious lending strategies, such as those specialising in house mortgages, where loans involving high percentages of valuation of the property require further security, the necessary capital levels could be quite small. For some wholesale institutions the risks could be large and the appropriate backing larger as well. Indeed this is one advantage of a disclosure system as a bank facing relatively high risks can demonstrate that it has adequate capital over and above the Basel minimum. For example, Bankers Trust (1997) in New Zealand goes out of its way to explain that it has more than the minimum cover, as this is appropriate for its business.
Capital adequacy alone is, however, thought to be inadequate by most supervisors. The main areas of contention are

- loan concentration and risk exposures;
- separation from the interests of owners;
- internal controls and accounting systems; and
- fit and proper persons.

New Zealand does not impose exposure limits but does seek to get disclosure so that concentration of loans to particular parties, sectors or countries is known. It is then up to the market to decide whether these exposures are acceptable. Clearly before registering a bank a supervisor has to form a view. However, some supervisors are more prescriptive and set limits. This of course begins to reintroduce the moral hazard as it could be taken to imply that exposures up to the limit are in some sense satisfactory.

The EU already imposes requirements for exposure limits on own funds to a single customer, to a parent or subsidiary and to large exposures in total. Individual regimes impose other restrictions, such as on net overnight exchange risk exposure. While these may not be necessary under market disclosure, many are unlikely to impose any great inhibition on banks’ activities. It would be for the banks to make a case that such restrictions were important but, where the limit is imposed by EU agreement, the regulations will have to stand.

The existence of adequate controls is a much more difficult subject. There are several important structural steps that can be taken, for example, separation of front and back offices, establishing a strong internal audit function, and establishing audit and risk committees that are chaired by external directors. Within reason it is possible to get banks to describe what they do, but where such descriptions do not relate to well-known products they will tend to be rather opaque and will convey little information. A good example of what can be done is the disclosure statement by Bankers Trust in New Zealand (Bankers Trust, 1998), which covers some four pages and deals explicitly, inter alia, with how they were handling the Year 2000 problem. Bankers Trust has its own proprietary system RAROC, which is well known, as well as the Daily Price Volatility assessment. In any case it is not the existence of systems alone that matters but the effectiveness with which they are operated in practice as well. The supervisor, large counterparties and analysts can use the disclosed information to enquire further.

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Bankers Trust has since been acquired by Deutsche Bank and the more recent (Deutsche Bank) Disclosure Statements can be viewed from their website www.deutschebank.co.nz.
For an existing organisation one can see the track record but that is a combination of
the operation and the risks encountered. Indeed for an existing organisation based
abroad but coming to an EEA country for the first time, it is possible to get a view on
its success in the existing jurisdiction from both supervisors and markets. For a new
organisation it may be possible to see the track record of the individuals concerned but
the validity of that also depends on the environment they were previously in. It is
difficult to go beyond the New Zealand solution of getting the directors to attest that
the appropriate systems are in place and effectively applied and to make them liable
should that statement be shown to be untrue.

Similarly if one wants to vet the appropriateness of bank directors one can only look
at their record. The criteria applied by the European countries vary considerably.
However, the aim is at least to comply with the BIS recommendations on what
constitutes a ‘fit and proper’ person. As a result a bank will tend to choose its directors
and senior management with a view to their external reputation as well as their
internal competence.

It is, of course, always helpful if there are strong independent credit rating agencies
that can give their own view of the quality of banks. Indeed if a bank wants to give an
idea of its quality to outsiders it will promote its rating in its statements in the same
way that commercial companies are concerned by their ratings. Such ratings are also
of considerable value in supporting a disclosure regime, to which we now turn.
International agencies operate in the European countries but a wider development of
domestic agencies could also be helpful to extend the range of assessments. The
smallest banks may find it difficult to get such ratings but will still face an incentive
to do so in order to demonstrate their strength over that of their competitors.

5.3 Transparency - availability of information - disclosure

The public availability of meaningful information sufficient for people to make
informed decisions about the likely standing of banks both individually and relatively
is the keystone of market discipline. (It is interesting to note that the rating agencies
were among the more vocal in support of the disclosure regime in New Zealand.
Publication with liability for accuracy of statements is likely to produce information in
which rating agencies can have greater confidence. Of course some of this might have
been just self-interest if they thought that the new regime would increase the demand
for their services.)
There is likely to be considerable debate over the level of detail to be disclosed. New Zealand has made a decision about the level of information that it feels is necessary (see Table 2). These are laid out in detail in the Banking Supervision Handbook (RBNZ, 1999), which is provided for registered banks on the Reserve Bank’s web page www.rbnz.govt.nz. It has also chosen to go for quarterly accounting periods, although a full audit is only required half yearly. This approach has been made in conformity with emerging practice in the US and international accounting standards – international standards have now caught up with the New Zealand practice with the interim proposals developed by the IASC. (Clearly in implementing any proposals one should try to align them with standards in a forward-looking not backward-looking manner, otherwise they will be rapidly outdated.)

As far as possible the disclosure statements have been designed to fit with modern accounting practice and the legislation puts the treatment of directors of banks very much on a par with the treatment of directors of other companies that issue securities under the terms of the Companies Act 1993, the Financial Reporting Act 1993, the Securities Act 1978 and Securities Regulations 1983 (Mortlock 1996). Indeed, bringing financial accounting and auditing practices into line was an essential part of ensuring that disclosure statements could be externally verified to a standard that would satisfy shareholders and depositors (and the Reserve Bank as supervisor).

**Table 2: Disclosure requirements in New Zealand**

- the income statement and balance sheet (including a 5 year summary of key financial data
- directors and their interests
- asset quality and provisioning
- the number of large exposures (including interbank exposures) as measured relative to the bank’s equity
- related party exposures as measured relative to the bank’s tier one capital
- sectoral exposures
- capital adequacy, including off-balance-sheet items
- market risk exposures
- credit rating (if held).

5 The web page provides not just the full handbook but a list of the registered banks with hypertext links to each of them where one can read their latest disclosure statements and related material. It also includes the Reserve Bank’s latest assessment of the state of the banking sector as a whole.
Although the disclosure requirements might seem onerous at first blush, they are designed to do no more than encourage directors to undertake their existing responsibilities conscientiously. It makes directors accountable; it encourages them to be well informed about the activities of the bank and the risks to which it may be exposed. In particular, it encourages them to make sure that the systems in place in the bank are adequate to monitor and manage those risks.

In taking this last step, the Reserve Bank has sought to get round a problem that entraps more traditional supervision systems, which lay down a set of procedures that should be followed. It is easy to find out whether the bank has actually put the procedures in place but it is very difficult, as an outside observer, to find out how well they are followed and whether it is the spirit of their purpose which has been implemented. The system of incentives encourages directors and managers to satisfy themselves that both the letter and the spirit are being followed, as they will be held accountable if there is a problem.

Since these statements should correspond closely to the quarterly information that banks would wish to produce to ensure their own good operation, the compliance costs should be reduced compared with other supervisory regimes – although no doubt there are transition costs as the new arrangements are implemented. The Reserve Bank has stopped charging banks for the costs of supervision and banks now have increased business freedom through the reduction of direct controls.

**Key Information Summary**

The disclosure statements are published in two forms. A Key Information Summary (KIS) is required to be displayed prominently in every bank branch and is available on demand. (The information available from the KISs is summarised for each bank on the RBNZ’s web page, www.rbnz.govt.nz, which also provides links to each individual bank’s web page, most of which include all disclosure documents.) The KIS contains the core information in the statement presented in a manner that is intended to be accessible to the ordinary bank customer, normally in the form of a single folded card placed in a pamphlet rack. It includes:

- the bank’s credit rating (or statement that it does not have one);
- capital ratios;
- information on peak exposure concentration, asset quality, shareholder guarantees (if any) and profitability.
The KIS is primarily aimed at the retail customer. However, the practice is that most individuals do not look at the documents and the numbers used are small. There are several reasons for this. The documents are not particularly simple to read. They are written in financial reporting jargon and hence most people would have difficulty interpreting them. Retail customers tend either to take the quality of the bank on trust or rely on others. The reader who can cope with the jargon readily is also likely to be interested in more detail.

Thus the idea of the KIS, while appealing in principle, has not really achieved its aim in practice of meeting the needs of those who walk into bank branches.\textsuperscript{6} Other information documents produced by the Reserve Bank to try to deal with the main practical questions concerning risks have also had a relatively low take-up although internet access widens the availability substantially. As a result the Bank has tried to adopt a different approach to trying to increase financial and economic literacy by providing resource packages for schools that form part of the main curriculum (RBNZ, 1995a; 1996).\textsuperscript{7} The UK FSA also has a public-awareness objective, under which it is likely to try to increase understanding of basic concepts such as the risk/return trade-off. Training depositors to assess the risks of individual institutions would be an unrealistic aim.

\textit{The General Disclosure Document}

The other publication is the \textit{General Disclosure Statement}, which contains the full list of information described above in a manner aimed principally at the professional analyst.

These documents can vary fairly substantially between the banks in terms of presentation. The KIS is usually two to four pages in length but the GDSs are much more substantial (ANZ 48 pages, BNZ 66 pages, Countrywide 41 pages, Westpac 52 pages for the six months ended February or March 1997).

GDSs include

\begin{enumerate}
\item the financial statement
\item the statement of financial position
\end{enumerate}

\textsuperscript{6} It is not readily possible to tell how internet access to KIS’s is used.

\textsuperscript{7} There have been other public sector attempts to increase the public’s perception of risk such as a campaign in 1997 to make people aware of the need to make adequate financial provision for themselves in retirement.
the cash flow statement
the notes on accounting policies, including valuation of derivatives and
treatment of market risk
related party transactions
risk management policy for derivatives and statement of on and off-balance
sheet risk
statement on fair value and concentration of credit risk
the explanation of market risk management and exposures to market risk
(including peak exposures)
the attestation statement by the directors

Much of the financial information is fairly conventional and by not presenting the
exposure information in ratio form it is not as helpful to the reader as it might be.
Around a quarter of the document is explanation. It is probably the last two items that
are of greatest interest.

New Zealand requires the disclosure of peak exposures, not just some quarterly average
or end-period value. This enables the disclosure of the full extent of the risks that have
been run. Disclosure would clearly be of much less market value if it did not also
include peaks or the number and nature of the greatest exposures. It is quite possible
that peak exposures will exceed either limits prescribed by the authorities or limits
voluntarily imposed in advance by the banks on themselves, but this is not a problem
for disclosure as such. It is up to the bank concerned to explain the overshoot in a
manner which the market finds convincing. As it happened, the illustration of a
disclosure document shown in Mayes (1997) for the National Bank of New Zealand
included an overshoot of the limits to exposure to related parties laid down by the
RBNZ. The NBNZ explained that this exposure – to its parent – occurred as the result
of a failed transaction and when this was publicly disclosed it went completely without
comment or noticeable reaction by the market. (The overshoot was notified
immediately to the supervisor without waiting for the next public disclosure date.) If
an overshoot were the result of an internal system not working properly not only would
the bank wish to correct that but it would want to do so in a manner that convinced
outsiders. Disclosure of excess risks does not therefore place obligations on banks that
they would not wish to place on themselves.

An issue that arises from the New Zealand context is the need to bring as much as
possible of the bank’s activities into the frame for disclosure and not just to consider
what is on the conventional balance sheet. It is risks associated with market activities
and in well-known cases with derivatives that have provided the crucial source of risk for some banks. It is therefore necessary to go rather further than the traditional accounts. Thus off-balance-sheet as well as on-balance-sheet risks are included.

The Reserve Bank has gone rather further than the Basel accord in requiring disclosure of Value at Risk not just for the banks’ trading book but for the whole of their balance sheet (Harrison, 1996; RBNZ, 1999). It has set out a common framework for the calculation of risk so that banks can be compared and assessed relative to a standard. (Banks can use their own systems to measure exposures provided that this does not generate results materially below those obtained from applying the Reserve Bank’s standard.) The market risks cover interest rate, exchange rate and equity exposures. The Basel ‘standard model’ forms the basis for the assessment, with interest risk decomposed into directional, yield curve and basis risks. Both end-of-quarter and peak risks during the quarter have to be disclosed. As from the end of 1998 these market risks have had to be externally audited along with the rest of the disclosure document.

The Reserve Bank has been opposed to laying down uniform quantitative risk limits. If such limits are to be effective in restricting risk in all normal circumstances they will tend to have to be set rather low, inhibiting some prudent business. On the other hand, if they are normally set fairly high, so as only to exclude imprudent behaviour, they will implicitly offer an endorsement of behaviour up to those limits, which could in some circumstances result in the taking on of undue risk. The problems of moral hazard are thus reintroduced. The Reserve Bank has therefore limited such ratios to the minimum number that international standards require.

Similarly, the Reserve Bank does not prescribe particular internal control mechanisms. If it did it would again face the twin dangers: that such controls might be thought to be adequate in all circumstances and hence allow the emergence of greater risks than banks would be prepared to tolerate of their own volition; and that such controls would be felt mandatory and hence their imposition might impose unnecessary costs on some banks, whose business does not require them. (Section 6.2 contains suggestions for improving on the New Zealand system in this particular area.)

By following this value-at-risk approach the New Zealand supervision system should be well adjusted to the advances being reported (see Jackson et al 1998, for example) in bank-based systems which can be ‘back-tested’ for accuracy compared with the unadjusted Basel criteria. By using a disclosure route it is possible for concerns over capital adequacy to be expressed before the bank reaches any specific limit. As
Goodhart (1996b) points out there is no material difference between capital adequacy of 8.0 and 7.999 per cent. Triggers for concern should be progressive and take into account an evaluation of the bank’s whole business, as well as the wider state of the financial system and the economy as a whole at the time (Benston and Kaufman 1994). Disclosure enables concern to be expressed with varying intensity at any juncture.

To some extent New Zealand requires the disclosure in public of what other authorities collect in private and do not disclose. One obvious approach for introducing disclosure elsewhere would be to say that everything which is currently (or planned to be) disclosed to the authorities should be disclosed in public, as clearly the authorities feel that all that information is necessary in forming a view about the standing of the institution. This criterion might however be too detailed and banks would feel that some of this information is too sensitive.

It is also likely that in the discussion with the banks over what should be disclosed, the authorities may find information that has been collected more for historical reasons than current benefit, and hence can be dropped with little loss. Some of the information that is currently provided to the authorities by banks, such as the detailed quarterly country risk, is collected for international statistical and surveillance purposes on behalf of the BIS and IMF and so would not directly indicate the appropriate level of detail that should be disclosed. Similarly, daily foreign exchange transaction information is collected for reasons of financial system management rather than for prudential supervision and hence would not be affected by a change in the supervision regime. Nevertheless it is to be expected that the burden on banks would be reduced, and that the specification of the disclosure requirement would be such that they could use the data that they collect for internal management purposes for public disclosure, and would not need to collect information for disclosure alone.

The European Commission (DG Markt) has also been discussing disclosure of financial instruments. The detail being discussed here is also greater than that required in New Zealand and fairly similar to that currently required by EEA supervisors. It is therefore likely that a disclosure regime implemented in the EEA would at least meet the level of detail in these draft proposals, assuming, that is, that an agreement is likely in the reasonably near future. It is anticipated that in due course there will be an EU recommendation advocating a similar level of public disclosure (but probably at annual rather than quarterly frequency).
In the New Zealand case it is probably the attestation by the directors that is the most important single item in the document. All of the directors, including the non-executives have to sign stating not just that the financial information is correct and that the bank has complied with the requirements on capital adequacy, risk exposure and reporting but that the necessary risk management procedures have been properly applied.

5.4 Rule of law – responsibility

A disclosure system is only going to work if compliance is the norm and, in general, breaking the regulations is by accident and not fraudulent intent. The system of penalties needs to act as a deterrent and as an adequate punishment in society’s eyes. For large institutions like banks, penalties have to be huge to be effective. However, if they are to be administered at a time when the bank is in distress they may end up being levied in effect on creditors and depositors not on the management and shareholders of the bank. It is therefore difficult to get them to be very effective. New Zealand tries to get round this by imposing penalties on the individual directors who have signed the disclosure statement. Here jail terms and unlimited civil liability can have a very real impact, as they apply to the individual and not the institution in difficulty. If the prospective penalties are such as to act as a genuine incentive to prudence by bank directors, and are believed to act as such by the public, then the system is likely to function.

Of course, the penalties must not be so harsh that they deter reputable people from becoming bank directors. This is not the case in New Zealand where the penalties are:

- a fine of up to $NZ 25,000;
- a jail term of up to 3 years;
- unlimited personal civil liability for losses sustained by reason of subscribing to any debt security (including bank deposits) issued by the bank in reliance on false or misleading information contained in a disclosure statement.

It is well known in economics that the system that maximises welfare is a compromise and not just one where all fraud is deterred (Acemoglu and Verdier, 1998; Tirole, 1996).

Penalties also need to be progressive. If the only effective threat is deregistration as a bank then the transgression of the regulations would need to be correspondingly
drastic and persistent. The authorities need not merely to be able to deter infringements at the margin but also to discourage banks from thinking that once they have broken a regulation there is no greater stigma from a large rather than a small breach. In general, the EU has not been very active in trying to establish market-wide minima for effective penalties and incentives for prudence.

These arrangements will encourage banks to appoint directors who are not only skilled in their own right and have established reputations but who have an incentive to see that the bank’s management has the necessary skills and experience. By having these reputational penalties and encouraging a regime which makes early identification of problems more likely it is hoped to provide at least some safeguard against ‘go for broke’ strategies (Kupiec and O’Brien 1995). That worry is that managers, having breached the criteria for prudence, have no greater downside penalty from following increasingly risky strategies. In the New Zealand regime the penalties for trying to cover up and get through a difficulty may be greater than those from disclosing an impending problem in the first place.

What is being sought here is a ‘contract’ between the supervisor and the registered bank, where the incentives are such that, for the minimum cost, the bank keeps the risks of imprudent behaviour below some minimum acceptable to the supervisor. (This is analogous at one remove to the sorts of optimal contracts discussed by Diamond (1984), inter alia, between lenders and borrowers, where the borrower is faced by a set of disincentives to fail to produce the required return for the lender.) Registration criteria help screen out high risks, and the range of risks to be covered in the disclosure statement help ensure that the identifiable facets of risk are covered. Managing the risk is achieved through a combination of specified minima, and pecuniary and non-pecuniary disincentives where the required standards cannot be expressed in any such directly quantitative form. Market disciplines are likely to be more effective than threat of fines and other similar penalties. It is not possible to draw the appropriate line for prudent minima or for the appropriate level of the disincentives with any precision. Furthermore, supervisors wish to avoid conducting any experiments that demonstrate what incentives are insufficient. The Reserve Bank of New Zealand’s system is thus not designed to test the margin of adequacy but to operate at a level where risks are low at the best international standards for supervision.

However, the importance of a reliable legal framework stretches rather wider than just compliance with regulations. Property rights need to be clearly established for incentives to be effective. Not only does the valuation of assets have to follow a
generally agreed system but the ownership of collateral needs to be clear if risks are to be properly assessed.

5.5 Banks can fail

Perhaps the most important part of the incentive structure is the understanding by all parties that bank failures are possible, even in well managed organisations, because banking involves the taking of risks. And those banks that do become insolvent will be allowed to fail by the authorities. If that is understood then shareholders will know that they will be the first at risk if the bank fails. They will then seek to ensure that the directors that are appointed are suitable and that the information disclosed is adequate for them to be convinced of the sense of their decisions. Customers, counterparties and depositors (who are not otherwise insured) will be keen to satisfy themselves about the strength of the bank. The directors and management themselves will be keen to ensure that they do not lose their jobs.

This is a normal requirement of most systems. The Bank of England was keen to make sure that shareholders should understand the treatment they will get even if the bank is rescued: ‘Central banks are not in the business of providing public subsidy to private shareholders. If we do provide support, we will try to structure it so that any losses fall first on the shareholders and any benefits come first to us...‘(George, 1993).

Unfortunately it is impossible to set up a completely credible prior commitment not to bail out insolvent banks, but the system can be set up in such a way as to make it difficult, and the extent of prior reassurances to the contrary can make reneging very expensive. Credibility of course breeds credibility. If people believe that there will be no bailouts and hence banks are run in a more prudent manner the risk of insolvency falls and the authorities’ resolve under pressure is not so tested. Even in small markets, where there are many small banks, the chance of testing the authorities’ resolve may be small. Small banks in difficulty either present little public problem if they fail or more likely they can rapidly be reconstructed by one or more larger banks through voluntary agreement. It may be some time before a larger institution whose failure would have a noticeable impact (in political as well as economic terms) gets into a difficulty that cannot be resolved within the banking sector.

Similarly if a bank actually fails and is not bailed out this will also increase the authorities’ credibility in the future. Some parts of the EEA obviously face a problem
of history, having bailed out the banking system in the last crisis. In such cases it is necessary to be even more effective in designing a system that makes it look less likely in the future. There are some simple structural aspects that will assist this:

- making sure that those responsible for resolving the crisis do not have direct access to public funds;
- making sure that those who resolve the crisis are completely independent of those who have funds at risk.

5.6 Good effective systems to handle systemic risk

The final requirement for the successful operation of a more market-based system of banking supervision is that there should be arrangements for the resolution of difficulties that enable the incentive structures to be effective. Namely, it must be possible to resolve a bank that is either insolvent or unable to meet the capital adequacy or other requirements for registration rapidly and without the need to bail out the shareholders. Liuksila (1998) suggests that there are some question marks over whether this is possible without shareholder agreement in the EU (which could effectively preclude a rapid resolution).\(^8\) In the New Zealand case there is no such barrier: ‘a statutory manager has, and may exercise, in the case of a body corporate, all the powers of the members in general meeting and the board of directors of that body corporate’ (Reserve Bank Act, 1989, section 129). The statutory manager can also:

- carry on the business (section 130);
- pay creditors and compromise claims (section 131);
- sell the bank (section 132);
- petition to wind the bank up (section 136).

By following the route of statutory management, there is a clear separation between the process of resolution and any access to government funds. The Reserve Bank of New Zealand also shall if it ‘considers it necessary for the soundness of the financial system, act as lender of last resort for the financial system’ (section 31). There has been no explanation either of the conditions that would merit such lending or the terms under which such lending would be made. Clearly it will weaken any incentives

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8 The problem is less evident for the UK than for many other EEA countries.
if the banks believe such facilities will be readily available or that the prospect of failure of any large bank would be thought to be an unacceptable threat to the soundness of the financial system as a whole.

A key feature of the New Zealand regime is that the idea of any implicit guarantee for registered banks should be minimised. Unlike most OECD countries New Zealand does not have any system of depositor protection, even for small retail deposits. Nevertheless, it is impossible to dismiss the idea that the government might step in in the event of the failure of a major retail bank, however much the authorities wish to precommit themselves not to act in that manner. The system is designed to permit individual banks to fail, whatever their size, and purely to try to make sure that the knock-on consequences for the financial system as a whole are minimised.

It is important to distinguish between liquidity and solvency problems (although this may be difficult to achieve in practice, particularly at a moment’s notice). The Reserve Bank has the power to provide whatever liquidity is necessary to maintain the confidence in individual banks and hence the system as a whole. This helps ensure that shocks which have a short-run adverse effect on liquidity do not spill out into a wider problem, whether the shocks are to the economy as a whole or to individual banks. (It would also prevent market participants driving some of their number into difficulty by cornering markets.) However, the Reserve Bank will not provide liquidity to banks which are either insolvent or likely to become insolvent and will instead recommend to the Treasurer that the bank be placed under statutory management. Such a recommendation would also be made if a bank in difficulty refused to consult, comply with a direction or behaved in a manner prejudicial to the soundness of the financial system.

The statutory manager has wider powers than a liquidator. There is a moratorium on legal proceedings. The manager can suspend payment on money owing and can convert a branch of an overseas bank into a locally incorporated entity. The statutory manager is subject to direction by the Reserve Bank. The prime regard of the statutory manager is the need to maintain public confidence in the operation and soundness of the financial system and to avoid significant damage to the financial system. However, consistent with that, they are also required to try to resolve the difficulties as soon as possible while preserving the position and maintaining the ranking of creditors’ claims.

The more common occurrence will, it is to be hoped, not be crises but breaches of the capital adequacy requirements. Here (RBNZ 1995b, p. 78) the Reserve Bank has
implemented a version of what Goodhart (1996a, p. 647) has described as ‘a pre-committed graduated series of responses in face of capital erosion’.

- If tier 1 capital falls below 4 per cent or total capital below 8 per cent of risk-weighted exposures, a bank must submit to the Reserve Bank a plan for restoring its capital at least to the minimum, and to publish that plan as soon as possible in a disclosure statement.
- The plan would have to include
  - no distributions are made to shareholders till the minimum position is regained;
  - no increase in the exposure to a related party from that prevailing at the time of the breach.
- If tier 1 capital falls below 3 per cent, gross credit exposures must not be increased above the level prevailing at the time of the breach.
- The Reserve Bank can, if necessary, enforce this policy by giving a ‘direction’ to the bank under the provisions of section 111 of the Reserve Bank Act.
6 The transferability of the New Zealand system

New Zealand is a small country with only 17 registered banks, which are all foreign owned except for one, and that one has a very small market share (Table 3). It is thus relatively easy to keep tabs on the whole of the financial system and to be relatively well informed about what is going on. However, it is sometimes argued (see Brash, 1997) that New Zealand is to some extent piggy-backing on the more traditional supervision regimes in other countries as home country regulators normally require reports on the whole operations of the banking group, including those in New Zealand.

To some extent this is true, in that if the supervisors in the parent’s jurisdiction were to do a poor job and allow the parent to fold the chances are that the New Zealand subsidiary and certainly a New Zealand branch would fold with it. New Zealand is thus reliant on adequate supervision of the parent. However, this reliance only extends to supervision within New Zealand in a rather limited sense. The Reserve Bank will normally place a lot of stock by the parent’s supervisor’s views of the standing of the institution and of the bank’s compliance with the requirements imposed by the home supervisor. However, if the Reserve Bank were not able to place that reliance it would have to make up its own mind.

However, the success of the system within New Zealand does not rely on external supervision but on the rules for registration, disclosure and crisis management.

Secondly the position would be very different if there were a large number of New Zealand registered banks which were doing substantial business in third markets. In these cases the Reserve Bank would in effect be supervising a parent and it is likely that the nature of disclosure would have to change to take account of substantial overseas operations.

Thirdly, it is worth noting that financial markets in New Zealand are highly developed. Information about financial institutions and those who run them is both substantial and accurate. There is fortunately no history of corrupt or suspect behaviour. Where a central bank has far more doubts about the quality of those wishing to run banks or the public lacks confidence then a more intrusive regime and a wider system of guarantees may be appropriate. The nature and adequacy of corporate law, the adequacy of accounting standards, auditing requirements and even the integrity of the accounting profession will all affect the efficiency of a disclosure based regime – as indeed will freedom and ownership of the press. As in so many circumstances this is a matter of weighing up the costs and benefits of the different regimes and there is no reason to expect that precisely the same conclusion will be drawn in each jurisdiction. Where the banking system is largely owned by the state, disclosure may be less meaningful as the implicit guarantees will be substantial. Even so a robust disclosure regime may encourage better risk management.
Furthermore the regulation of the banking sector has to be balanced against the regulation of closely related sectors. If the regulation of banks is too harsh, in relative terms, then some of the task of intermediation undertaken by banks will tend to migrate to less regulated sectors. This migration may itself tend to lessen the stability of both the financial sector as a whole and the banking sector in particular. In New Zealand the whole system of financial regulation has been developing in parallel, with some steps, outside the banking sector, still to be completed.

**Table 3: Registered Banks as at 30 September 1999**

<table>
<thead>
<tr>
<th>(a) New Zealand Incorporated Banks</th>
<th>Owner(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Registered Bank</strong></td>
<td><strong>Owner(s)</strong></td>
</tr>
<tr>
<td>ANZ Banking Group (New Zealand) Limited</td>
<td>Australia and New Zealand Banking Group Limited</td>
</tr>
<tr>
<td>ASB Bank Limited</td>
<td>Commonwealth Bank of Australia (75 %),</td>
</tr>
<tr>
<td></td>
<td>ASB Community Trust (25 %)</td>
</tr>
<tr>
<td>Bank of New Zealand</td>
<td>National Australia Bank Limited</td>
</tr>
<tr>
<td>BNZ Finance Limited</td>
<td>National Australia Bank Limited</td>
</tr>
<tr>
<td>Rabobank New Zealand Limited</td>
<td>Rabobank Nederland</td>
</tr>
<tr>
<td>The National Bank of New Zealand Limited</td>
<td>Lloyds TSB Group plc</td>
</tr>
<tr>
<td>TSB Bank Limited</td>
<td>TSB Community Trust</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(b) Overseas Incorporated Banks</th>
<th>Owner(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABN AMRO Bank N V</td>
<td></td>
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<tr>
<td>AMP Bank Limited</td>
<td></td>
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<tr>
<td>Bank of Tokyo-Mitsubishi (Australia) Limited</td>
<td></td>
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<tr>
<td>Banque Nationale de Paris S.A.</td>
<td></td>
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<tr>
<td>Citibank N.A.</td>
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<tr>
<td>Deutsche Bank A.G.</td>
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<tr>
<td>Hong Kong and Shanghai Banking Corporation</td>
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<tr>
<td>Kookmin Bank</td>
<td></td>
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<tr>
<td>Rabobank Nederland</td>
<td></td>
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<tr>
<td>Westpac Banking Corporation</td>
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</table>
Lastly, regime changes can always lead to uncertainty. Even if a disclosure based regime might be more effective in the long run, introducing it at a time of fragility in the financial system might be ill advised.

It is also worth noting that while this paper may appear to have focused on systemic risk, this does not mean investor protection is neglected by the New Zealand approach. The absence of any public or private insurance schemes for depositor protection does not mean that depositors are not protected. The system is designed to provide sufficiently strong incentives to prudential management that such schemes are unnecessary. Indeed, it is argued that the presence of such schemes would themselves weaken the incentives and increase the chances of a failure and hence the need to bail out depositors.

Not all jurisdictions might feel that they had the confidence to operate such a scheme. Ultimately the fallout from losses by retail depositors will be political, as they are also electors. As Goodhart (1996b) points out (p. 27) there is one sense in which the contract between depositors and banks differs from that with other transactions. Here one cannot inspect the goods before parting with the money. The depositors part with their money now in return for the promise of more later under various conditions.

In some respects it is the treatment of deposit insurance that provides the clearest difference between the New Zealand regime and the progress towards greater disclosure occurring in other OECD countries. The New Zealand system does offer a substitute for deposit insurance in that the incentives in the system should encourage more prudent behaviour by the banks and depositors in the first place.

Others (Diamond and Dyvbig 1983, for example) have suggested that the lender of last resort facility to deal with liquidity problems for banks that are basically solvent but faced with a crisis of confidence can act as an alternative to deposit insurance. There it is hoped that the existence of the facility will provide the necessary confidence, so that runs will not occur in the first place. As with government backed deposit insurance schemes, where the payout can be covered by taxation, no cost is incurred if the facility is not called on. (There are of course severe practical problems in distinguishing between liquidity and solvency problems in a crisis as action has to be swift. The quality of the decisions made will depend upon the accuracy of the knowledge available to the central bank at the time.)

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9 The Diamond and Dyvbig results have been challenged (Dowd, 1996, for example).
However, comparable economies are not starting from a clean slate. Most have deposit insurance already. It is probably unlikely that countries with deposit insurance would feel inclined to remove it, although changes in form to focus on the depositors with the greatest difficulty in obtaining information on the risks to banks, i.e. small retail depositors, might occur. In no way does this mean that a disclosure regime only makes sense if there is no deposit insurance. All of the other incentives on directors, shareholders and non-insured depositors still apply, as do the incentives for competitors to highlight difficulties – they may have to pick up some of the bill should there be a call on the deposit insurance – and for analysts and the media to search for value and for stories.

6.1 The main barriers to transfer

The discussion so far has identified five main issues that need to be addressed if greater market discipline is to be introduced successfully in EEA countries:

- accounting and auditing standards;
- the structure of the banking industry, with high concentration on the one hand and a string of small banks on the other;
- the role of deposit insurance;
- the powers of crisis resolution; and
- the treatment of market risk.

The last of these is qualitatively different, as, unlike the first four, it is not a just a question of whether existing experience in successful supervision regimes can be emulated but whether existing regimes, and the New Zealand one in particular, can be improved upon.

I have discussed (in section 5.2) the fact that current EU legislation permits (but does not compel) member states to apply international reporting standards that would enable the necessary quality and comparability of disclosure statements, so I do not return to it here. I turn instead in the next section (6.2) to the second issue of the structure of the banking industry. I have argued already that many of the smaller banks individually, and in some cases in total, do not present much of a systemic risk and could therefore be subject to a different regime. Market pressures may in any case encourage merger. Section 6.2 therefore focuses on the other end of the scale – on the
issue of ‘too big to fail’. Deposit insurance is dealt with in Section 6.3 and market risk in Section 6.4. The question of crisis resolution, while extremely important, is a general issue and not specific to the introduction of more market discipline. It is therefore also left on one side. (A detailed treatment can be found in chapter 8 of Mayes et al (2000).)

One further problem that does not affect New Zealand or other jurisdictions is the requirements of EU legislation. One issue has been clearly identified in this regard

- the problem of home country control

and this is the subject of Section 6.5.

The single European market legislation as expressed in the Second Banking Co-ordination Directive (1989) required that, subject to a set of minimum prudential requirements that must be applied by all member states, a bank headquartered in one member state and meeting the requirements to be registered as a bank in that state has the right to set up branches in other member states. Furthermore, although some data will be collected from branches in other host countries, supervision will be exercised on a consolidated basis by the authorities in the home state. (The issue of home country control is treated in more detail in Mayes and Vesala (1998).)

The host authorities may thus have limited information on banks operating in their market but headquartered elsewhere in the EEA, and even more limited powers of action should those banks get into difficulty. While the host authority has the responsibility for the systemic implications for its own market, the authority with the power of resolution will have responsibility only for its own financial system. Thus small member states may find they have banks with significant implications for systemic stability in their market yet rather less importance for the financial stability of the home market.

Secondly, if multinational banks have an element of choice of where to be headquartered and registered within the EEA, they may move away (towards) a jurisdiction that introduces a less (more) favourable regime.

Clearly the EEA, like other countries, is facing the consequences of trends in financial markets, such as the rapid growth of information technology, improved payment systems and the introduction of new products, especially derivatives. All of this will
have an influence on the introduction of changes to the supervision regime. These will be exacerbated by the completion of the single European market and the innovations involved with participation in Stage 3 of EMU. In general these forces either increase the need for introducing greater market discipline or make its introduction rather easier, such as the improvements in payments systems. So I do not deal with them explicitly in this section.

6.2 ‘Too big to fail’

The system of market discipline works well in New Zealand, first because all of the main banks are quite large and are publicly quoted either themselves or through their parents. Secondly not only are there five main banks competing for retail deposits but none of them has a dominant position. Competition is thus very real.

Some EEA countries are not so fortunate in the structure of their markets. First, in some cases one or two banks have a dominant position, and secondly, some EEA banks are government owned. This leads one to question the extent of the effect that external pressures, whether from the market or from government, would have. However, such problems remain whether or not more market discipline is introduced. A third difficulty in some countries is that there are many small banks, so that the degree to which they would be effectively monitored by the market is limited: they are mainly regional and therefore would attract interest in the region but perhaps not much from the main national or international money markets. Fourthly, many of the banks are co-operative in structure and for these the nature of the incentives varies from the traditional model. Owners are not so readily divorced from customers. Nevertheless the management still has the same incentives if they are personally at risk.

Small banks pose problems for appropriate supervision. On the one hand should any of them fail the systemic consequences will be negligible. Larger banks can afford to acquire them. Hence there is less ‘need’ in some senses to spend major effort in supervising them. On the other hand smallness makes it less likely that sophisticated risk management methods will be applied, often because the business is sufficiently simple that it can be monitored by more direct means. The risks from poor management could therefore be greater but by the same token the risks in the type of business may be less with no extensive trading in derivatives that could bring the bank down. There is a general danger in supervision systems that small banks may have more than proportionate attention paid to them compared with their importance in order to
ensure equal treatment of banks irrespective of size, while large near-bank financial institutions, whose demise would pose substantial problems, may receive attention less than proportionate to their importance. Such near-banks normally do not have so much reliance on assets that are difficult to value in a crisis or realise without substantial penalty.

All supervision regimes face a test of credibility. In a crisis there are enormous pressures to bail out a bank in difficulty with taxpayers’ money, particularly because far reaching decisions have to be made at high speed. If there is a history of such bailouts it is even more important to give a clear signal that a different approach will be followed in the future. Regrettably the most convincing way of giving that signal is to allow the first bank which encounters difficulties to fail (and to hope that it is not so large that it presents serious systemic problems) (Mishkin, 1998).

6.3 Deposit insurance

In New Zealand there is no deposit insurance, so in one sense the moral hazard is reduced as bank managements and owners can expect that they will have to face the full responsibility for the loss incurred even by small depositors. However, it is not clear how much this is a realistic difference from the EU schemes, which have insurance up to some limit. It is unlikely that it will be politically viable to allow large numbers of small depositors – who are also voters – to incur losses that amount to a substantial proportion of their small resources. Indeed it may be better to have explicit rules, which are known in advance and cover the political risk, than to leave the position open for people to guess. Their uninformed expectations may be rather larger than could be agreed beforehand, at a time when there was no crisis and hence no specific people who were about to become losers unless the authorities acted.

With the partial insurance provided in the EEA, at least some depositors know their funds are at risk. Since these are the larger deposits there is a good chance that their holders appreciate the risks involved. With only limited insurance there is less of a barrier to entry for banks in terms of the funds they must hold against the risk. Most small depositors will probably have little idea of the actual level of protection in place.

What is more interesting in the EU environment is whether the hazard is affected by the nature of the insurance system, and the relationship between the insurer and the authority responsible for deciding upon how the problem should be resolved. If the
insurance is provided by the public then the insurer may want to try to trade off the costs of a bail-out against the insurance. Certainly any insurer will want to trade off the costs of the resolution against the costs from paying out on the insurance, as in the case of the FDIC in the United States. Hence industry-based insurers would increase the chance of the industry itself mounting a rescue for the bank in difficulty. Here the incentive structure is quite complex. If banks think they will be bailed out by their colleagues then they may be less prudent. However, they do not want to be pushed into acquiring their competitors' assets at a time when the market as a whole is under pressure. There could be an incentive then to weaken a competitor that is having idiosyncratic difficulties in order to pick up its assets at a discount. This would strengthen the case for having a resolution procedure based purely on avoiding systemic risk, and one where the concerns of those with assets at risk are only treated relative to each other and not in some context of the wider good or the interest of one specific group. Mishkin (1998) has recently made some interesting additions.

6.4 Market risk

The New Zealand authorities had wanted, first, to introduce a regime that required the banks to disclose how they handled market risk and, second, to ensure that the quality of that management at least met the latest Basel standards. This second objective did not imply that these standards were thought to be either ideal or adequate, but that they were likely to become the international standard and New Zealand was concerned that its banks would face difficulties in capital markets if standards were perceived to be below the norm.

The problem is that assessment of market risk is not a simple task and assessment methods are complex and difficult to describe. Disclosing the methods used would therefore be a substantial process and one only assessable by a very small group of specialists. In other regimes it has only been supervisory authorities that have been prepared to assess alternative risk management models against the standard, through methods such as ‘back testing’.

The Reserve Bank therefore found itself pushed into setting out a version of the emerging Basel standards as a description of the sort of regime that would be acceptable (RBNZ, 1999, part 6). A bank could then apply that model of Value at Risk

\[ V = \max(0, R - \lambda) \]

10 The RBNZ ‘standard model’ is also compatible with the EU Capital Adequacy Directive.
and disclose the outcome without any need to justify the method being used in the disclosure statement. However, the RBNZ did not want to compel banks to use that specific model, as it might very well not be appropriate to their specific businesses. For example, covariances might be important either in reducing or increasing the overall risk. The RBNZ did not want to impose a compliance cost on the banks by compelling them to use one model for disclosure while they actually used another in managing the risk in practice. Having different internal models and disclosure models is suboptimal in two further respects. Not only does it mean that banks do not demonstrate that they are employing risk management methods that they think are superior to the standard model, but it may also mean that banks have to have cover in excess of the risks they perceive internally, thereby inhibiting the business and imposing further costs (on customers). However, one point to note in the New Zealand system is that there is no requirement to hold capital against the disclosed Value at Risk. That is a commercial choice for the banks. The market can observe what capital they do hold. In practice the retail banks have not always held enough capital (in addition to the capital adequacy requirements) to cover this risk fully in the manner normally advocated (see Ruthenberg, 1997, for example). Wholesale banks, on the other hand, have normally exceeded it, sometimes by a substantial margin, which could be interpreted as a demonstration of the prudent management of risk in relation to the specific business.

The result of specifying the standard model as a guideline was that all banks disclosed using that model, irrelevant of whether they used the model internally. While this has the advantage of comparability, it did not really reflect the intent of the regime. Some of the banks claimed that they preferred not to disclose their internal models because this revealed more about their competitive strategies than their competitors were revealing. This is a classic prisoners’ dilemma. If all the banks revealed their internal models then the playing field would be even again, the disclosures would be more meaningful and the banks could demonstrate a competitive edge over each other in terms of the quality of the methods they used. The incentive structure would tend towards encouraging greater quality of risk management, not the bare minimum.

Kupiec and O’Brien (1997) offer an alternative approach, which might get round this difficulty, by suggesting that banks could ‘precommit’ themselves to cover value at risk. They would use their own VaR models and choose what capital they wish to hold against the computed risk. If the capital held turns out to be inadequate then the bank is faced with having to recapitalise itself to meet both the capital adequacy standards and the market risk for the future, under what are likely to be adverse conditions. The market will
be aware of why the self-imposed capital cover has been breached, because the bank will have had to disclose it. If that reflects bad luck rather than bad management then the market may be relatively tolerant, but if in the opinion of the market the risk should have been identified then the bank will be penalised in terms of the costs of recapitalisation, and can expect to have to take appropriate measures in terms of improving procedures and probably dispensing with the services of those responsible in order to secure the new capital backing. This regime would reflect clear market discipline.

It also has the advantage that it is progressive. The self-imposed limits do not have to be breached for the market to start raising the cost of capital for the bank. Indeed, prudent behaviour can also be rewarded as investors seek to provide capital to a well-managed bank.

In the literature surveyed by Kupiec and O’Brien (1997) it is usually suggested that the supervisor might wish to impose some penalty on the banks in addition to market discipline if the precommitted value is breached. This could take a number of forms. The idea of a fine seems rather inappropriate as it would be eroding the bank’s capital base just at the time it needs to replenish it and would make resolution of the problem more difficult and increase the chance of turning a difficulty into failure. A more appropriate threat, which is also suggested, is to relate the supervision regime to the past performance. Thus a bank that fails in its precommitment could expect to have to face a much more intrusive supervisory regime until the supervisor is convinced that the new processes and management are adequate for a return to precommitment. (Indeed some market valuation approach could be used so that the regime switch is in effect dictated by the market.)

There is some attraction in this latter approach particularly if market discipline is being introduced (see Mayes, 1998, for an application to the transition economies). A supervisor could progressively grant banks the freedom to operate under market discipline instead of detailed supervision as it became confident of their standing, an idea that is being trialled in the US (Kupiec and O’Brien, 1997). This is relatively easy under the US framework as the Fed assesses the quality of banks regularly according to a battery of criteria. A cut-off value could be established at which the regime shift could take place. However, this assessment is not published at present.

It is also the case that in the US system the Federal Reserve assesses the adequacy of the VaR system that is being used. Any such assessment would tend to reintroduce an element of moral hazard in the sense that it could be taken both by the management
of the bank and by the market as an endorsement that the risk management system is appropriate. It also exposes the authorities to an implicit obligation that, should the system be shown to be inadequate, they should prevent the failure of the bank or ease its recapitalisation in the event of difficulty. It would be up to the authorities to make it clear that they recognised no such obligation under a disclosure regime and that any individual bank would be allowed to fail. Nevertheless, either the VaR model itself or its properties relative to the ‘standard’ would have to be disclosed, if the market was to be convinced and adequately informed in the absence of an official ‘acceptance’ of an undisclosed model.

6.5 Home country control

Although there are agreements on minimum requirements for aspects of financial supervision among the member states considerable scope remains for individual jurisdictions to decide to improve upon them. The risk that banks would indulge in ‘regime shopping’ is fairly small for the major retail banks but rather higher for the more specialised banks operating in a variety of EU markets and rather higher for the EU subsidiaries of large non-EU banks which may be rather more flexible about where they headquarter their activities. On the whole the larger concerns have chosen one of the established financial centres, but as the case of BCCI illustrates the choice of a less regulated centre may attract those who intend to act outside the rules. By and large, the main regime-shoppers are likely to present relatively limited systemic risk.

The major concerns in the present circumstances are not from the point of view of the systemic risk which may occur within a country which has ‘lower’ supervision requirements, but from the sheer complexity of having banks operating under several different regimes in the same member state, and from the problem facing the authorities in the host country when a bank headquartered elsewhere has difficulties. This latter problem has two facets: the home country authorities are unlikely to view depositors, shareholders and creditors in other member states as being equally important as they do not represent the same political risk. Although EU legislation limits the extent to which there can be any home country preference there is no requirement to concentrate attention in the state where the systemic risk is greatest. A bank may be a smaller systemic risk in its state of incorporation than it is in some of the other states where it operates. If a substantial proportion of the banking system were to be foreign-owned this would pose problems that are not present in New Zealand.
In the New Zealand case the RBNZ still supervises the local branch or subsidiary, and needs to be convinced that branches provide adequate arrangements otherwise it can demand local incorporation. Thus while New Zealand banks may face the problem that the New Zealand supervisor requires one disclosure regime, the home country supervisor a second, and both of these differ from the information and risk management systems used for internal purposes, the problem would be the other way round in an EU country with substantial foreign ownership. Customers would face one level of disclosure from banks that are locally incorporated and different levels from those headquartered elsewhere. This could weaken the effectiveness of market discipline. However, if banks find that there are benefits from disclosure, it is likely that those headquartered elsewhere within the EEA will voluntarily disclose similar information to that required of the domestic banks, if they are not to suffer a competitive disadvantage. ‘Competition among rules’ could emerge with some banks trying to offer the reputation of their home supervisors as a substitute for disclosure (Mayes, 1997). A legislative solution would be for the EU to impose a common minimum standard for disclosure by EEA banks.

7 The process of implementation

The concern of this paper up to this point has been to establish that there are no facets of the structure of the financial system or EU law that make a more market-based banking supervision regime either impossible or unsuitable. We have noted that some of the incentives may be rather more blunted than in New Zealand, where such a scheme already operates, due to the structure of the banking system, aspects of corporate governance, the existence of deposit insurance and the history of having had to bail out the banking system. We have also noted that there is a somewhat bigger step to be taken in getting the information to be released onto a generally accepted and clearly comparable basis. Auditing and accounting conventions will require some modifications.

The question addressed in this section is whether there are any obvious lessons that should be borne in mind when implementing the regime, if a decision is taken to move ahead. This raises two subsidiary questions:

- Are there any requirements for the ordering of change?
What are the minimum requirements for a more-market based system to operate effectively?

There is always the temptation to push steadily in the direction of change rather than take large steps and implement a new system as a whole rather than in parts.

7.1 The process of change

The disadvantage of proceeding piecemeal is that a new regime may not prove effective until most of it has been implemented. In the meantime, existing controls may be weakened or the burdens on the banks and the costs on the system in general increased. Indeed both could occur, giving increased costs and decreased effectiveness. With progressive change the participants have to change on a number of occasions. There is a cost associated with making any change and hence by separating the process into separate steps the total cost may be increased. Banks might have to change their internal systems more than once for example. Secondly, the will to change may alter during the process, leaving the system between regimes.

However, this does not mean that trying to achieve more rapid and complete change is without drawbacks either. Because of the extent of the change, the number of items to be agreed on any one occasion is higher. This makes it more likely that there will be at least one aspect which some party to the discussions is uncomfortable with. If one party can hold up the whole process then the period before which any change occurs is lengthened. The costs of the change are likely to be more concentrated than if they were separated into a series of steps. That single lump may prove more difficult to accommodate in purely cashflow terms than the greater but more spread-out cost of gradual change.

Implementing any change takes time. If we take New Zealand as an example, nearly five years was required between starting the discussions in late 1991 and full implementation in 1996. New Zealand had one important advantage in that legislative change was not required. The Reserve Bank Act of 1989 was sufficiently encompassing in its terms that the Reserve Bank had the power to introduce the new regime through regulation alone. However, it had to ensure that what it was suggesting for the banking sector was compatible with legislation covering the corporate sector in general. Most of the time was taken up with discussions between the Reserve Bank, the commercial banks (both individually but mainly through the New Zealand Bankers Association) and the accounting profession to ensure that the proposals would be practical, not unduly costly and would actually achieve the objectives of the change.
If New Zealand had had a previous pattern to follow, progress could no doubt have been swifter, as both the Reserve Bank and the commercial banks would have had other experience to turn to. Now that the New Zealand example exists, other countries can implement a similar (but improved) regime rather more swiftly. However, as we have noted, there are some aspects of the EU system that may make change a little more cumbersome. In the first case EU law tends to be rather more prescriptive in detail and hence changes to reporting requirements and incentives may require legislative change. Halme (1997) sets out a table of required changes relating to owners, management and regulators (Table 4). Indeed these requirements may extend somewhat further into aspects of corporate governance. Secondly, there may be some changes in the structure of the system necessary to ensure that the system of crisis resolution enables the authorities to reconstitute a bank rapidly without bailing out the existing shareholders (Liukasila, 1998) and to avoid ready access to public funds so that shareholders, management, creditors and uninsured depositors do recognise that their own funds (or jobs) may be at risk. EU legislation is in the main concerned with the imposition of minimum standards and in the case of accounting standards seeks to permit both Anglo-Saxon and continental approaches. Thus while it does not compel a disclosure regime, nor indeed does it seem likely to do so at present, it does not forbid one.

Nevertheless, it seems difficult to disagree with the dictum that one should ‘do as much as possible as soon as possible’. Currently there is a window of opportunity, as it is important to introduce banking system regime changes when the economy is not fragile. The EU economy is growing, without inflationary pressure. The advent of stage 3 of EMU and the increasing integration of financial markets both enlarges the window and poses a threat. Having a single monetary policy may act as a stabilising influence but the introduction of the euro and the increasing integration of financial markets may mean that financial innovation or entry into new markets results in the sorts of increase in risk that have accompanied other bursts of financial deregulation (Llewellyn, 1995). There is hence a threat that when the next downturn does come it will contain an increased risk of financial difficulty. The ECB has an extremely difficult job in estimating how a new currency area works and might, for example, overestimate the scope for non-inflationary growth. The resulting crack-down to restrict the inflationary consequences may put pressure on the banking system. It therefore seems that rapid progress would be desirable, even if some of the changes in structure come later. The accounting and auditing requirements are already incorporated into international standards so there is a blueprint to follow that could be transposed into regulation by the national authorities.
Table 4.

<table>
<thead>
<tr>
<th></th>
<th>Commitment</th>
<th>Market Discipline</th>
<th>Control</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Management</strong></td>
<td>Responsibility *clear cut rules for responsibility for different sanctions</td>
<td>Obligations for disclosure *key financial ratios</td>
<td>Efficient internal control *audit committees</td>
</tr>
<tr>
<td></td>
<td>Sanctions *clear cut tort and punitive sanctions for non-compliance of key rules</td>
<td>*key risk exposures *key incentive schemes Code of ethics</td>
<td>*reporting to independent units Efficient shareholder control *NED’s, GBD’s, constituency directors</td>
</tr>
<tr>
<td><strong>Owners</strong></td>
<td>Responsibility *capital adequacy *rules for wrongful intermediation</td>
<td>Take over threat *obligations for disclosure of ownership</td>
<td>Efficient legal form for ownership Control of abuse of legal form</td>
</tr>
<tr>
<td></td>
<td>Sanctions *liquidation rules *zeroing of share capital</td>
<td>Effective competition *neutralising the too big to fail effect</td>
<td></td>
</tr>
<tr>
<td><strong>Regulators</strong></td>
<td>Responsibility *limitations of discretion *schemes for early intervention</td>
<td>Obligations for disclosure *decisions *special provisions exercised sanctions</td>
<td>Supervision vs. Norm-setting Control by legislator</td>
</tr>
<tr>
<td></td>
<td>Sanctions *reputation</td>
<td>Role as a communicator *minimisation of private information</td>
<td></td>
</tr>
</tbody>
</table>

Source: Halme (1997)
7.2 Consultation

It is worth recalling finally that one of the key features of the successful introduction of what was then a radical change in New Zealand was extensive consultation between the parties: the various authorities, banks and the accounting bodies. While the Reserve Bank produced an initial draft, it was the consultation that ensured that the proposals did not put undue pressure on banks. These discussions were held not in the framework of trying to decide whether the changes should be made but how the principles should be implemented. Ultimately it was still up to the Reserve Bank to decide. However, to illustrate what such discussions can achieve, two main changes, inter alia, can be observed from the initial proposals as a result of consultation: a reduction in the detail of disclosure; and the introduction of a ‘standard model’ for assessing market risk. (As we have seen the second of these was necessary to get the proposals implemented rapidly although better compromises now seem possible as suggested in section 6.4.)

Since the more market-based regime is intended to produce benefits for the banks themselves as well as for society at large as customers, creditors and taxpayers, it is only appropriate to try to ensure that the nature of those potential benefits is properly understood by the authorities when drawing up the regime.

7.3 The next steps

There are two key areas, ongoing supervision and crisis management. In the case of ongoing supervision the path is more straightforward, though arduous over the coming years. While it is open to the authorities to produce discussion papers explaining outline plans, a timetable and the consultation process for the introduction of public disclosure and the change in its focus towards systemic issues, some parallel steps would help ease the change. It would be helpful to explore whether the appropriate incentives are likely to be sufficient, not just in terms of penalties and legal liabilities, but also in terms of market institutions – rating agencies, independent analysis, etc. Secondly, it would be useful to investigate whether the system of corporate governance was likely to produce adequate transparency and effective procedures within banks to encourage greater prudential risk management: through audit committees and independent directors, for example. The small co-operative and savings banks present problems under both headings and indeed it may be more appropriate to offer to continue with current arrangements for them if they wish it. Although international standards for financial
reporting are now adequate for a successful disclosure regime, implementing the appropriate valuation, accounting and auditing arrangements is likely to provide the most time-consuming part of the process.

Crisis management provides a greater problem, as it requires both the development of co-operation with supervisors in other countries and the attempt to convince markets and shareholders, in particular, that there will be no bail-outs — without wishing to have even a small crisis that gives an opportunity to demonstrate that resolve. The development of greater powers to help resolve crises and permit the authorities to organise the management of insolvent or undercapitalised banks without bailing out the existing owners would help make that message more credible.

Given the benefits anticipated for all those involved — customers, creditors and counterparties as they see information on the risks they face improve; shareholders, customers and managers as they see the costs of compliance and the restraints on well-managed business fall; supervisors as they can concentrate on systemic issues and all parties including the taxpayer as they see the risks of distress or failure recede — the earlier the process starts the better. While there are difficulties, and the process of implementation is unlikely to be either as straightforward or as comprehensive as it was in New Zealand, these do not appear insurmountable. Furthermore it has been possible to learn from experience and design a scheme more suited to the specific conditions in Europe. As economic conditions are now favourable and integration and innovation in financial markets are likely to increase the pressure on existing methods of supervision, the changes proposed would be timely.

8 Concluding remarks

It is easy to exaggerate the differences between the New Zealand scheme and that in place in many other jurisdictions. One way to view it is that the New Zealand arrangements are a more direct interpretation of the principles that others also espouse. For example, Core Principles for Effective Banking Supervision published by the Basel Committee on Banking Supervision (1997) includes the following — ‘supervisors should encourage and pursue market discipline by encouraging good corporate
governance and enhancing market transparency and surveillance.’ (p.8). Again on page 9 it suggests ‘Supervision cannot, and should not, provide an assurance that banks will not fail. In a market economy failures are part of risk taking.’ and on page 12, ‘Effective market discipline depends on an adequate flow of information to market participants, appropriate financial incentives to reward well-managed institutions and arrangements that ensure that investors are not insulated from the consequences of their decisions’.

Sufficiently flexible powers are necessary in order to effect an efficient resolution of problems in banks. Where problems are remediable, supervisors will normally seek to identify and implement solutions that fully address their concerns; where they are not, the prompt and orderly exit of institutions that are no longer able to meet supervisory requirements is a necessary part of an efficient financial system. Forbearance, whether or not the result of political pressure, normally leads to worsening problems and higher resolution costs.

Some prefer to view the New Zealand regime as being, if anything, rather towards one end of a spectrum of possible approaches to banking supervision than representing a complete paradigm shift which others would find it difficult to emulate (Nicholl, 1996). What they have done is unwind the process that George (1996) notes – the danger that every time there is a failure of supervision there is a temptation to ratchet regulation a notch tighter. There is still an essential role for supervisors to play and the Reserve Bank still thinks it important to publish annual surveys of the banking system in the Reserve Bank Bulletin each June. It is able to flag developments that it can see in the system as a whole, which may not appear from the scrutiny of individual disclosure statements. For example, as OECD (1997) put it: ‘Caution flags should be raised by the regulatory authorities when financial market participants begin to assemble on the same village green.’ (p.38).

New Zealand’s experience with the new regime will be studied closely by supervisors in other countries. Subject to the requirements for capital adequacy and depositor protection, there will be considerable incentives for the authorities in the EU countries to increase the role of market disciplines and of public disclosure, as increasing cross-border operation makes it more difficult for national supervisors to keep track of the operations of large international banks.

There are some potential stumbling blocks for the implementation of more disclosure. First, the principle of home country supervision could mean that substantial
differences in requirements emerged for competitors in the same market. As a result banks might feel encouraged to change the jurisdiction that applies to them.

Secondly, harmonisation with accounting standards, with regulation of the rest of the financial sector and with regulators of other aspects of banks' behaviour may be difficult.

Thirdly, substantial changes in legislation may be required if crisis management powers are to be strengthened to make credible the threat that insolvent banks will be allowed to fail and the viable business restructured and transferred (see Liuksla 1998). Implementation of the new regime in New Zealand was greatly facilitated because the Reserve Bank already had all the necessary powers under the 1989 Act. With a small exception (Reserve Bank Amendment Act 1995) new legislation was not required. Registration and crisis management powers were already in place and the disclosure regime could be implemented by Orders-in-Council, without recourse to parliament. However, given that New Zealand already has the necessary legislation and orders in place, other countries have a precedent to follow and could draw up the legislation they need and implement a regime involving more market discipline much more rapidly than in New Zealand, even after allowing time for adequate consultation with the banks.

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