Prudential Supervision of the Banking System

edited by Bernard Galvin

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3. The New Wave of Financial Controls: the Case of Prudential Supervision

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Introduction

Given the rapid accumulation over only several years of an extensive array of prudential controls over banks both in New Zealand and in other countries, it is salutary to be reminded that the first formal piece of legislation addressing prudential surveillance in an explicit and generalised way for banks was contained in the new Reserve Bank legislation in the late 1980s. It is surprising to register just how recent was this development, bearing in mind what now seems to be a widely held conventional wisdom that government-sponsored prudential oversight of the banking system is essential.

It is thus interesting to reflect on why prudential controls have become suddenly so important for the good health of the banking system despite their absence for many prior decades during which the banking system survived satisfactorily. Moreover, it is significantly less than a decade ago when the conventional wisdom was whole-heartedly agreed that the mass of highly diverse regulatory interventions in the New Zealand financial system which prevailed up until 1984 should be abolished. These included interest rate controls on both assets and liabilities, extensive and highly variable asset ratio requirements, credit allocation guidelines and ceilings, foreign exchange controls, a pegged and invariably inappropriately valued exchange rate, and various other forms of official oversight of financial institutions euphemistically referred to as 'moral persuasion'.

It was unfortunate but not surprising that the unwinding of these interventions, particularly during the second half of 1984 and throughout 1985, came to be partly associated with some of the difficulties experienced by some financial institutions in adapting to a more market-orientated financial system freed of the artificial props of the regulatory structures. This development, associated with more widespread adjustment complications for the New Zealand economy as it endeavoured to 'rejoin the world' with a mix of more stringent fiscal and monetary policies and the removal of many aspects of both internal and external protection, stimulated the question of whether a government-sponsored official prudential regime was warranted for banking.

At the same time, international pressures emerged upon New Zealand to collude with other OECD regulatory authorities, particularly central banks and the Bank of International Settlements (BIS), in introducing prudential controls of a type akin to those recommended by the prudential authorities under the auspices of the BIS. As Deputy Governor of the Reserve Bank up until early 1986, I have clear recollections of the nature of those pressures from both the BIS and the Bank of England.

Nevertheless, after the enormous effort put in to removing the distortions of many years of accumulated financial controls, it is disconcerting to record the rapidity with which we succumbed to the new wave of financial controls in the form of the present prudential legislation and its implementation by the Reserve Bank.

However, this is not a new trend in the sense that there have been calls within New Zealand as elsewhere for new forms of regulation to appear in areas such as safety, the environment and consumer policy as well as prudential policy, as old forms of regulation, particularly of prices and entry arrangements, have been removed.

This tendency can be seen in the debates on legislative and regulatory issues with respect to a wide array of matters such as occupational safety and health, food regulations, smoking, building requirements, the Resource Management Act, insider trading laws, takeover regulatory issues, financial reporting, duties of directors, carbon emissions, residential tenancy legislation, 'fair' trading, and so on.

In the area of prudential controls, the real question must be whether we have learnt the lessons from the past and whether we can avoid incurring again the costs of the past. The debate currently proceeding within the Reserve Bank on the appropriate role for prudential supervision is reassuring evidence that there is indeed a considerable consciousness of the need to rework the lessons of history and indeed to endeavour to avoid those costs.

Current Prudential Policy

By way of summary, my understanding of the supposed rationale for the current official policy on prudential supervision is that banks are different from other business firms; that their capital ratios are much lower and the issue of customers' confidence relatively more important; that the critical role of banks relates to their financial intermediation, provision of liquidity, and operation of the payments system; that the need for a high level of confidence in banks can arise not only from their own prudent management but also from official

oversight and an expectation that the government has a last resort role in the event of bank and/or system failure; that these official interventions have potential costs associated with them but that the overriding need for preservation of confidence in the banking system implies net gains from such interventions.

This general line of argument has been reflected in the Reserve Bank Act which establishes the objectives of banking supervision as being to promote the maintenance of a sound and efficient financial system, or to avoid significant damage to the financial system that could result from the failure of a registered bank.

As I understand it, this has led to the development of a monitoring framework within the Reserve Bank which involves a number of key elements.

These include the registration of banks, conditional upon minimum capital requirements, limits on large exposures and connected lending, adequate internal controls, and prior approval for changes in ownership.

Monitoring is then based on a variety of prudential returns encompassing a return of capital adequacy and off balance sheet business, a large exposures return, both profit and loss and balance sheet returns, foreign exchange position returns, and a property sector return. These are typically collected on a quarterly basis or in some cases six monthly. Returns are analysed by Reserve Bank staff who prepare reports on the financial condition of each bank. Consultations with banks take place at a senior management level.

In the monitoring process, there is recognition of the important role of outside parties including auditors, bank directors, rating agencies, and other market analysts such as trustees. The significant role of internal controls is also acknowledged.

As was predicted in some of the early papers on a prudential control regime written in 1985, the regulatory framework has become rapidly more detailed and complex. This has involved returns to the Reserve Bank covering a vast array of information; a ten-fold increase in Reserve Bank staff allocated to this function (there were no more than two or three staff in this area in early 1986); and the introduction of a range of arbitrary ratios ranging from a minimum capital requirement of 8% to an exposure limit for a single borrower of no more than 35% of capital, to a complex risk weighting scheme for capital requirements with a strong bias favouring government and quasi government organisations, a partial bias towards housing, and the least favourable treatment for the remainder of the private sector.

In principle, these requirements are emerging as astonishingly similar to those imposed under a mix of official regulations in the pre-1984 period. At that time, there were asset ratio requirements which favoured government over the private sector, which set limits on exposures to particular sectors; and credit guidelines which favoured some sectors at the expense of others. It may be protested that the pre-1984 controls were more pervasive and detailed than the present prudential arrangements, but it is disturbing to observe that the prudential controls are in their early years of evolution whereas the old pre-1984 controls had been developed over several decades. The analogies are remarkably close and thoroughly disconcerting.

The Real Issues

As Tyler Cowen observes in his comprehensive and generally well disposed treatment of the policy reforms with respect to central banking in New Zealand, "Criticism of the current regime, however, does not imply opposition to the concept of prudential supervision. Both prudence and supervision are certainly desirable. The issue is not whether one favours or opposes prudence, but whether markets or government regulation are a better source of prudential management".[2]

This point, which is commonly misunderstood, cannot be emphasised too strongly. If it is accepted that prudential management is of the utmost importance for any financial system, then it is useful to ask what are the real issues associated with such management.

For example, why should it be assumed that a group of officials in Basle, or a group of officials in Wellington, should know better than bank directors and management what is an appropriate minimum capital ratio for a bank, or a maximum exposure to a particular customer? Moreover, why should it be assumed that all banks should have an identical minimum capital requirement, or an identical maximum exposure percentage requirement regardless of the nature and security of the customer?

Analogous questions follow from the initial establishment of such ratios. Since the ratios are an intervention of a non-market character, what are the criteria to be for their initial establishment and for subsequent changes in them over time? What distortions may arise in bank asset and liability structures as a result of the official ratio requirements, and what is their effect on the incentives and sanctions of both the directors and management of banks, and the officials who administer the regulations?

How are these requirements and their consequences interpreted by the government whose involvement is effectively assured by the establishment of the ratios; by tax payers who may well end up bearing the cost of any subsidies which might emerge from the prudential regime; and by customers who may believe that the government is in effect protecting depositors' funds in the event of a possible bank failure, a view which may well depart from that of the officials and the government itself, who typically would claim to be more interested in system stability aspects than individual bank protection?

Beyond this, what effects do prudential regimes have on entry conditions for the banking system; on the interrelationship between banking and the activities of other financial institutions not categorised as banks but which carry out similar or in some cases identical functions; on the competitiveness and adaptability of the regulated industry over time; and on the particular activities which are relatively favoured or not favoured by the system of controls utilised in the name of prudential supervision?

If foreign-owned banks dominate the domestic banking system, as indeed is the case in New Zealand, what is to be the relationship between prudential supervision within New Zealand and the extensive supervisory regimes to which the head offices of the foreign-owned banks are typically subject in their own countries?

Given that the predominant responsibility of the Reserve Bank under its Act is to seek and preserve price stability, to what extent is there a risk that its reputation in the monetary policy arena may be impugned by any problems it encounters in its role as a prudential supervisor? If a major supervised bank were to fail, would there be a loss of central bank credibility?

At the most fundamental level, the real issue is whether banks and the banking system are 'special' to a greater extent than other industries, and particularly other 'essential' industries, and whether any arguments about the special nature of banking lead one to conclude that a government supervisory regime is to be preferred over normal private sector market mechanisms?

Other questions which flow from this include the issue of whether contagion (the spread of problems throughout the banking system from the failure of an individual bank) is an issue which needs to be addressed by official controls, and would these be effective in any event in preventing contagious effects? Once a banking supervision regime is in place, would there be material effects and indeed net costs from changes in this regime or the abolition of it? If other countries supervise their banking systems, is there likely to be any cost imposed

on domestic banks, and New Zealand generally, if local banks are not also subject to similar supervision?

The Costs and Benefits of Regulations

New Zealand has probably had more experience than any other market-based Western economy with regulatory structures. It is salutary to be reminded that as recently as in the period leading up to mid-1984, New Zealand had a control regime which endeavoured to freeze every interest rate, price, wage, rent, and dividend for a period of around two years. Prior to that, there were other extensive official interventions in a number of these areas. Moreover, financial institutions were subject to additional controls by way of ratio requirements, credit ceilings, lending guidelines, an officially controlled forward exchange market, and a pegged exchange rate.

The lessons from this massive array of regulations were clear. They finally culminated in grave distortionary effects with respect to individual financial institutions; biased asset and liability portfolios in a seriously distortionary manner; and resulted in major imbalances within the economy, especially with respect to the fiscal deficit and the external current account deficit. They resulted in the foreign exchange crisis of mid-1984, one of the responses to which was to unwind the control regime in favour of a more market-related financial system.

The lessons to be drawn from that period of regulation are just as relevant today as they were at that time.

Because regulations invariably fail to achieve the ends which are initially ascribed to them, controls tend to breed additional controls as regulators look for increasingly complex ways to resolve problems which, it ultimately turns out, are actually not resolvable by regulatory mechanisms.

Regulations tend to shift the accountabilities for management of the regulated institutions from directors and management to the regulators. These effects are sometimes overt but sometimes subtle. Capture of the regulator by the regulated normally becomes a problem within regulatory systems, and indeed in time there is a risk that the regulated become dependent upon the regulations, protected by them, and in turn seek to protect the interests of the regulator.

The arbitrary nature of regulation, its slowness to adapt to change, its strong historical bias, and the unknown extent of the departure between the regulated world and what the market might really produce were classically illustrated in New Zealand in the pre-1984 period.

It is not surprising to observe that government officials do not know how to run businesses since this is not their job and most of them do not have a strong business training or business background. This being the case, extreme caution seems to be required in assuming that officials will be better able to ensure certain business outcomes than the managers charged with directly operating the businesses subject to regulation.

All of these points must make one very dubious about the benefits of the sort of comprehensive regulatory supervisory regime New Zealand has now embarked upon with respect to its banking system. Given the similarities of many of the ratio-type requirements and the information provision requirements to earlier regulatory systems, it can be expected that all of the problems which were encountered under the earlier regimes will either have emerged or will in due course emerge with respect to prudential supervision. It is simply the new wave of financial controls.

Some Practical Issues

At a practical level, and taking for granted the need for sound prudential management by banks, it is of interest to reflect on the costs and benefits of public sector supervision of banks, and whether such supervision may reduce the risk of bank failure without unacceptable costs.

The Reserve Bank has indicated that the direct costs of bank supervision are in the region of $4 million per annum, and most of these costs are borne directly by the supervised banks. This is not a large figure in its own right.

However, the indirect costs are much more substantial and pervasive. Official supervision leaves the perception that the government is safeguarding the interests of depositors, and runs the risk of distorting bank behaviour.

Despite the existence of a supervisory regime, a number of major New Zealand financial institutions have experienced severe difficulties in recent years, including the Bank of New Zealand, New Zealand Insurance and its associated bank subsidiary, and the DFC. These problems did little for central bank credibility and indeed may well have impaired it. It can of course be argued that the problems these organisations experienced had their origins in periods prior to the introduction of the prudential surveillance system, but that does not seem to be the essence of the matter.

The United States experiences with bank failures, and particularly with the enormously costly failures and difficulties of the savings and loan associations, illustrate graphically the complications which arise with official supervisory regimes and public sector involvement in compulsory financial insurance

arrangements. Current estimates of the United States government's financial liability exceed $NZ830 billion.[3]

The problems experienced both within New Zealand over the years and overseas suggest that government officials will always have difficulty in predicting bank failures and in preventing them. This should not be a surprise to anyone. It is inevitable that information flows to officials well after it has been received and analysed by bank directors and managements, and typically officials will have less expertise in assessing and interpreting the information than bank directors or managements should have. Despite these problems, the risks may be heightened if bank managements come to rely upon the efficacy of prudential controls or official oversight of their activities. This is the shift in accountability problem.

Apart from the demonstrated difficulties of official regimes not being able to prevent bank failures, there is the issue of any costs which arise from the distortions promoted by prudential controls.

For example, under the current prudential rules, lending arrangements to government and quasi government organisations, and strangely enough to the housing sector, have much lower capital requirements than lending to business, regardless of the quality of the private sector corporations. The regime is presumably based on the thought that lending to governments and housing are lower risk activities than lending to the corporate sector.

The experiences of many banks over the past several decades in lending to some governments illustrate sharply the nonsense of this proposition. Apart from the fact that there have been many governments throughout the world which have failed to meet their financial obligations (albeit predominantly developing countries), the justification for particular favours in lending to governments which may in turn simply encourage fiscal profligacy and thus more relaxed fiscal and monetary policies, is well demonstrated by the point that the most secure prudential policy available for a banking system must be a high degree of confidence in a relatively stable monetary and fiscal policy position on the part of governments. Special favours for lending to governments hardly seem consistent with fiscal stringency.

The artificial stimulation to lending to the housing sector will in time inevitably lead to an over-exposure of bank lending to the housing market, an artificial stimulation to asset values in that market, and an increase in riskiness of such loans as a consequence of these distortions. Past New Zealand evidence on this sort of point has been so conclusive that it is astonishing to find ourselves

reintroducing asset ratio controls so few years after their inadequacies had been so categorically demonstrated within the New Zealand financial system.

As far as the minimum capital ratio requirement of 8% is concerned, it is mystifying to know just why this particular figure chosen by central bank officials should be the magic guideline, and why it should be the same for all banks. In a normal business environment, capital ratio requirements change over time and vary substantially from business to business and from firm to firm. This should also be true of banking, where different banks will engage in different forms of activities, with different risks associated with them, and with different skills brought to bear by various boards of directors and bank managements. This is as it should be.

Officials would argue that the capital requirement is only a minimum one, but all past experiences with ratios of this sort indicate strongly the way in which minimum ratios too easily become norms.

In the same way, the maximum exposure ratio of 35% of capital to any individual customer may be far too high a figure for some relatively high risk customers, and too low a figure for particularly secure and large customers. This is an illustration of a matter which should be decided by bank directors and managements, and for which they should take sole accountability.

The prudential supervision system seems to assume that banks have inadequate incentives to conduct their businesses in a suitably prudent fashion, and that banks' boards of directors are inadequate monitors. Yet if banks live by their reputations, not only should they have very strong incentives to operate in a prudent fashion, but individual banks should also be concerned to ensure that the payment system operates prudently and be particularly conscious of the nature of their interrelationships with other banks within that system. It can be argued that there is indeed a risk that these incentives are weakened by official supervision and the illusion of some sort of implicit government guarantee for depositors.

Private Sector Monitoring

Given the costs and problems involved with public sector supervision of banks, it is interesting to reflect on the comprehensiveness of the market-based monitoring systems which already exist for banks by way of the role of bank shareholders, large creditors and depositors, and the takeover/acquisition market for corporate control. Not only do these parties have the appropriate expertise and incentives to operate banks in a prudent manner and to adopt appropriate standards of behaviour, but they are also in turn monitored by a

complex network of market institutions such as funds managers, sharemarket analysts, credit rating agencies, auditors, and the media.

If anything, it can be persuasively argued that the parties involved in private sector monitoring activity have stronger incentives to ensure good prudential management of the banks with which they deal than government officials. This is because the private sector parties typically have funds at risk, and have stronger immediate financial incentives to monitor successfully. They are more likely to be closer to banks on a day-to-day basis and may typically have more expertise at financial monitoring than officials may be expected to possess.

The role of shareholders in overseeing banks is well illustrated in the case of New Zealand where the major banks have large foreign shareholders who will be concerned not only with the maintenance of the value of their investment but also with the preservation of their reputation in a broader context than just New Zealand. Beyond this, these foreign shareholders as banks resident in other countries will be subject to prudential oversight by the central banks of their countries of residence. As far as monitoring by the corporate sector is concerned, if my experience with the Electricity Corporation is any guide, large creditors and depositors with banks, and other financial institutions for that matter, can be relied upon to be vigilant in their monitoring activities since they have a very strong interest in ensuring the preservation of their funds under exposure to the financial sector. On the takeover front, there have been a number of interesting illustrations of the ways in which takeovers in effect help to resolve prudential problems, unwittingly or otherwise, as illustrated by the General Accident takeover of New Zealand Insurance, and by the way in which the Government has extricated itself from a concern as owner of the Bank of New Zealand by the sale of its shares to the National Australia Bank.

Analysis of this sort would suggest that the most important single role for the government with respect to prudential policy should be the enforcement of private contracts and compliance with normal statutory arrangements. For example, the Companies Act has provisions for the appointment of statutory managers and winding up procedures; the Commerce Act sets out arrangements governing mergers and takeovers; and the Crimes Act provides appropriate remedies with respect to fraud. Legislation specifies directors' duties for public companies and provides also for the appointment of auditors.

Given these statutory arrangements which appear to work effectively for the rest of the corporate sector, the arguments in this paper would suggest that they should also be adequate for banks. The implication of this is the need to maintain to a minimum the restrictions on the ability of financial institutions

to manage their assets and liabilities in a sound way and to be able to respond to competition and market forces. Any limitation upon the adaptability of financial institutions as a result of prudential controls may in fact exacerbate the very problems which those controls are ostensibly designed to address.

The other major role for the government is that referred to earlier of conducting its own monetary policy and fiscal policy in such a way as to provide underlying stability for both the economy and the financial system in particular. If private sector monitoring of banks is to be relied upon and to be fully effective, there would also be a need for the government to create a climate of understanding that the authorities will not stand behind failing institutions, whether they be banks, other financial institutions or other corporates.

It seems to be only by this means that the problem of how to assess and apply sanctions for imprudent behaviour can be addressed in an appropriate commercial fashion. One of the problems typically associated with control regimes is the issue of how to utilise sanctions for non-compliance with the regulations. If private sector monitoring arrangements are utilised, and normal corporate legislative provisions are relied upon, then the threat of failure becomes the principal sanction and must be a more powerful one than any typical legislative penalty.

This approach also would help overcome the problem of the implicit guarantee, and the potentially enormous cost to the government of such perceived guarantees, under a prudential supervision regime where at the end of the day the central bank ends up with an obligation to protect or subsidise a failing institution.

In addition, the promotion of the highest level of incentives for directors and managers of banks to manage their own affairs efficiently and prudently through non-reliance upon any official prudential underpinning would also seem to be the most reliable way to ensure more general protection of the payment system. Reliance on market mechanisms and normal commercial disciplines to ensure that banks exercise the greatest care in dealing with each other, and in not only protecting their own reputations but also the integrity of the payments system itself, should promote the most appropriate mix of incentives and sanctions for banks and their managers, and minimise the problems and risks associated with bureaucratic oversight of the payments system. New Zealand's past extensive experience with financial regulations would suggest predominantly that these incentives and sanctions are significantly weakened by official controls.

It should be recognised of course that neither official prudential surveillance nor private sector monitoring provide any assurance that banks will not encounter financial difficulties and, in extreme cases, fail. That is the nature of business. The fundamental point is that banking does not appear to be sufficiently 'different' from other activities to warrant its own set of official prudential controls beyond the normal commercial framework for handling corporate financial problem cases. Indeed, such controls may risk distorting balance sheets and incentives in such a way as to exacerbate problems over time rather than help avoid them. This is the predominant lesson from past New Zealand experience with financial ratios and guidelines imposed by government. It is a lesson we currently risk overlooking.

Conclusions

Over the past few years, New Zealand has moved to develop a system of prudential regulation with respect to its banking system that is disconcertingly akin to the earlier mix of ratio controls, credit ceilings, and lending guidelines which were prevalent prior to 1984. In effect, we are now witnessing the emergence of a new wave of financial controls which are highly likely to produce distortionary effects and weakened managerial incentives in a manner analogous to the earlier control regime.

On the other hand, sound prudential management of banks is vitally important to the stability of the economy and the preservation of the payments system. That issue is not the one in question.

Instead, the important issue is whether private sector monitoring arrangements are adequate to ensure sound prudential management and to resolve problems of potential bank failure. In this respect, the paper has argued that there already exists an array of private sector monitoring arrangements with strong incentives and sanctions associated with them. It is important to avoid artificial official interventions in the prudential area because regulations simply breed more regulations, controls are arbitrary in character, regulations weaken private sector incentives for self-management, and in any event officials are unlikely to be able to predict or resolve bank failures any more reliably than private sector mechanisms assisted by normal commercial legislative arrangements.

This is not to say that there is not an important role for government with respect to prudential policy. However, that policy should not take the form of a range of ratio requirements and information gathering, but should rather concentrate on the fundamental elements of an appropriate body of corporate

and commercial law, the enforcement of private contracts, the avoidance of subsidies to failing institutions, and the preservation of sound monetary and fiscal policy.

If those matters are adequately attended to by government, then prudential monitoring by shareholders, directors, creditors, depositors, market analysts, other potential owners of banks, and auditors should be satisfactory without the intervention of Reserve Bank or other supervisory officials. This would leave the Reserve Bank free to concentrate entirely on the principal task which has been assigned to it, that of controlling inflation.

Footnotes:

1. This paper has benefited from views or information provided by a number of colleagues including R W R White, former Governor of the Reserve Bank, R L Kerr, B D Wilkinson, Tyler Cowen, and a very considerable body of papers generously provided for my perusal by the Reserve Bank. In considering the Bank's material, it is appropriate that I should acknowledge my appreciation of the opportunity to read papers by Dr Donald Brash, Governor of the Bank, David Archer, Bruce White, Mark Swinburne, and Geoff Mortlock. Despite this note of appreciation, it will be readily apparent to most readers that the views contained in this paper are my own and should not be attributed to any other parties.
2. Tyler Cowen (September 1991). *The Reserve Bank of New Zealand: Policy Reforms and Institutional Structure,* New Zealand Business Roundtable, Wellington.
3. See Tyler Cowen, *op. cit.*, p 65.

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The issue of prudential surveillance of the financial system, usually by the central bank, has attracted considerable attention in recent times. This reflects in part the failures or near failures of financial institutions that have occurred in a number of countries in the Western world.

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