A SUBMISSION ON THE PAPER

PROPOSED REVISIONS TO BANKING SUPERVISION ARRANGEMENTS

RESERVE BANK OF NEW ZEALAND

NEW ZEALAND BUSINESS ROUNDTABLE
SEPTEMBER 1993

ACKNOWLEDGEMENT

The assistance of Tyler Cowen, Professor of Economics, George Mason University, Bryce Wilkinson, CS First Boston (NZ) Ltd, and Geoffrey Miller, Professor of Law, University of Chicago Law School, with the preparation of this paper is gratefully acknowledged.

TABLE OF CONTENTS

	SECTION	PAGE
1.	Introduction	1
2.	The Nature of Banking	2
3.	Reserve Bank Prudential Supervision vs Reliance on Market Mechanisms	5
4.	Basle Capital Requirements	13
5.	Depositor Protection	17
6.	Lender of Last Resort Policy	20
7.	Payment System Risk	23
8.	Summary of Recommendations	25

1. INTRODUCTION

This paper analyses the policies for bank regulation proposed by the Reserve Bank of New Zealand in its 1993 document *Proposed Revisions to Banking Supervision Arrangements*. It considers whether the suggested reforms will be effective in achieving their desired ends and whether other reforms should be considered. In summary, it concludes that the Reserve Bank's proposals are in general highly desirable but that further improvements are possible.

Section 2 considers the nature of banking, focusing on competition from non-banks, the implications of the pressures faced by governments when banks fail, and the interventionist dynamic.

Section 3 contrasts Reserve Bank prudential supervision and market-based supervision, commenting specifically on the costs of the current regime, the advantages of the proposed credit rating system, the proposed disclosure requirements, the registration fee, and exposure limits and currency positions.

Section 4 considers the Basle capital requirements, commenting specifically on the reasons for dropping such requirements, the international pressures to conform, the problems arising from subjective, non-uniform, risk weights and the proposal to tie Reserve Bank responses to measured bank capital.

Section 5 looks at depositor protection, considering foreign-owned banks first and Trust Bank second.

Section 6 comments on lender of last resort policy.

Section 7 focuses on the most likely source of contagion effects in banking - payment system risk.

Section 8 summarises our recommendations.

2. THE NATURE OF BANKING

In New Zealand, banks are defined legally by the registration process with the Reserve Bank. The Reserve Bank allows an institution to achieve bank registration if that institution provides borrowing and lending services and agrees to abide by Reserve Bank regulations and supervision.

In more general terms, banks provide a combination of economic services. Banks create liquid deposits, serve as specialised lenders and loan monitors, and provide access to payments systems and clearing houses. Banking is a 'cluster concept' - no one of these functions is either sufficient or necessary to define a bank, but their combination produces an indisputably bank-like entity. Because many kinds of institutions perform some of these functions, what is a bank is a matter of degree.

While banks can in principle operate with one hundred percent reserves, modern banks rarely do so. Banks do not generally keep on hand the liquid resources necessary to redeem all deposit liabilities. Bank liabilities tend to be more liquid than bank assets - this creates the fundamental problem of banking. Banks rely heavily on the confidence of the public and on the steady inflow of liquid funds from other financial institutions. These features are said to create the potential for 'contagion effects', where the financial problems of one bank may spread to other banks.

These special features of banks determine the goals of regulatory policy. Regulators should seek to find the general rules of the game that will allow banks to flourish as safe and economically viable institutions. Yet regulators should not always seek to control. Banking also is special in at least three ways that provide a case for a relatively unregulated environment.[1]

2.1 Banking Services can be Provided through Non-banks

When banks must bear an especially high regulatory burden, bank services of lending, deposit taking, and account clearing can be performed through alternative institutions. In the United States, for instance, commercial credit lenders, checkable money market funds, securitised pools of credit, and the so-called 'non-bank banks' (they are not legally classified as banks because they exploit certain legal loopholes) have achieved considerable market share. Banks, narrowly defined, are special only up to a point.[2]

---

1 For an examination of some arguments that banks are special, see Tyler Cowen and Randall Kroszner, *Mutual Fund Banking: A Market Approach*, Cato Journal, Spring/Summer 1990, 10 (1), 223-237.

2 See Tyler Cowen and Randall Kroszner, op. cit.

New Zealand has not experienced non-bank displacement of bank functions to the degree found in America. New Zealand has a more transparent and sensible regulatory structure that does not place banks at a serious disadvantage. The point is that non-bank competition constrains the regulatory options that are available. Many government regulations, far from achieving additional control, only push financial activity into unregulated and perhaps riskier areas.

Even in New Zealand non-bank institutions are achieving additional market share. Brokerage houses and securities market participants are beginning to perform bank-like functions. Within a generation the differences between banks and non-banks are likely to be negligible, regardless of regulatory structure. Financial services will be provided by conglomerates active in the areas of insurance, securities, lending, and deposit taking.

The regulation of financial institutions ought, in principle, to cover all financial intermediaries in the same manner. Regulators should strive to create a level playing field. Special regulatory treatment of banks, even if desired in principle, will become outmoded within a short period of time. The Reserve Bank, which has recognised this point in its paper, should consider attaching sunset clauses to any interim regulatory measures that do not address forthcoming financial integration.

2.2 Difficulty of Government Pre-Commitment

Governments find it difficult to allow banks to fail. A bank failure imposes significant costs on the borrowers and depositors of that bank, both active political constituencies. When the crunch comes, governments have frequently offered some kind of assistance to ailing financial institutions. Because of the potentially fragile nature of bank liquidity and confidence, pressures for assistance are especially strong. It does not matter that an initial government promise of laissez-faire might have produced superior results; banks know that the government is likely to renege *ex post* on its earlier hands-off promise.

This problem of pre-commitment links governments with the safety of financial institutions whether we like it or not. Banking is special because political pressures make it so - in no other industry are the political pressures for government bail-outs so strong. The Reserve Bank faces the task of responding to political pressures while maintaining relatively sound policies. The Reserve Bank should attempt to erect a regime that will withstand the political pressures that will be brought to bear. In a later section the paper considers how sensible pre-commitment measures that keep undesirable intervention to a minimum might be designed.

2.3 The Interventionist Dynamic

Government intervention in the banking system tends to accumulate and expand over time according to an interventionist dynamic. Initial sets of regulations create economic problems that can be addressed only by additional regulations. Government tends to grow steadily and follows one regulation with another.

New Zealand may find this interventionist dynamic occurring with the prudential supervision functions of the Reserve Bank. Prudential supervision runs the risk of eventually placing the Reserve Bank in the role of guaranteeing banking deposits (this argument is made in further detail below). Once it has guaranteed banking deposits, the Reserve Bank will eventually regulate bank assets and bank risk taking to limit the moral hazard problem. As bank profitability then declines, the Reserve Bank would be likely to place restrictions on competing non-bank financial institutions. The initial regulation, the supervision function, will end up occasioning more intervention than its proponents had desired. Even over the last few years, New Zealand has moved from a policy of very light bank monitoring to a detailed and costly application of prudential supervision.

The interventionist dynamic is particularly strong in banking precisely because the government cannot pre-commit to leaving the system alone. The danger is ever-present that the entire financial services industry will fall under the systematic control of the government. We need to be especially careful about which interventions we advocate. Many proposed interventions sound fine but actually open up a Pandora's Box of future difficulties.

3. RESERVE BANK PRUDENTIAL SUPERVISION VS RELIANCE ON MARKET MECHANISMS

The most beneficial reform suggested by the Reserve Bank would give market monitors a greater role in carrying out the mandate of the Reserve Bank to supervise registered banks. Mandatory credit ratings and public disclosure of bank information would replace the ineffectual paperwork processing that is currently performed by Reserve Bank staff.[3]

Criticism of the current regime does not imply opposition to the concept of prudential supervision. Both prudence and supervision are indisputably desirable. The critical question is whether markets or government regulation provide a better source of prudential management.[4]

The adopted system of prudential regulation is distressingly similar to previous banking controls. These earlier regulations involved ratio controls, credit ceilings, and lending guidelines prior to 1984. There is a strong consensus that these regulations failed to provide economic growth and failed to ensure the safety of the banking sector. Yet the same ideas have been reborn in the current system of Reserve Bank supervision and in the Basle capital requirements.

Section 67 of the Reserve Bank Act does require that the Reserve Bank register and supervise banks. Mandatory credit ratings, combined with disclosure requirements, can serve as the new form of supervision. In effect, the Reserve Bank would be contracting out its supervision function to the private sector.

Costs of the Current Supervision Regime

Previous arrangements for Reserve Bank supervision offered little chance of reducing bank failure risk or even spotting that risk with advance warning. Experience with bank supervision, both in New Zealand and abroad, shows that governmental regulatory supervision has been ineffective. The United States savings and loan crisis was not prevented by any of the numerous government agencies that oversee the American banking system. Japan has experienced problems with bank soundness as well. Far from policing the situation, its regulators have attempted to cover up the crisis, as did regulators in the United States. In both cases election year pressures induced governments to choose secrecy rather than disclosure.

---

3 For a recent defence of this approach in an American context, see Jerry L Jordan, *A Market Approach to Banking Regulation*, unpublished manuscript, 1993. Jordan is President of the Federal Reserve Bank of Cleveland.

4 For a general analysis of prudential management in the New Zealand context, see Tyler Cowen, *The Reserve Bank of New Zealand: Policy Reforms and Institutional Structure*, New Zealand Business Roundtable, September 1991.

In New Zealand, the government has mismanaged its financial participation in the DFC and the BNZ. True, the present regulatory regime was not in place when these institutions made some of their problem loans. Nonetheless, the government had been taking an active role in overseeing, and in some cases running, financial institutions. The problems of those institutions arose in an era of considerable government involvement in the banking system.

This connection between government involvement and financial crises is found frequently. In Australia, for instance, most bank financial difficulties have occurred in institutions that were government-owned - the State Bank of South Australia, the State Bank of Victoria, and the R. & I. Bank in Western Australia.

Under the status quo in New Zealand, registered banks are required to fill out and submit lengthy paperwork to the Reserve Bank which has to draw a judgment about the financial condition of the submitting bank.

Direct government or central bank supervision involves significant costs of paperwork and bureaucracy. The Reserve Bank spends about $4 million per year on supervision and the banks themselves incur high costs meeting paperwork requirements. These costs are difficult to measure but have been estimated roughly to exceed several millions of dollars.[5]

But the most important costs of the current supervision regime spring from the interventionist dynamic, as discussed above. The Reserve Bank role as supervisor implies an eventual Reserve Bank role as guarantor of deposits.

The public does not perceive a strong difference between these two roles. This is not a matter of ignorance that can be overcome by education and publicity. Rather, the public is savvy and perceptive in understanding the political pressures that can be brought to bear on a quasi-public institution like the Reserve Bank. The Bank cannot be assigned a public duty, like supervision, without being held accountable for the performance of the activities it is supervising.

The potential responsibilities of the Reserve Bank under the current regime become especially clear when we consider a bank that falls below the mandated capital requirements. Under current policy, the Reserve Bank will not cancel the bank's registration immediately, nor should it. Yet the Reserve Bank increases its perceived responsibility by

---

5 See the Reserve Bank paper, *Review of the Rationale for Banking Supervision by the Reserve Bank*, 14 May 1992.

keeping the bank open. Depositors would be understandably upset with a government that had allowed the Reserve Bank to keep open a failing institution. Eventually the Reserve Bank will find itself pressured to bail out the depositors of supervised institutions.

Charging fees for bank supervision increases the perception that banks or depositors are receiving some kind of protection in return. These fees are not taxes in the legal sense. Yet if they are truly fees, we would expect that some service is offered in return.

The Reserve Bank faces further difficulties when it is asked to comment upon the financial soundness of banks. The political pressures to comment are enormous; indeed, the Reserve Bank has already felt compelled to comment in the cases of the United Building Society (1988) and PostBank (1989). It is fruitless to blame the Reserve Bank for commenting in these instances. The Bank understood the long-term costs of making such pronouncements but was under irresistible political pressure to reassure depositors.

Under current methods of supervision, the Reserve Bank is perceived as the holder of privileged information about the banking system. This increases the pressure on the Reserve Bank to comment on the financial status of registered banks and increases the implicit liability of the Reserve Bank if a registered bank fails.

The pressures on the Reserve Bank to comment on the soundness of banks create an unstable long-run dynamic. Whenever a bank appears to be in trouble, the Reserve Bank receives ever-increasing pressure to offer an evaluation. Given that the Reserve Bank has offered reassuring comments in the past, failure to comment would be taken as bad news. The Reserve Bank is almost forced to comment favourably when the bank is in fact sound, but the pressure increases to comment on subsequent incidents.

An unfavourable comment, of course, would almost certainly sentence the designated bank to failure. Unfavourable comments thus imply statutory management or some equally drastic procedure. The bank's decline may be hurried in an undesirable fashion.

With either a favourable or unfavourable comment, the Reserve Bank may end up taking over the bank or guaranteeing its deposits. If a favourable comment is offered and the bank eventually fails, the Reserve Bank will come under enormous political pressure to relieve aggrieved depositors. (The Reserve Bank may even have a legal liability to do so, although this is not certain.) If either silence or an unfavourable comment is offered, the Reserve Bank may have the entire institution on its hands.

The only long-run political equilibrium for this process involves a Reserve Bank guarantee for bank deposits, either explicit or implicit. Then, the Reserve Bank could either cease commenting or could offer negative comments without precipitating a run on the named bank.

Governmental guarantees of deposits also will lead to government restrictions on bank assets. No competent insuring agency should allow its clients to play a 'heads I win, tails you lose' game at its expense. (The American experience with this problem has been especially painful.) Bank freedom and profitability in New Zealand would decline as the interventionist dynamic developed. One apparently straightforward government policy, prudential supervision, is likely to lead to an overly regulated and inflexible banking system.

The Advantages of the Proposed Credit Rating System

Recognising these difficulties, the Reserve Bank wishes to abandon its current position as collector and evaluator of bank information. All the relevant information should be made public to all interested eyes. Under the proposed reforms, the process of bank evaluation would be performed by private credit rating agencies.

Credit-rating agencies can spot bank financial difficulties more effectively than can the Reserve Bank. Reserve Bank personnel are not trained in financial supervision and evaluation, and any training that might be offered would not compare to the knowledge and experience held by top professionals. The point is not that Reserve Bank employees are somehow untalented or incompetent. Rather, they have been asked to perform a job which requires the talents of commercial specialists with strong personal and institutional experience.

Private credit rating agencies have the strongest incentives to evaluate the financial soundness of banks as well as possible. The future business of the agency depends on its ability to issue ratings that accurately measure the riskiness of the institution being evaluated.

Rating agencies are in a strong position to request information from issuers which is not in the public domain but which is relevant to the rating. For example, information concerning credit spreads in the inter-bank market may reflect inside information amongst other banks as to the relative soundness of individual banks. If so, rating agencies would be in a strong position to both extract such information from the banks and to interpret it in a sophisticated manner.

The incentives of the Reserve Bank are less clear-cut. To a large degree the Reserve Bank wishes to preserve its political independence. This desire is understandable and indeed

desirable, but may sometimes skew the evaluation process. First, the Reserve Bank will wish to collect voluminous information documents as a cover against potential parliamentary blame-pointing. Second, the Reserve Bank, even if well-informed, may be reluctant to take a controversial stand for fear of losing its political independence. Third, the Reserve Bank may be afraid to pronounce a bank sound when that bank does not meet certain arbitrary numerical requirements, like the Basle standards, or like limits of large exposures or foreign currency positions.

Privately-issued credit ratings remove bank evaluation from these political pressures. A credit rating institution is accountable to its customers, not to politicians. Credit rating agencies will not hesitate to issue politically unpalatable evaluations when appropriate.

Private credit agencies will eschew placing undue weight on any politically announced set of quantitative standards, such as the Basle capital requirements or limits on large exposures. These agencies have the knowledge and the flexibility to assess when large exposures might be dangerous and when they are likely to be safe. In some cases large single-borrower exposures can be dangerous before the legal limit is attained, and in other cases single-borrower exposures may be safe over current legal limits. No single regulatory limit can contain all of the information that a specialised agency can bring to bear on the issue.

By disclosing all relevant information to the public, the credit rating proposal produces other benefits as well. Under the proposed regime, the Reserve Bank would be removed from its awkward role as privileged holder of information about bank financial soundness. The interventionist dynamic would be weakened, although not stopped altogether.

The credit rating proposal does generate several concerns. The first question is whose credit rating shall be considered valid for regulatory purposes. Clearly a credit rating issued by a 'fly-by-night' firm or a firm closely affiliated with the bank might be of little value. Eventually the government may, either explicitly or implicitly, draw up a list of firms whose credit ratings satisfy the proposed legal requirement.

This action could have the undesirable secondary consequence of stifling competition in the market for New Zealand credit ratings. Firms that had not been granted government approval might find market access difficult. Knowing that they have a secure market position, the favoured agencies may become slack with regard to the quality of their credit ratings.

To overcome this problem, the proposed policy must rely on competitive pressures in the

market for credit rating agencies. Even if the market for credit rating of banks becomes partially regulated, credit rating firms will wish to protect their reputations in other markets. This will discourage them from slacking in their evaluation of New Zealand banks. To encourage competition in the market for the credit evaluation of banks, the government could also offer fairly general standards for which credit rating agencies are acceptable. Rather than specifying agencies by name, for instance, the government might rule that any agency above a certain size would be eligible. This also would prevent the government from removing the eligibility of firms whose credit ratings it did not like, for whatever reason. The danger of over-regulating the market for credit evaluation is real, but it can be minimised by carefully thought out policy.

Rating agencies are not omniscient. Even if they were today, a rating could still change markedly during the life of a term deposit. It may be important to ensure that depositors cannot claim ignorance of this. The danger is that depositors may blame the government for the credit rating policy if a crisis occurs during the life of a term deposit.

Credit rating agencies may initially find it easier to rate a major overseas owned bank than a locally-owned bank. In both cases they will form a judgment about the degree to which the home authorities will bail out a bank in trouble. In the case of a New Zealand-owned bank they will have to consider the degree to which the changed regulatory environment has reduced the likelihood that a failed bank will be bailed out by the Reserve Bank. However, this is not an argument against the rating agency approach since depositors need to make the same judgment in any case when deciding whether to bank with an overseas-owned or a New Zealand-owned bank.

Disclosure Requirements

Under the new Reserve Bank proposal, registered banks would be required to provide quarterly disclosure of their financial position, audits every six months, and disclosure of large loan exposures. This information would then be available for the private sector to interpret when judging bank soundness. Again, this represents a move away from government-controlled supervision towards a more efficient and flexible form of private sector supervision.

It can be questioned whether it is necessary to mandate the disclosure of such information by law. In an unregulated environment, banks are likely to provide information of this kind voluntarily. Demonstration of fundamental soundness will lower the costs of capital for a healthy bank. We can even imagine banks providing additional information, rather than simply meeting some set of legal requirements. Commercial constraints would also impel less

financially sound banks to provide detailed information, if they wanted to stay in business at all. Failure to provide relevant information would be taken as a strongly negative signal and would damage a bank's prospects for credit and deposits.

The case for voluntary disclosure is a good one, but in today's political environment this further deregulation might not be attainable. Under the proposed change in policy, mandatory disclosure is one substitute for the previous emphasis on direct Reserve Bank prudential supervision. Since insisting on voluntary disclosure might endanger the move away from the current supervisory regime, we would support mandatory disclosure, provided it is combined with the other deregulatory measures.

In considering the frequency and amount of disclosure to enforce, it is necessary to be aware that more is not always better than less. First, there are the costs of forced disclosure of commercially-sensitive information. More subtly, it is risky to force the disclosure of information before major shareholders and management have had time to take corrective action. Whereas timely action to sell an asset and/or to inject more capital may preserve the viability of an institution, the forced disclosure of an incipient problem - before management, shareholders and major creditors have had time to consider the best course of action - may simply precipitate a run on the bank and a possibly sub-optimal outcome.

Registration Fee

The Reserve Bank proposes to eliminate the registration fees that are charged to banks. This change in policy would have beneficial consequences. Banks (and indirectly depositors) are spared the payment of fees that are not assessed on a competitive basis. The elimination of such fees also symbolises the move away from governmental prudential supervision and towards market supervision. In lieu of fees, banks should pay explicitly for the disclosure and credit rating costs that they will incur under the new regime. The new regime would create a clear link between what the banks pay for and what services they receive.

Exposure Limits and Foreign Currency Positions

The Reserve Bank is reviewing the possibility of relaxing restrictions on bank exposures to single borrowers and interconnected borrowers. Such restrictions penalise large and successful corporations by raising their cost of capital. New Zealand banks will also lose business to overseas banks, as the corporations go elsewhere to satisfy their capital needs. These regulations can push banks into riskier lending, if they are denied the maximum possible business with their best customers.

The maximum exposure restrictions are especially binding for a small country like New

Zealand. The largest New Zealand corporations are large relative to the banking system. The current restrictions prevent a bank from lending more than 35 percent of its capital to a single borrower or closely connected set of borrowers.

The Reserve Bank is moving to eliminate maximum exposure restrictions, thereby replacing an inflexible, bureaucratic solution with a market-based monitoring scheme. The new proposal for full disclosure requirements for exposures, combined with mandatory credit ratings, provides the necessary degree of safety. Large exposures can involve high degrees of risk, but there is no simple formula for judging the degree of this risk. Any numerical formula proposed by the Bank will sometimes be too high and sometimes be too low. The Reserve Bank is improving the quality of financial monitoring by allowing private credit-rating agencies to bring their expertise to bear on this problem.

The Reserve Bank is also reviewing the removal of restrictions on the foreign currency positions that banks are allowed to assume. This change would be beneficial for reasons similar to those spelt out above. Private credit-rating agencies can judge and monitor the riskiness of foreign currency positions much better than the Reserve Bank can. The Reserve Bank needs only to enforce the regulation of full disclosure.

4. BASLE CAPITAL REQUIREMENTS

The Reserve Bank has proposed maintaining the bank capital requirements stipulated in the Basle international convention. New Zealand has decided to adhere to this worldwide convention, which requires registered banks to meet an 8 percent capital ratio relative to a weighted measure of their assets.

It is submitted that the Reserve Bank should drop its adherence to the regulatory status quo. With a system of mandatory disclosure and credit rating in place, the capital requirements represent little more than a tax on bank lending. Levels of bank capitalisation represent only one factor among many that go into a systematic credit assessment. When such a final credit assessment is available, the capital requirements are superfluous.

How much capital a bank should hold is a complex function of the bank's assets and liabilities. An 8 percent level of capital is sometimes too dangerous and sometimes too safe, depending upon the entire position of the bank. When the 8 percent level is too safe, the Basle conventions impose undue costs on bank lending activities.

When the 8 percent level is too dangerous, the Basle requirements create the illusion that the bank is attaining a minimum acceptable standard. This perception can only be harmful. The ability of a registered bank to meet the 8 percent requirement would, in this case, misleadingly signal safety when in fact danger was present. Whatever alarm system we need is more usefully provided by mandatory credit ratings and public disclosure of information.

In neither case - with the 8 percent standard too high or too low - do the Basle capital requirements provide a useful service to banks, the Reserve Bank, or the public.

The Basle capital requirements also weaken the long-run safety and soundness of the banking industry. The capital requirements increase the cost of bank loans and push loans out of the banking system. This tax places the greatest burden on safe commercial loans, which would not require significant capital backing without the Basle regulations. These safe loans can now be made at lower cost outside the banking system, especially because the traditional bank function of loan monitoring adds less value to relatively safe loans. As safe loans leave the banking system, registered banks will find that capital requirements raise the average riskiness of their portfolio.[6]

---

6 Banks cannot easily avoid these constraints by deregistering as 'banks' in the legal sense. The Reserve Bank would be placing the deregistered bank at a severe reputational disadvantage vis-a-vis the public. In addition, it is currently unclear whether non-bank institutions would be granted the same access to the payments system.

In response to this dilemma, regulators might be tempted to extend capital requirements to all kinds of financial intermediaries. But this reaction would only exacerbate the basic problem. Most commercial institutions can and do engage in lending to various degrees, if only through the medium of trade credit. By extending capital requirements to immediate bank competitors, regulators widen the sphere of taxed activity and push loans even further away from mainstream financial institutions.

Many defenders of mandatory capital standards cite international pressures on New Zealand to adhere to these agreements. These pressures are conceivably of two kinds - governmental and commercial. But no foreign government has threatened New Zealand with dire consequences if the standards are not upheld. None is likely to break off diplomatic relations or suspend New Zealand's membership in various trade agreements. As for the commercial pressures, the mandatory credit rating and disclosure system should alleviate these. New Zealand would, on the whole, have a safer banking system than those countries adhering only to the Basle standards.

To insist that foreign pressures will nonetheless be strong does not justify the proposed regulations. Banks in New Zealand would still have the option of meeting the 8 percent standard, or some more stringent standard of their own design, if they feel a need to do so to protect their international creditworthiness. If necessary, the Reserve Bank could provide certification for banks that voluntarily met the Basle capital standards.

The spectre of 'foreign pressures' is too often invoked as a reason to avoid politically unpalatable actions (eliminating the Basle standards would imply the Reserve Bank had been mistaken in their earlier adoption). In fact small countries throughout the world, including Hongkong, Singapore, Taiwan, Iceland, and New Zealand itself, have demonstrated that it is possible for them to take unpopular actions for their own benefit and ultimately be vindicated even on the world stage.

If the Reserve Bank is committed to keeping mandatory capital standards, they should be made as unobtrusive as possible. Specifically, the risk-weighting scheme for measuring required capital should be altered. The current weightings strongly encourage investment in government securities and housing loans and discourage commercial loans. Bank portfolios are altered in a manner that discourages economic growth and encourages additional public sector borrowing.

As the Basle convention currently stands, the capital to be held against a loan asset depends on the kind of asset. Claims on government and quasi-governmental organisations are weighted at either 0 or 20 percent, housing loans are weighted at 50 percent, and other loans are weighted at the full 100 percent. Whereas a full 8 percent of capital must be held against a commercial loan, only 4 percent must be held against a housing loan. In effect, these regulations alter the net price of making each kind of loan.

Regulatory attempts to forecast which kinds of loans are safe are likely to backfire; regulators have no systematic means of ascertaining the true riskiness of different asset classes. The experience of the late 1980s and 1990s, in particular, raises serious questions about whether real estate loans are especially safe. More insidiously, the very existence of a Reserve Bank-conferred preferred risk weighting could well be used by creditors to support a claim that the government had an obligation to assist that institution to meet its commitments to creditors.[7]

The Reserve Bank should change the weighting scheme to equalise the treatment of housing and commercial loans. It should not force housing loans up to the full 100 percent weighting. This would constitute a heavy tax increase on the banking industry and on real estate. A better solution would have the two weights meet halfway, perhaps at 75 percent or some other number to be determined by the Reserve Bank. Of course, a universal weight of 75 percent with an 8 percent capital requirement creates an effective 6 percent capital requirement. This policy thus involves an effective relaxation of the Basle standards.[8]

The Reserve Bank also should re-evaluate its decision to attach a zero weight to holdings of government securities. It is true that government securities are less risky than housing or commercial loans. But this does not mean that there is a case to encourage such assets to the degree provided by current regulations. Excess public sector borrowing is already a problem for the New Zealand economy. To the extent that lending to governments is encouraged at the expense of lending to the private sector, economic growth contracts and employment suffers. As government revenue falls, the total government deficit may increase. The policy is not even an effective means of reducing the government debt.

Capital requirements should be applied through a single, across-the-board weighting scheme. While not all assets are equally risky, this minimises the possibility for political

---

7 For example, the producer boards have a 50 percent risk-weighting. This artificially lowers their cost of capital relative to other commercial entities, so inducing resource misallocation.

8 This example illustrates another pernicious effect of having adopted the Basle regime. We cannot equalise the weighting of different loans without either relaxing the effective capital requirement or sharply increasing the regulatory burden on a particular kind of loan.

favouritism in the weighting scheme. In addition, the least risky assets, such as government securities, have the least need of regulatory subsidisation. Failure to move to an across-the-board weighting scheme would be tantamount to maintaining the sectoral priorities for lending that New Zealand experimented with unsuccessfully in the 1960s and 1970s. Once the government starts planning the allocation of capital, this process is difficult to stop without eventually incurring economic shock therapy and the heavy costs of adjustment that accompany such reforms.

Unfortunately, the Reserve Bank is actually moving to toughen the capital requirements. It has proposed increasing the minimum ratio above 8 percent and decreasing the ability of banks to rely on 'tier two capital.' Either banks would be required to hold 10 percent capital or tier two capital would not be counted at all. The Reserve Bank has not suggested dropping risk-weighting requirements.[9]

The Reserve Bank also proposes to use capital measurements to determine the treatment of banks that do not meet the stipulated requirements. At various levels of capital, dividends would be suspended, the banks would come under close scrutiny, and eventually the bank's registration could be suspended, with the institution placed under statutory management. The exact guidelines set out by the Reserve Bank represent an improvement over previous policy, which gave the Reserve Bank too much discretion in applying these various steps.

Nonetheless, measured capital is not the best standard for determining Reserve Bank policy towards financially unsound banks. For the reasons discussed above, credit ratings are a far better measure of a bank's position. When deciding which disciplinary actions to take, the stipulated actions should be linked to credit ratings rather than to capital, or at least credit ratings taken in conjunction with measured capital. Enforcement procedures should reflect the possibility that banks with low measured capital may nonetheless be in a reasonably sound financial position. Alternatively, banks with high measured capital may be in a precarious financial position.

---

9 Tier two capital is defined by the Basle agreements in terms of quasi-equity instruments and subordinated debt. Tier one capital is basic proprietors' equity.

5. DEPOSITOR PROTECTION

In lieu of the Basle capital requirements, the Reserve Bank should consider other measures to improve depositor safety. These potential reforms include increasing the legal liabilities of foreign-owned banks operating in New Zealand and resolving the currently ambiguous status of Trust Bank.

Honouring Foreign Commitments

Foreign-owned institutions dominate the New Zealand banking market. These institutions are of sufficient size that solvency or liquidity problems in New Zealand alone will not endanger their ability to honour their commitments. Policies which protect New Zealand depositors must therefore consider two possible cases: (i) the entire parent company fails, and (ii) the parent company cannot or will not fully honour its New Zealand commitments.

New Zealand policy makers can do little to regulate the overseas behaviour of the foreign-owned parent companies involved in the New Zealand banking system. But they can decrease the chance that New Zealanders will be left unprotected. The Reserve Bank favours strengthening disclosure requirements and is examining a more stringent treatment of legal liabilities - two appropriate remedies for the problem at hand.

New Zealand depositors can choose to place their funds in a branch of an overseas parent company or in a separately incorporated subsidiary.[10] A branch gives depositors strong assurance that the parent company is liable, in return for the risk that branch depositors will not get priority over overseas depositors and creditors. A subsidiary gives depositors priority over overseas creditors upon the resources of that subsidiary. At the same time, the subsidiary form weakens the link to the resources of the parent company. Parent companies are usually loathe to let their subsidiaries fail for reputational reasons, but the resources of the parent company are now one step removed from a legal point of view.

The risks of both branch and subsidiary arrangements could be addressed by legal reform. Specifically, the New Zealand government could require that registered banks stipulate that a certain quantity of their assets, whether held in New Zealand or abroad, be reachable under New Zealand law. In this case the New Zealand government would be ensuring that the foreign-owned banks were making credible promises to their depositors. Banks could be given the option of ignoring this mandate, provided that they informed their

10 Current branches of overseas banks comprise Banque Indosuez, Barclays, Citibank NA, Hong Kong & Shanghai, Primary Industry Bank of Australia, State Bank of South Australia, and Westpac. Current subsidiaries of overseas banks comprise ANZ, ASB, BNZ, BNZ Finance, Bankers Trust New Zealand, Countrywide, National Australia Bank (NZ), PostBank, The National Bank of New Zealand, The Rural Bank and United Bank.

customers of this choice. The Reserve Bank also could require that banks disclose the legal consequences of their incorporation arrangements to depositors.

These policies further one of the goals of capital standards - depositor protection - without placing an outright tax on bank lending. While the cost of doing banking business in New Zealand would increase slightly, this increase in cost would in fact achieve greater efficiency. The Reserve Bank would be announcing to foreign-owned institutions that they cannot expect a subsidy from the New Zealand taxpayer and that they must honour the commitments they make to New Zealand depositors. Any bank that withdrew its business from New Zealand in response should not be in the market in the first place.

Trust Bank New Zealand

The government can also improve depositor safety by clarifying its position towards New Zealand-held institutions. Only two New Zealand-held institutions remain in the banking system.[11] Most prominent of these is Trust Bank, with over one million individual depositors.

In the past Trust Bank's deposits were government guaranteed. The 1988 legislation provided for the phased elimination of that guarantee. Today, the guarantee would only apply to term deposits which have not matured since the passing of that legislation. This would be a minuscule proportion of total deposits.

However, legal reality is one thing, public perception of governmental responsibility is another - there is little doubt that the public perceives a government commitment to depositor safety. Public perceptions of a governmental responsibility to depositors in Trust Bank may be strengthened by the fact that the minister of finance appoints the trustees of the regional community trusts that own the shares in Trust Bank.

In the interests of transparency and accountability, the government should clarify its policy towards Trust Bank and other domestic institutions, as the Reserve Bank has suggested. The best solution would be privatisation, as with the ASB. A newly-privatised Trust Bank could stand on an equal footing with other private sector banks.

Under a full privatisation, in the sense in which the term is being used here, there would be no central government involvement in any entity which owned shares in Trust Bank. To the extent that this could not be achieved, the smaller the shareholding of entities associated with the government the better.

---

11 Trust Bank New Zealand, and TSB Bank.

Options for improving on the current situation include shifting responsibility for appointing trustees away from the minister of finance, perhaps to local or regional government[12], and/or increasing the pressure on trustees to acknowledge the desirability of reducing their investment in Trust Bank, both because the Trustee Act requires trustees to act as a prudent person (e.g. by diversifying each trust's investments) and because the viability of Trust Bank would surely be improved if it was substantially owned by shareholders who had the capital resources to assist it when necessary.

Delay in clarifying the Trust Bank situation only increases its potential costs. The current Trust Bank, operating with an implicit governmental guarantee, cannot run a portfolio that offers depositors superior or equal returns compared to other banks. To do so would be to allow the government-backed institution to capture a dominant market share. The safer Trust Bank portfolio makes the bank less profitable and dynamic and thus more difficult to privatise. Over time, government-backed institutions will become economic dinosaurs in an industry that is changing with increasing rapidity. This situation should be avoided by privatising and by instituting a level playing field in the regulatory arena.

12 This would be difficult in that the regional trusts do not have the same regional boundaries as local government.

6. LENDER OF LAST RESORT POLICY

The government and Reserve Bank are not required to serve as a lender of last resort for the New Zealand banking system. New Zealand banks are small relative to the world economy and could purchase emergency lines of credit from larger financial institutions. We could even imagine a system of private deposit insurance purchased from Japanese or American financial institutions. Even through purely domestic operations, New Zealand banks can increase their safety by holding government securities, highgrade commercial paper, and a diversified loan portfolio. Risk-averse depositors could also hold checkable mutual fund accounts backed by safe financial assets, similar to the American checkable mutual fund accounts.[13]

Banking may be subject to contagion effects but the private market does the best job of limiting the scope of potentially harmful interdependencies. Bank shareholders, creditors and depositors all have strong incentives to see that their financial stake is protected from contagion by economically ailing financial institutions. The flexibility of private contracts and insurance are likely to provide better protection than government regulations, which tend to be inflexible and politically motivated.

Government regulation in fact tends to increase the scope for contagion effects. When financial institutions anticipate a government bail-out they take fewer protective measures of their own. The dangerous interdependencies in payments systems around the world have arisen from this perception. Because private liabilities have not been clearly assigned and enforced, banks assume (correctly) that the government will take responsibility for a system-wide crisis. In response banks have failed to provide adequate market protection against contagion effects.

The arguments against giving the Reserve Bank a lender of last resort function, while analytically sound, do not take political constraints into account. Short of a fundamental change in the political environment, no New Zealand government will allow a system-wide crisis that requires bank depositors to suffer large-scale losses. Knowing this political 'weakness' in advance, banks may not take adequate protective precautions of their own; this is the problem of pre-commitment discussed earlier. Government involvement then becomes necessary in response to a problem that the government itself created.

Reserve Bank policy should attempt to satisfy political constraints while keeping the Reserve Bank lender of last resort role to a minimum. The lender of last resort function is not a public good to be maximised in provision; rather the lender of last resort function results from the weakness of government and should be strictly limited in advance whenever possible.

13 For a further discussion of these points, see Tyler Cowen, op. cit, section VII.

The Reserve Bank should (and no doubt intends to) satisfy its lender of last resort role through the conduct of open market operations. When a system-wide crisis hits, the Bank can provide additional liquidity to the system through an expansionary monetary policy. The supply of loanable funds will increase, interest rates will fall, and troubled institutions will have greater access to emergency credits and loans. If other financial institutions are unwilling to loan to the troubled institution, the Reserve Bank should be unwilling also. The only real alternative is for the Reserve Bank to assume explicit responsibility for the solvency and liquidity of each and every financial market participant.

Restricting the lender of last resort role to open market operations removes the Reserve Bank from the difficult role of making decisions about the merits of particular financial institutions. When the Reserve Bank can lend funds to troubled institutions, the decision of whether to lend and how much to lend is inevitably political. Since the Reserve Bank is only lending because other market participants will not, the decision cannot be made or justified on the grounds of profitability or other standard economic criteria. Open market operations, in contrast, restrict the Reserve Bank to monetary policy and place lending decisions in the hands of the marketplace.

Even if the Reserve Bank fully intends to restrict the lender of last resort role to open market operations, such a policy may be overturned in a crisis. To strengthen its ability to adhere to this policy, the Reserve Bank should be prohibited by law from engaging in unsecured lending to individual institutions. This would preserve the neutrality of the Bank vis-a-vis competing financial institutions. Legislation to limit the lender of last resort role to open market operations would also retain incentives for banks to protect themselves from contagion effects. Banks would monitor their exposure to troubled institutions, and would perhaps purchase insurance or emergency lines of credit from abroad to protect against failure of their trading partners.[14]

Some depositors may still believe that this arrangement involves an unacceptable level of risk. To respond to such concerns, the government can maintain the availability of an ultra-safe investment for retail investors. Kiwi Bonds currently provide such an outlet. Another possibility would involve turning the Trust Bank into a safe haven for this purpose. The

14 The Reserve Bank claims that its current policies do not place taxpayer funds at risk. But current policies may be insufficiently robust against the pressures to do just that. In practice in other countries, the lender of last resort function has not remained restricted to solvent but illiquid banks in need of temporary assistance. In America, for instance, it has come to light that the Federal Reserve System has abused its lender of last resort function by widespread lending to insolvent banks. Central banking lending becomes a critical option precisely in those cases when other banks will not lend, i.e. when a high risk of loss is present.

government could guarantee Trust Bank deposits explicitly and require Trust Bank to invest in safe, low-yield assets. Nonetheless, privatisation of Trust Bank is probably the superior option, with the safe haven role being assigned to Kiwi Bonds. If depositors desire low-risk outlets for their funds, the exact organisation of such outlets is best left to the market. The private sector already retails government debt directly and through trusts, and these financial opportunities could be expanded.[15]

15 Unfortunately the Reserve Bank has inhibited the latter process by refusing to register government stock holdings with a face value of less than $10,000.

7. PAYMENT SYSTEM RISK

The likelihood of contagion effects in the New Zealand banking system is greatest through the payments system. Banks commonly provide cleared funds to other banks and bank customers before having received the funds themselves. These intra-day exposures are often quite large. If a crisis occurred, perhaps because of a bank failure, other banks would not receive expected funds. The initial failure could spread to other banks or a payment system 'grid lock' could result, with all transfers frozen or suspended.[16]

While these outcomes are regarded as unlikely, their costs would be high. The Kiwi Inter-Bank Transfer System (KITS) handles hundreds of millions of dollars of transferred funds per day.

The potential for payment system problems is faced by most developed economies today. As in New Zealand, most electronic funds transfer systems do not provide instantaneous or 'real-time' transfer of funds. Banks can wire funds now, even if they do not send the actual funds until later. If the wiring bank should fail, the exact legal status of the funds remains unclear. Political pressures might require the central bank to supply liquidity and fund a bail-out.

The Reserve Bank has indeed recognised the importance of these issues and is moving to reform payment system problems. The available policy options include:

- a move towards real-time settlement. Under this option, banks must actually transfer funds at the time they wire the funds. This procedure has been adopted in Switzerland.

- clarification of the legal status of intra-day funds, in case of bank failure. The law should make clear whether the receiving banks owns the funds or, if not, where the receiving bank stands in the line of creditors. Increased legal certainty would remove an implicit Reserve Bank responsibility for systematic failure and help banks manage their funds.

- institution of 'netting' practices. Netting involves offsetting of multiple liabilities so that only the net position need be paid off. Netting decreases the number and value of payments and thus decreases the burden placed on the payment system.

---

16 For an analytical framework and excellent bibliography on payments system issues, see William Roberts, *The Rise of Electronic Payments Networks and the Future Role of the Fed With Regard to Payment Finality*, Economic Review, Federal Reserve Bank of Atlanta, March/April 1993, volume 78, no.2, pp.1-22. For an analysis of payments system problems in New Zealand, see John Tait, *Reform of the New Zealand Payment System*, Reserve Bank Bulletin, 1993, 56 (2), 139-146.

- collateral requirements. Some clearinghouse networks, such as CHIPS in New York, require members to post collateral. If a member bank failed with outstanding intra-day liabilities, this collateral would be used to pay them off.

- monitoring. The clearinghouse could monitor bank intra-day exposures, perhaps placing limits on allowable positions. This solution need not be implemented by the government but can arise from contractual arrangements through a privately-owned clearinghouse.

Each of these arrangements has low regulatory costs and/or has proven practicable elsewhere in the world. By addressing payment systems issues now, before a crisis arises, the Reserve Bank can increase the soundness of the banking system at low political and economic cost.

8. SUMMARY OF RECOMMENDATIONS

The analysis presented in this paper leads us to make the following recommendations:

(i) Direct Reserve Bank prudential supervision should be replaced by greater reliance upon market mechanisms. Specifically, full disclosure and mandatory credit ratings offer the public the best protection possible. Proposed Reserve Bank policies in these areas represent significant improvements over the status quo.

(ii) The Reserve Bank should remove itself from the position of implicitly guaranteeing bank deposits. Turning supervision over to the private sector and eliminating bank registration fees, as proposed, would help accomplish this.

(iii) Once mandatory credit ratings are in place, the Reserve Bank should remove its restrictions on single borrower exposure limits and open foreign currency positions, as proposed.

(iv) The Reserve Bank should reverse its adherence to the Basle capital requirements. These requirements will become superfluous under the new regulatory proposals. They will represent a tax on banking and lending and will drive safe loans out of the banking system. The proposal to strengthen the application of these standards should be dropped.

(v) If the Basle capital requirements are not removed, they should be made as unobtrusive as possible. One interim option is to make certification for their observance voluntary. In any event, a timetable should be set for their removal. The Reserve Bank should remove the preferential treatment given to housing, the producer boards and government securities.

(vi) If the Reserve Bank desires additional protection for depositors, it should tighten bank disclosure requirements and bank legal liabilities towards depositors.

(vii) The government should clarify the situation of Trust Bank, with an eye to privatising that institution.

(viii) The Reserve Bank role as a lender of last resort is inescapable in the current political environment. By statute, this role should be limited to providing liquidity to the system as a whole, rather than performing unsecured lending to particular banks. The latter should be prohibited by law.

(ix) The greatest problem of systemic risk lies in the payment system. The Reserve Bank should institute real-time settlement for electronic funds transfers. Barring that reform, the Bank should clarify the legal status of outstanding intra-day funds, and institute netting and collateral requirements.