

# Banking supervision: placing a new emphasis on the role of bank directors

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*On 1 January 1996 a new set of banking supervision and disclosure arrangements came into force. An important feature of the new arrangements is the emphasis now being placed on the role of the Board of Directors in overseeing the management of their bank.*

*This article discusses the Reserve Bank's requirements relating to bank directors and the expectations which the Reserve Bank has of the role played by directors. It also discusses the importance which the Reserve Bank attaches to banks having a well qualified and suitably experienced management team.*

## I Background

The banking supervision framework adopted at the start of this year involved a shift in emphasis away from detailed prudential regulation by the Reserve Bank to a greater emphasis being placed on market disciplines as the principal means of maintaining a sound and efficient financial system. The cornerstone of the new approach is a disclosure regime for banks. This requires all banks to publish public disclosure statements each quarter, containing a wide range of financial and risk-related information.

The disclosure statements are intended to meet a number of objectives, including:

- to sharpen the incentives for the management and directors of banks to ensure that their bank is managed soundly - and in particular to ensure that they have systems in place to identify, monitor and manage their risks effectively;
- to increase the market's ability to assess the performance and soundness of banks and to compare one bank with another;
- to strengthen the accountability of the management and directors of banks; and
- to provide depositors and other bank customers with improved information with which to determine where they should bank.

In the expectation that increased disclosure will result in banks giving greater attention to risk identification and management, a number of prudential controls have been removed. These include the former limit on the amount which banks could lend to individual customers, the former limit on open foreign exchange positions and the Reserve Bank's guidelines on internal controls and associated audit arrangements.

## II Roles of directors and management

A fundamental component of the new supervisory and disclosure arrangements is the emphasis they place on the role of bank directors and senior management. The new arrangements aim to strengthen the role and accountability of directors and senior management as the persons with ultimate responsibility for the management of their bank.

The Reserve Bank's policies on bank directors recognise the critical role which directors have in overseeing the stewardship of their bank and in ensuring that the senior management team have the necessary skills, experience and integrity to manage the bank's affairs soundly. Ultimately, a bank's financial soundness and performance, and therefore, cumulatively, the soundness of the financial system as a whole, depend on the quality of the Board of Directors and the senior management of the bank. The strategic positioning of a bank, the nature of a bank's risk profile, and the adequacy of the systems for identifying, monitoring and managing the bank's risks ultimately reflect the quality of the management team and the adequacy of the directors' oversight of the bank. For these reasons, the Reserve Bank believes that the most effective initiative it can take to promote a sound financial system is to strengthen the accountability of the directors and management of banks and to sharpen the incentives for them to manage their banks prudently.

Unlike some supervisory authorities in other countries, the Reserve Bank's policies do not include a "fitness and properness" test for a bank's directors or senior management. The Reserve Bank has no role to play in approving the appointment of bank directors or the members of a bank's senior management team. The appointment of directors is the sole responsibility of the shareholders of a bank, and the appointment of senior management is the responsibility of the directors. The Reserve Bank believes that banks and their shareholders have strong commercial and reputational incentives to ensure that the directors and senior management have the necessary skills,

experience and integrity to manage the bank's affairs in a sound manner. The Bank's policies seek to reinforce these incentives by improving the market's ability to hold directors and management to account.

Although the Reserve Bank has no role in approving the appointment of a bank's directors or senior management, in exceptional circumstances the Bank might need to reassess whether a bank should continue to retain its registration as a bank if its standing is seriously jeopardised as a result of particular director or senior management appointments. Similarly, if a bank is experiencing serious financial distress, or has failed, the Reserve Bank has the power to give a direction to the bank to remove particular directors or management. Such a direction could only be given with the prior consent of the Minister of Finance and only where the bank's circumstances pose a significant threat to the soundness of the financial system.

### III Director requirements - statutory context

The Reserve Bank's policies on directors complement and reinforce a number of the requirements imposed on directors under common law and various statutes, most notably the Companies Act 1993 and Financial Reporting Act 1993. Therefore, before discussing the Reserve Bank's policies in detail, it is useful to outline the principal duties and responsibilities of directors as contained in the Companies Act and Financial Reporting Act.

**Companies Act 1993.** The Companies Act sets out the duties of directors. These include the following:

- A director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company. The Companies Act provides an exception to this where a company's constitution empowers directors to act in the best interests of the company's holding company, even though in so doing this may not be in the best interests of the company itself.

Banks incorporated in New Zealand are subject to a condition of registration which prohibits them from including a provision in their constitution enabling directors to act in the interests of a holding company where to do so would conflict with the interests of the bank in New Zealand, to the detriment of the bank's creditors. This condition of registration recognises the important role banks play in the economy and therefore the need for them to be managed in a manner consistent with the interests of banks' creditors.

- A director of a company must exercise a power for a proper purpose.
- A director of a company must not act, or agree to the company acting, in a manner that contravenes the Companies Act or the constitution of the company.
- A director of a company must not:
  - agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or
  - cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.
- A director of a company must not agree to the company incurring an obligation unless the director believes at that time, on reasonable grounds, that the company will be able to perform the obligation when it is required to do so.
- A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances, taking into account such factors as:
  - the nature of the company;
  - the nature of the decision; and
  - the position of the director and the nature of the responsibilities undertaken by him or her.
- A director of a company, when exercising powers or performing duties as a director, may rely on reports, data and other information prepared or supplied, and on professional expert advice given by:
  - an employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned;
  - a professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence; and
  - any other director or committee of directors, upon which the director did not serve, in relation to matters within the director's or committee's designated authority.

However, the Companies Act makes it clear that a director may only place such reliance if the director:

- acts in good faith;
- makes proper enquiry where the need for inquiry is indicated by the circumstances; and
- has no knowledge that such reliance is unwarranted.

In addition to these duties, the Companies Act imposes certain other responsibilities on directors. These include:

- the obligation for directors to declare and register any interests they may have in relation to the company and its business operations.
- the requirement that, before authorising any distribution to shareholders, directors certify that the company would, immediately after making the distribution, meet the solvency test specified by the Companies Act. The solvency test is met if:
  - the company is able to pay its debts as they become due in the normal course of business; and
  - the value of the company's assets is greater than the value of its liabilities, including contingent liabilities;
- directors are required to ensure that the company maintains proper accounting records of the company's affairs.

**Financial Reporting Act 1993.** The Financial Reporting Act also imposes certain requirements on company directors. These requirements are of fundamental relevance to the directors of banks in New Zealand and harmonise closely with the disclosure requirements imposed on banks pursuant to the Reserve Bank of New Zealand Act.

The Financial Reporting Act requires the directors of entities subject to the Act (which include registered banks) to ensure that the entity prepares financial statements which comply with generally accepted accounting practice, including applicable financial reporting standards approved by the Accounting Standards Review Board. Where compliance with generally accepted accounting practice would not result in the financial statements conveying a true and fair view of the matters to which they relate, the directors must ensure that the entity discloses such further information and explanations as will give a true and fair view of those matters.

**Penalties for directors.** Directors face severe penalties for breaches of their duties under the Companies Act and

for non-compliance with requirements imposed under that Act and the Financial Reporting Act. These penalties include:

- substantial fines;
- substantial terms of imprisonment (for example for the making of false statements, falsifying records or carrying on business fraudulently); and
- unlimited personal liability (for example where creditors sustain losses as a result of improperly maintained accounting records).

In addition to these penalties, directors can also be disqualified from holding office by the Court for, among other matters, the making of false statements, the fraudulent use or destruction of property, the falsification of records or the persistent failure to comply with the provisions of the Companies Act or Securities Act. Moreover, in some circumstances, the Registrar of Companies can prohibit persons, including directors, from managing companies.

**Securities Act 1978.** In addition to the Companies Act and Financial Reporting Act, directors of banks in New Zealand which issue securities to the public are subject to the requirements of the Securities Act 1978 and Securities Regulations 1993. The Securities Act imposes a number of requirements on entities which issue securities to the public, including a requirement to maintain proper accounting records and disclosure requirements in relation to advertisements and prospectuses. Under the Act, directors can be held personally liable for untrue statements contained in advertisements or registered prospectuses, and can be fined or imprisoned for breaches of the Act.

## IV Reserve Bank policies on bank directors

Reflecting the importance which the Reserve Bank attaches to the role played by the directors and management of banks, the new banking supervision and disclosure arrangements contain a number of policies relating to directors. Indirectly, these requirements also have strong implications for the responsibilities and accountability of the senior management of banks. These specific policies include:

- a requirement for attestations, signed by each director, to be contained in each bank's quarterly disclosure statement;
- a requirement for the disclosure of directors' conflicts of interest and the policies in place for dealing with conflicts;

- an obligation on every bank director to sign their bank's disclosure statement;
- the penalties applicable to directors if their bank's disclosure statement is found to be false or misleading; and
- requirements relating to the composition of the board of directors.

Each of these policies is discussed below.

**Director attestations.** Perhaps the single most important part of the disclosure provisions is the requirement for all directors to sign quarterly attestations relating to the conduct of their bank's business. The attestations are required to be published in each bank's disclosure statement. The attestations comprise statements:

- as to whether the bank has systems in place to monitor and control adequately the banking group's material risks, including credit risk, exposure concentration risk, interest rate risk, currency risk, equity risk, liquidity risk and other business risks, and whether those systems are being properly applied;
- as to whether all conditions of registration applicable to the bank in question are being complied with;
- as to whether exposures to connected persons (ie, persons or entities capable of controlling or significantly influencing the bank) are contrary to the interests of the banking group; and
- that all required disclosures have been made and that the disclosure statement is not false or misleading as at the date on which the disclosure statement is signed.

These attestations are required to be made by each director of the bank after "due enquiry" by them. The extent of director enquiry into the affairs of their bank is a matter for each director to assess, having regard to such factors as the circumstances of the bank, the quality of the senior management team, the nature of the management systems, the nature and extent of the bank's internal controls and internal audit, and the scope of external audit.

The director attestations are intended to fulfil a number of objectives. Probably the most important of these are:

- to increase the accountability of bank directors and to encourage them to take a focused approach to their duties as the persons with ultimate responsibility for the stewardship of their bank;

- to strengthen the incentives for bank directors to maintain a well informed overview of their bank's business activities and the nature of the risks inherent in that business;
- to encourage directors and their management team to satisfy themselves that their bank has adequate systems in place to monitor and manage those risks effectively, and to ensure that their bank has sufficient internal controls, including internal audit arrangements where appropriate, to ensure that the risk management systems are being properly applied;
- to provide an assurance that each bank's disclosure statement complies with the disclosure requirements and is not misleading or false.

Although the attestations are the responsibility of each bank's directors, the attestations are expected to have a positive influence on the accountability and disciplines on each bank's senior management team. Placing an obligation on directors to sign the attestations each quarter could be expected to strengthen the nature and extent of the enquiry which directors make of their bank's chief executive and senior management team. In turn, this is likely to reinforce existing incentives for banks to ensure that they have adequate management systems and accountability structures in place.

**Disclosure of director qualifications and conflicts of interest.** Another feature of the disclosure arrangements is that they require the disclosure of the qualifications and experience of each director. In addition, banks are required to disclose the nature and amount of any transaction which any director or immediate relative or close business associate of the director has had with the bank or any member of the bank's banking group, other than dealings of a strictly commercial and arm's length nature. Moreover, each bank is required to disclose the policy of the board of directors for avoiding or addressing directors' conflicts of interest.

The disclosure requirements regarding conflicts of interest are intended to reinforce the director conflicts requirements of the Companies Act 1993 and to increase the accountability of bank boards with respect to conflict issues.

**Criminal and civil penalties on directors.** Under the Reserve Bank of New Zealand Act, a bank's directors face criminal and civil penalties where their bank's disclosure statement is found to be false or misleading. These penalties include:

- a fine of up to \$25,000;

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

These penalties are severe, and could be expected to add to the existing incentives to encourage directors to exercise close scrutiny over their banks. However, the penalties provided for in the Reserve Bank of New Zealand Act are very similar to those in the Securities Act with respect to the publication of false or misleading prospectuses by issuers of securities to the public. Accordingly, in this respect, there is a level playing field across all public securities issuers.

**Defences available to directors.** Under the Reserve Bank of New Zealand Act, certain defences are available to directors to avoid the penalties referred to above. Again, these are similar to those in the Securities Act. In brief, these defences are:

- where the false or misleading information can be proved to be immaterial;
- where a director proves that he or she had reasonable grounds to believe, and did believe, that the information in question was true;
- where a director proves that the disclosure statement in question was published without his or her knowledge or consent, and gave public notice (and notice to the Reserve Bank) of that fact;
- where a director proves that, after the publication of the disclosure statement, but before any debt securities were subscribed for, the director, on becoming aware of the false or misleading information, withdrew his or her consent, and gave public notice (and notice to the Reserve Bank) of that fact.

**Director disclosure requirements apply to all banks, regardless of the country of incorporation.** The director attestations and other director disclosure requirements, including the penalties for issuing false or misleading disclosure statements, apply to the directors of all banks operating in New Zealand, regardless of whether the bank is incorporated in New Zealand or overseas, and regardless of whether the director is resident in New Zealand or resident overseas. However, in recognition that it will not always be possible for the director of a bank to sign their bank's disclosure statement, the Reserve Bank of New Zealand Act makes provision for a bank director to authorise another person to sign the disclosure statement on

his or her behalf. For practical reasons, a number of bank disclosure statements have been signed by a person or persons on behalf of one or more of the directors.

Where a director does authorise another person to sign the disclosure statement on his or her behalf, the director responsibilities and liabilities under the Reserve Bank of New Zealand Act remain with the director.

**Requirements relating to the composition of the board of directors.** Reflecting the importance which the Reserve Bank places on the board of directors, all banks incorporated in New Zealand are required to have at least two independent directors - ie, persons who are neither employees of the bank nor directors or employees of any entity capable of controlling or significantly influencing the bank.

This requirement recognises that independent directors can bring additional and sometimes more objective scrutiny to aspects of a bank's business. This is particularly the case in respect of a bank's dealings with its controlling shareholders and other related parties, where independent directors are better placed to ensure that any such dealings are not contrary to the interests of the bank in New Zealand. In addition, independent directors can sometimes be better placed to ensure that their bank's risk management systems and internal controls receive adequate external scrutiny (ie, in addition to reviews conducted by or on behalf of a controlling shareholder). Directors drawn solely from the staff of a bank and from the staff or board of a controlling shareholder are generally not as well placed to perform these roles. The policy also recognises that independent directors can bring fresh perspectives to the management of banking business - different perspectives to those available from controlling shareholders.

In addition to the minimum independent director requirement, all banks incorporated in New Zealand must have a non-executive chairperson - ie, a person who is not an employee of the bank. However, the chairperson can be a director or employee of a parent shareholder or other entity in a position to control or significantly influence the bank.

The objective of prohibiting the chairperson from being an employee of the bank is to reinforce the role of the board in scrutinising the performance of management. The Reserve Bank believes that there is a risk that such scrutiny might be less objective and rigorous where the board is chaired by a member of the bank's senior management team.

## V Reactions to the Reserve Bank's policies on bank directors

In the early stages of implementing the new regime, the Reserve Bank's policies on the role of directors met with some resistance. One aspect of this resistance was based on a view that the Bank's approach places an excessive emphasis on the role of bank directors and asks too much of them. In particular, it has been said that the Reserve Bank expects bank directors:

- to be experts in banking risks and risk management systems;
- to understand the intimate details of their banks' business; and
- to manage their banks' day-to-day affairs.

The Reserve Bank does not have such expectations. The Bank is satisfied that the disclosure requirements, as they relate to bank directors, are fully consistent with the duties of directors as specified in the Companies Act 1993 and at common law. But it is expected that the disclosure framework will bring a sharper focus to these duties.

Although the Reserve Bank does not have expectations that bank directors will necessarily be experts on banking, the policies on directors are predicated on certain general expectations as to the attributes and roles of a bank's board. These include the following:

- Directors should have the skills, knowledge and experience to enable them to perform their duties effectively. The Bank believes that there are strong commercial and reputational reasons for banks to ensure that they do maintain boards of high calibre.
- Directors should ensure that a bank's management team has the necessary skills, knowledge, experience and sense of judgement to manage the bank's affairs in a sound and responsible manner. Arguably, this is their foremost duty.
- Directors should ensure that the management team is accountable to the board of directors and that there are robust structures in place to facilitate this. A good example of such a structure is the presence of an audit committee, chaired by a non-executive director.
- Directors should have a sound understanding of the nature of their bank's business activities and the types of risks inherent in conducting that business. And they should take all reasonable steps to ensure that management has put in place robust systems to monitor and control those risks adequately. The directors

need not be experts in banking risks and risk management systems. But they should satisfy themselves that such expertise is available to the bank and that the risk management systems receive appropriate scrutiny from those suitably qualified to conduct such a review.

- Directors should satisfy themselves that the bank has adequate controls (including internal audit arrangements, where appropriate) to ensure that the risk management systems are being properly applied at all times. Again, this expectation does not mean that directors need be experts in their bank's internal controls and internal audit arrangements. But it does mean that they should make sufficient enquiry of persons with relevant expertise, both within the bank and, as appropriate, outside the bank, to satisfy themselves that such controls and audit arrangements are robust and are being properly applied.
- Directors should take all reasonable steps to ensure that the information disclosed in their bank's disclosure statements is not false or misleading. This does not require them to review the disclosures in great detail. In most cases that would neither be practicable nor appropriate. But they should satisfy themselves that their bank has adequate internal procedures in place, coupled with an adequacy of external audit or other external review where appropriate, to ensure that information disclosed by their bank is not false or misleading.

Another criticism made of the new arrangements is that the disclosure and director requirements have limited usefulness, given that, with only one exception, they apply to the subsidiaries and branches of overseas banks. It has been argued that the soundness of the banks in New Zealand is determined by the health of the parent banks, rather than the actions of local management and directors.

There is undoubtedly some truth to this, particularly in respect of those banks that operate in New Zealand as branches, and are therefore part of the same legal entity as the overseas bank. Even in the case of banks operating in New Zealand as subsidiaries of overseas banks, it is inevitable that the financial condition of the local banks will be substantially influenced by the health of their parents.

Nonetheless, the actions of directors and management in New Zealand do play a very significant role in determining the health of banks incorporated in New Zealand. The directors and management of a locally incorporated, overseas owned bank have a very important role to play in determining the risk profile of their bank and the way in which those risks are managed. Although, to some ex-

tent, the risk management systems and management structures of the local bank will be grafted from those of the parent bank, the application of those systems, the application of internal controls and internal audit arrangements, the appetite for risk, the judgement of financial conditions in the local market, and the making of business decisions on the basis of those judgements, are all matters that fall significantly to the local management and are overseen by the local board of directors. All these factors play an important role in shaping the long-run health of the banks operating in New Zealand and therefore the soundness of New Zealand's financial system. It is therefore important that there are appropriate disciplines on the boards of directors and management of the New Zealand operations of overseas banks.

## **VI Conclusion**

Although it is too early to make a definitive judgement on the new banking supervision and disclosure arrangements, the Reserve Bank is confident that they will lead to a more focused approach to the management of banking risks and to an enhanced accountability for bank directors and management. Over time, it is expected that the new approach will make an important contribution to the maintenance of a sound and efficient financial system.

