

A Specific Role for Boards in a Regulatory Framework: The New Zealand Banking Case

M. L. McIntyre
Sprott School of Business
Carleton University
1125 Colonel By Drive
Ottawa, Ontario
Canada K1H 6S6
mmcintyr@sprott.carleton.ca
+1 613 520-2600 ext 2514

David Tripe
Centre for Banking Studies
Private Bag 11-222
Massey University
Palmerston North, New Zealand
D.W.Tripe@massey.ac.nz
+64 6 350-5799 ext 2337

October 2006

Key Words: Board of Director, Governance, Bank Regulation

Abstract

The Reserve Bank of New Zealand's ("RBNZ") regulatory framework for the New Zealand banking system specifies a role for the boards of locally incorporated banks and also specifies some features of bank board construction. The latter is intended to increase the probability of bank boards fulfilling their regulatory role. In this paper we consider how the RBNZ's specifications for board construction compare to the standards espoused in the literature. We also examine actual bank board construction in New Zealand to determine the extent to which locally incorporated banks have met or exceeded the RBNZ's requirements. We find that while some banks have taken a minimalist approach to observing the RBNZ's requirements, others seem to have formed boards that far exceed them. This finding calls into question critics' claims that the RBNZ's rules for bank board construction lead to boards that are excessively costly and potentially dysfunctional. We also find that the RBNZ's requirements for board construction omit two features commonly associated with effective boards of directors.

1. Introduction

The Reserve Bank of New Zealand's ("RBNZ") regulatory framework for the New Zealand banking system specifies a role for the boards of locally incorporated banks, and also specifies some features of bank board construction. The latter is intended to increase the probability of bank boards fulfilling their regulatory role. In this paper we consider how the RBNZ's specifications for board construction compare to the standards espoused in the literature. We also examine actual bank board construction in New Zealand to determine the extent to which locally incorporated banks have met or exceeded the RBNZ's requirements.

The approach in this paper is idiographic in that the goal is to observe and describe phenomena and then interpret them using existing theory. The approach is therefore qualitative in nature. This is in contrast to the nomothetic approach in which one seeks to present hypotheses and then test whether or not a suitably large sample of data supports the hypotheses in a statistically significant way.

We find that the RBNZ's requirements for boards address only a small fraction of the dimensions that the literature on effective boards considers important. We also find that the RBNZ standard omits two basic and desirable features of effective boards – independent audit committees, and an independent chair. In our view, the addition of these two requirements would better position the boards of locally owned banks to fulfill the regulatory role envisaged for them.

While some banks in our sample meet only the minimum standards set out by the RBNZ, others have formed boards that far exceed them. In our view this calls into question the views expressed by critics that the RBNZ's requirements are excessive. It also suggests that the RBNZ could raise its standards for locally incorporated bank boards.

This paper is organized as follows. In section 2 we present a literature review. In section 3 we present details of how our sample of boards is constructed. Section 4 presents a discussion of our empirical findings. Section 5 concludes.

2. Discussion and Literature Review

In New Zealand, the primary bank regulator is the RBNZ. Similar to other bank regulators, it must decide upon a sensible regulatory regime that takes account of matters such as the positive externalities associated with a well functioning banking system (Levine, 1997), the substantial adjustment costs that may follow from a bank or systemic failure (Llewellyn & Mayes, 2003, p 22, Goodhart et al, 1999) and the inherent fragility that arises out of operating within an inter-linked payments system (De Vries, 2005).

Unlike many other countries, the New Zealand banking system is characterized by a high degree of foreign ownership. The four major banks (ANZ, ASB, BNZ and Westpac)¹, all

¹ See Table 1 for full names and ownership details.

of which are foreign owned, collectively accounted for 89.1% of banking system assets as at December 31, 2005. Thus, in addition to adopting a regulatory regime that addresses the risks associated with overwhelmingly foreign ownership, the RBNZ must be sensitive to the idea that the costs its regime imposes will have an effect on foreign banks' willingness to operate in New Zealand. The balancing act is an important one because foreign banks can contribute benefits to a host country.

Hull (2002), Evans & Quigley (2002), and Mortlock (2003) acknowledge that a high level of foreign-bank ownership has been good for New Zealand because foreign-owned banks have enhanced the efficiency of the New Zealand financial system and its ability to manage in a crisis. The key reason for this is that the foreign-owned banks have access to international capital markets at lower cost than New Zealand's smaller locally-owned banks (To & Tripe, 2002). Studies by Crystal, Dages & Goldberg (2002), and Dages, Goldberg & Kinney (2000) show that in the Argentinean case, foreign-owned banks provided a stabilising effect on the financial marketplace by providing more effective risk management practises and better access to foreign capital markets than domestic banks.

While there are benefits to foreign ownership in the banking sector, a foreign-parent can face a large number competing interests in its many spheres of operation, not least of which are the regulators in its home jurisdiction. The operation in each host country is vulnerable to the risk that the foreign parent or head office might respond to exigencies at home or elsewhere, and that its actions might not be optimal for the operations in the host country.

The challenge for the RBNZ has been to ensure that its regulatory approach properly addresses the risks to which the local banking system is exposed, including the risks associated with substantial foreign ownership, while continuing to provide an environment that is attractive for foreign banks to operate in. It has done so within a regulatory regime that is relatively less interventionist than the regimes of other developed economies, in particular, Canada, the United States, and Great Britain. For example, its approach includes neither deposit insurance nor regular bank audits by the supervisory agency. Rather, the RBNZ exercises a self-described "light-handed regulatory regime for banks, which relies on a combination of self, market and regulatory discipline." (RBNZ, 2004, p. 1). It applies a specific disclosure regime to support its reliance on market discipline, and this disclosure regime calls for the ready availability of two documents: the Key Information Summary and the General Disclosure Statement (c.f. Mortlock, 1996a for a detailed discussion).

In addition, the RBNZ's regulatory policy requires that banks meeting certain criteria must carry on operations in New Zealand through locally incorporated subsidiaries. One of the results of local incorporation is that the locally incorporated entity has a board of directors. The RBNZ has made these boards an integral part of its regulatory framework. It has done this by specifying a particular structure for the boards, requiring them to perform certain tasks, and having them ensure the company adopts and adheres to various operating goals, which are specified in the RBNZ's *Statement of Principles: Bank Registration and Supervision* (January 2006).

According to RBNZ policy, the boards must include two independent members and a non-executive chair. The RBNZ has also spoken in favour of an audit committee chaired by a non-executive director (Mortlock, 1996b). To facilitate later discussion, we refer to these as the “Board Prescriptions”.

In addition to its specific board composition requirements, the RBNZ also stipulates that:

“the composition of the board is such that it does not give rise to concerns about the bank's ability to pursue its own interests when these conflict with those of the shareholders.” (RBNZ, 2006, p 12)

To facilitate later discussion, we refer to this as the “Overarching Goal”.

This requirement of locally incorporated banks raises an important question: How should bank boards be constructed to increase the chances of them achieving this goal? In a paper that addresses a similar question, Murphy and McIntyre (2007) look to the organizational behaviour literature to identify team characteristics that are likely to correlate with board effectiveness. McIntyre, Mitchell & Murphy (2007) test some of the ideas in Murphy and McIntyre (2007) in a study of 151 companies listed on the Toronto Stock Exchange, and their 1,678 directors. They find that diversity with respect to tenure and age on boards is positively correlated with firm performance, large levels of diversity are correlated with diminished firm performance, and that smaller Boards are associated with higher levels of firm performance.

In a comprehensive study of board performance, Brown, Brown & Anastasopoulos (2002) find that board performance across a number of wide-ranging measures improves with the number of women on the board. They report²:

“By investigating the impact of women’s contributions in six key areas of good governance practice, we show that board processes differ when diverse perspectives are brought to the boardroom table. And these differences in process lead directly to differences in outcome.” (Brown, et al, 2002, p 1)

Finally, PriceWaterhouseCoopers’ assessment of the root causes of the National Australia Bank’s A\$360 million in trading losses in late 2003 and early 2004 is instructive for boards. In their 2004 report on the matter, they identified weakness in governance and culture as one of three critical areas of weakness leading to the losses³. In their view, organizational culture was characterized by “an arrogance in dealing with warning signs (ie APRA letters, market comments etc).” As they put it, “Ultimately, the Board and the CEO must accept responsibility for the ‘tone at the top’ and the culture that exists in certain parts of the National.” (PriceWaterhouseCoopers, 2004, p 4) Clearly, boards need

² Citing Catalyst (2002), Brown et al (2002) report that in 2001 women held 9.8 per cent of board seats in Canada’s Financial Post 500 companies, and 12.4 per cent of board seats in Fortune 500 companies.

³ The other two areas of weakness were the integrity of people and the risk and control framework.

to be properly constructed in order to send strong and appropriate organizational culture signals to management and staff.

The foregoing suggests that it may be important to consider team effectiveness concepts when deciding upon appropriate board composition. In considering the importance of applying an effective team to the matter of New Zealand bank oversight, it is worth noting that as at December 2005 the four largest New Zealand banks reported aggregate assets of NZ\$224 billion and shareholders' equity of NZ\$17 billion. It would seem worthwhile, considering the magnitude of the matter, to apply the best possible governance structure.

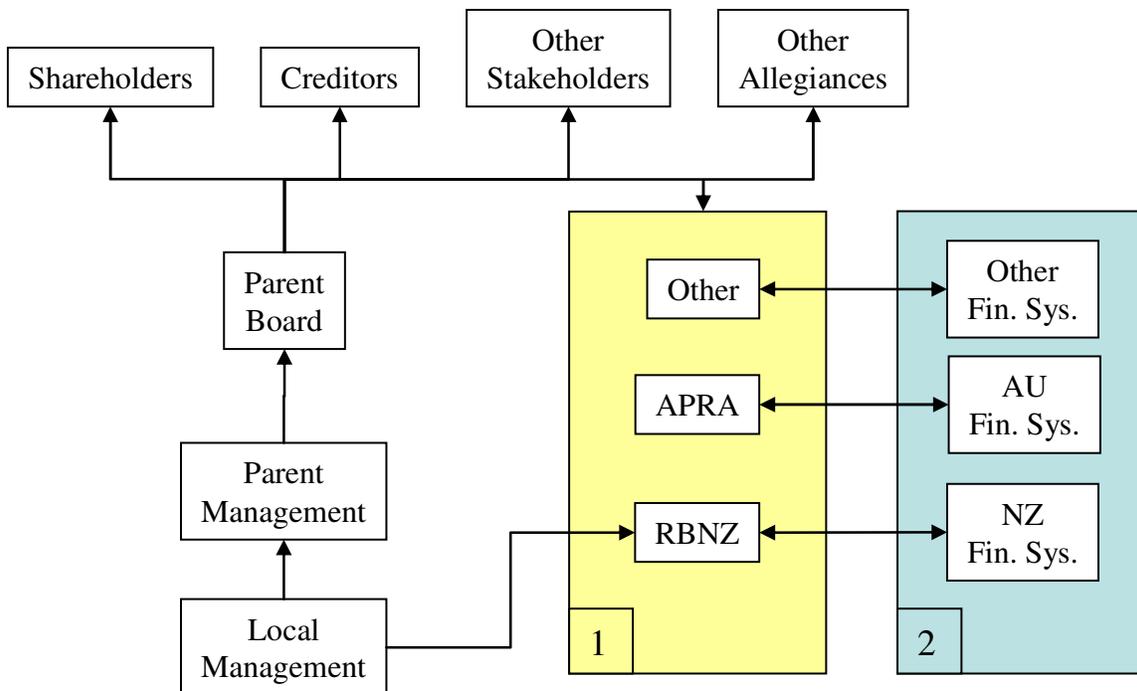
Critics of local incorporation combined with a local governance approach suggest that parent banks are capable of providing all the supervision and direction that is required, and that the increased cost of local incorporation is unwarranted. They also suggest that the assignment to boards of a role in contributing to banking system soundness amounts to a counter-productive complication. For example, Evans & Quigley (2002) argue that a local board would reduce governance effectiveness by:

- “Increasing the complexity of the principal-agent relationships associated with the governance structure of the bank;
- Requiring the appointment of outside directors who do not have a financial investment in the local entity (though they may own shares in the global entity);
- Imposing a governance structure that is inconsistent with the efficient operational structure of the New Zealand operations of Australian banks.” (Evans & Quigley, 2002, p 23)

To evaluate the increase in complexity that local governance introduces consider a representation of the significant interest groups a parent board would consider in its governance role. The Australian Prudential Regulation Authority is noted specifically because the four largest New Zealand banks are owned by Australian banks. The entry in Figures 1 and 2 in respect of “Other Allegiances” refers to the possibility that board members may have private exigencies and objective functions that are unrelated to the interests of stakeholders.

Figure 1

**Board Perspective –
Local Branch Operation**

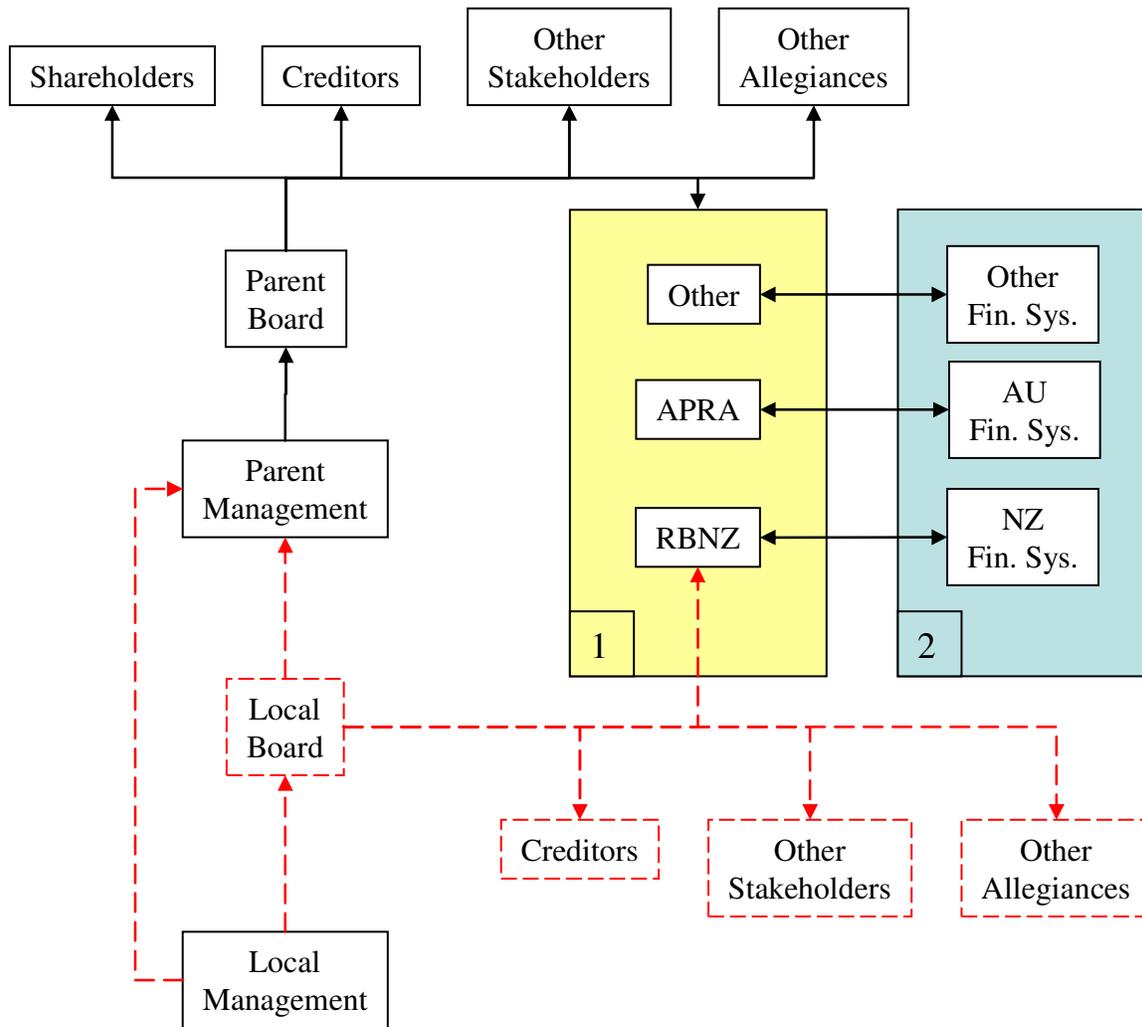


Box 1 represents the pool of regulators to which the bank must respond. The Australian and New Zealand financial systems are specified individually within it because in the New Zealand context, we are primarily considering Australian banks with operations in New Zealand as well as other locations around the world. Box 2 represents the pool of financial systems to which regulators and the banks must respond. The boxes identified using “Other” and “Other Fin. Sys.” respectively are placeholders for the regulator and the financial system in all other locations in which a bank operates. If there are, for example, a dozen such locations, there would be a dozen pairs of boxes. Note that in the absence of local incorporation and a local board local management there would be a direct relationship between local management and the RBNZ.

In contrast, the structure of relationships with local governance presented in Figure 2 includes additional considerations.

Figure 2

**Board Perspective –
Local Bank Incorporation**



The additional components and relationships arising from local incorporation and governance by a local board are clear from a comparison of Figures 1 and 2. In particular, the latter structure creates a direct relationship between the local board and the RBNZ. It also introduces the possibility of a second set of private exigencies and objective functions at the local board level as well as a potentially complicated set of relationships among the local board, local management and parent management. For example, Evans and Quigley (2002) raise the following issue:

“Governance problems may also arise from attempts by the management to treat local directors as principals who can be “played off” against the owners of the bank. Where local management disagrees with policies set down by the

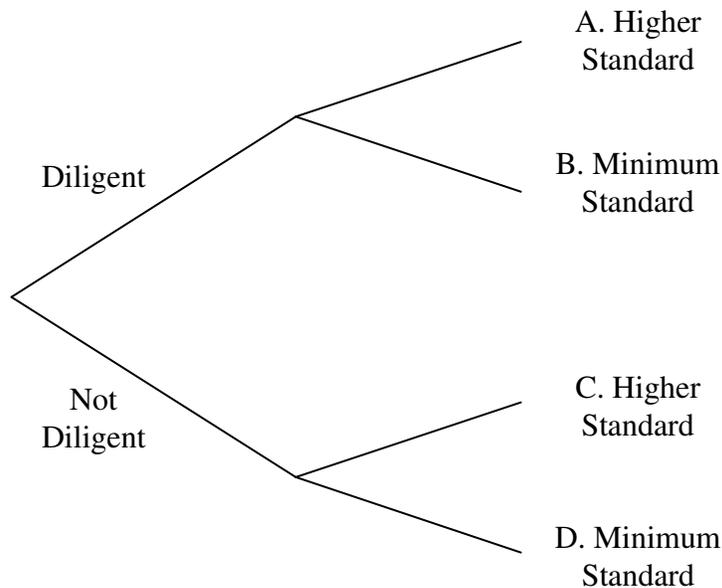
shareholder, they may attempt to enlist the support of the local directors in repudiating these policies. Where these local directors also have a quasi-official status through recognition by, or reports to the financial sector regulator, the scope for these challenges to policy from the head office of the bank may be extended. Ultimately the ability of management to enlist local directors in support of their views is likely to lead to ineffective governance structure and management capture of decision-making.”

A further issue is that the corporate structure presented in Figure 2 might not be harmonized with management reporting structures. In a single company setting, there usually little doubt that, for example, the Chief Financial Officer (“CFO”) reports to the Chief Executive Officer (“CEO”) who, in turn, reports to the board of directors. In the corporate structure presented in Figure 2 there is the possibility of a matrix management structure under which local management follows reporting relationships within the local subsidiary as well as reporting relationships within the parent. Extending the CFO example to the structure in Figure 2, a local CFO might report to the local CEO on some issues, but might also report to the parent’s CFO, or someone in his or her office, on other issues. If such reporting relationships exist, it complicates the local board’s ability to assert itself with local management.

While the set-up in Figure 2 raises the possibility of a local board comprised of a majority of directors who are independent of the parent, it is not necessarily the case that they would act independently. It would be difficult for them to act in conflict with the parent company knowing that it is the parent’s capital, reputation, and perhaps even credit rating that are at risk, as well as local management’s career prospects within the parent. Also, the locally incorporated New Zealand entities of concern in this paper are all wholly owned by their parent companies. This means that a parent company would have the ability to replace directors who disagree with it, not necessarily immediately, but certainly after the passage of time. These matters would suggest the parent companies could exert considerable moral suasion over independent local boards.

The discussion so far can be distilled into a few different viewpoints, depicted on the decision tree in Figure 3. The decisions depicted on the tree are a) whether or not to set up a local board that diligently pursues the Overarching Goal; and, b) whether or not to set up a local board that meets the RBNZ’s Board Prescriptions

Figure 3
Board Decision Tree



We assume that board construction is observable, but that diligent pursuit of the Overarching Goal is not. A parent organization may refrain from encouraging a local board to diligently pursue the Overarching Goal for a variety of reasons. It simply may elect to act out of self-interest, which may render a diligent local board sub-optimal from its point of view. Also, a parent organization may hold the view that a local board is not capable of achieving the Overarching Goal or perhaps is not the most appropriate mechanism through which to pursue the Overarching Goal. If all parent organizations thought this way we would expect to observe local boards that meet only the minimum standards of the Board Prescriptions (branch D of the decision tree).

Alternatively, parent organizations may seek to set up local boards that diligently pursue the Overarching Goal. Some of these organizations may take the view that meeting the Board Prescriptions is sufficient to empower the local boards to achieve the Overarching Goal (branch A of the decision tree). Others may take the view that more careful board construction is required if the board is to have a reasonable chance of achieving the Overarching Goal. As discussed above, there is reasonable evidence in the organizational behaviour literature on team effectiveness to suggest this is the case. If some organizations think this way, we would expect to see local boards that exceed, or even far exceed the Board Prescriptions (branch B of the decision tree).

Finally, some parent organizations may view local boards as an important contributor to the overall effectiveness of the local organization, and may also adopt a team

effectiveness approach to board formation. We would also expect these parent organizations to form local boards that exceed, or even far exceed the Board Prescriptions (branch B of the decision tree).

In summary then, the regulatory regime in New Zealand offers the opportunity of forming a board that meets only a few simple requirements – two independent directors, a non-executive chair, and an audit committee chaired by a non-executive director. But the questions that arise concerning a minimalist board are as follows:

- a) can such a board deliver on the supervision the RBNZ expects of it;
- b) does a more comprehensively constructed board offer informational and analysis advantages that a simpler board cannot;
- c) do the benefits of a comprehensively constructed board outweigh the costs; and,
- d) do the organizational complications of a local board counteract any benefit a comprehensively constructed board might offer?

In the remainder of this paper we present some of the more significant details of the boards that locally incorporated banks have selected.

3. Board Construction

We gathered data concerning the boards of eight New Zealand banks using the September and December 2005 General Disclosure Statements of each.

Table 1

Sample of Banks

New Zealand Incorporated Entity		Ultimate Parent
Short Form	Formal Name	
ANZ	ANZ National Bank Limited	Australia and New Zealand Banking Group Limited
ASB	ASB Bank Limited	Commonwealth Bank of Australia
BNZ	Bank of New Zealand	National Australia Bank Limited
Westpac	n/a	Westpac Banking Corporation
TSB	TSB Bank Limited	TSB Community Trust
Kiwibank	Kiwibank Limited	New Zealand Post Limited
Superbank	St. George Bank New Zealand Limited	St. George Bank Limited
Rabobank	Rabobank New Zealand Limited	Rabobank Nederland

Our selection includes the four largest banks in New Zealand, which are all Australian owned. Three of these four operate as locally incorporated subsidiaries. The fourth,

Westpac, currently operates as a branch of its Australian incorporated parent, but is in the process of converting to a locally incorporated subsidiary. Superbank is a smaller New Zealand bank that operates as a locally incorporated subsidiary of its Australian parent. It is included because of its local incorporation⁴. TSB and Kiwibank are New Zealand owned banks, with the former being a wholly owned subsidiary of TSB Community Trust, a trust formed principally for the benefit of the people of the Taranaki community (TSB, 2005), and the latter being a wholly owned subsidiary New Zealand Post. Rabobank is a New Zealand incorporated subsidiary which is fully guaranteed by its parent, Rabobank Nederland. We present various details of the boards of these banks in Table 2.

Table 2

Board Details

Panel A:				
	Executive			
	Director	Related Party	Independent	Total
ANZ	1	4	3	8
ASB	1	3	6	10
BNZ	1	3	6	10
Westpac	1	0	7	8
TSB	1	2	5	8
Kiwibank	0	4	3	7
Superbank	0	3	2	5
Rabobank	3	0	0	3

Panel B:				
	Residency		Gender	
	Other	NZ	Male	Female
ANZ	3	5	8	0
ASB	4	6	9	1
BNZ	2	8	7	3
Westpac	7	1	6	2
TSB	0	8	5	3
Kiwibank	0	7	6	1
Superbank	3	2	4	1
Rabobank	2	1	3	0

⁴ This bank accumulated losses during its early years of operation and in August 2006 it announced the sale of its loan book to GE, and advised that it would seek to transfer its deposits to other banks. Some might argue that its board was not sufficiently independent of its parent, and that that made it hard to respond appropriately to New Zealand market conditions in building a viable business.

Because audit committees are particularly important in the New Zealand bank context, and are specifically addressed in Mortlock (1996b), we report some details of the audit committee for each bank.

Table 3

Audit Committee Details

	Independent	Related Party	Total
ANZ	3	2	5
ASB	5	1	6
BNZ	3	0	3
Westpac	6	0	6
TSB	2	1	3
Kiwibank	2	1	3
Superbank	2	0	2
Rabobank	n/a	n/a	n/a

In general, audit committees and their construction are important because they help to ensure that management provides timely, accurate, and unbiased financial information to shareholders and other stakeholders, and that management is providing an environment that allows the auditor to do the work necessary to support the audit opinion. Audit committees of banks in New Zealand are especially important for the following reasons:

- a) the RBNZ’s regulatory regime for banks explicitly depends on market discipline exerted by retail and other depositors;
- b) the RBNZ has specified a disclosure regime that is intended to provide the transparency market participants, including retail depositors, require if they are to properly exert market discipline; and,
- c) the audit committee is an important part in the process that ensures banks adhere to the disclosure regime, and provide meaningful financial information to market participants.

As can be seen from Table 4, board costs vary considerably by bank, as does the inclination to report director’s fees. Also, with the lowest reported cost being NZ\$79,000, one could argue that none of the reported costs could be regarded as trivial. Directors’ fees for Rabobank do not appear to be reported in its General Disclosure Statement. We point out that all of the directors of Rabobank are also employees of Rabobank so it may be the case that there is no specific remuneration for director’s duties additional to their compensation packages as employees.

Table 4
Directors' Fees⁵

	Fiscal Year Ended 2005 NZ\$000's
ANZ	375
ASB	300
BNZ	519
Westpac	1,830
TSB	171
Kiwibank	185
Superbank	79
Rabobank	Not Reported

In the next section we analyze the data presented above and discuss each board individually.

4. Discussion and Analysis

Table 5 presents an evaluation of the data presented in Tables 1 and 2 across the dimensions listed on the leftmost column of Table 5. On the upper three lines of the table, above the bold line, the dimensions are the three basic requirements of the RBNZ for board construction and the audit committee. Note that, except for Rabobank, all the cells in the table contain bullet points, which means that, except for Rabobank, all the banks in our sample meet the RBNZ's minimum requirements. As Rabobank is fully guaranteed by its parent bank, which is itself a AAA rated institution, its Conditions of Registration for operating as a bank in New Zealand exempt it from the requirement for its board to include two independent directors, and for the chair of its board to be a non-executive director.

The cells below the line (items 4 through 13) in Table 5 address dimensions that are in excess of the RBNZ's minimum requirements. As there are numerous bullet points in the cells, it is clear that in many cases the banks have constructed boards with features that exceed the RBNZ's minimum requirements. This in itself is noteworthy as it has been argued that a local governance system is both costly, incentive incompatible and inefficient (c.f. Evans & Quigley, 2002). We also note that there is considerable variation in the extent to which banks have elected to exceed the RBNZ's requirements.

⁵ The value reported for Westpac is A\$1,525,000 converted at NZ\$1.20 per A\$ representing an approximate exchange rate, and is in respect of outside directors only.

Table 5

Analysis of Board Details

	ANZ	ASB	BNZ	WP	TSB	KWB	SB	RAB
1. Minimum two independent directors								x
2. Non-executive chair								x
3. Non-executive chair of the audit committee								x
4. Independent chair	x		x			x	x	x
5. Majority of independent directors on audit committee								x
6. Audit committee overwhelmingly comprised of independent directors					x	x		x
7. Audit committee comprised entirely of independent directors	x	x			x	x		x
8. Audit Committee comprised of three or more members							x	x
9. Majority of independent directors on the board	x					x	x	x
10. Exclusively independent directors on the board excluding the Executive Director	x	x	x		x	x	x	x
11. Majority resident in NZ				x		x	x	x
12. Exclusively resident in NZ	x	x	x	x			x	x
13. Female director(s)	x							x

In identifying directors as independent or otherwise, we have followed the declarations in this regard that appear in the General Disclosure Statements of the banks included in this study, and have therefore followed the RBNZ’s definition of independence. We have not investigated to determine the accuracy of these declarations nor have we investigated whether any of the directors are subject to matters that might undermine their ability or inclination to act independently. Having said this, we have no reason to doubt the declarations in the General Disclosure Statements and no reason to believe that the independence of any director is compromised.

4.1 Board and Audit Committee Issues

In much of the literature on board and audit committee construction independence is a key issue. Generally, authors and regulators are concerned about the independence of directors, the chair and members of the audit committee from management and from a controlling shareholder, whether by way of a majority or minority position. The focus on independence arises out of concern that the interests of the shareholders obtain proper

representation. A board with a significant allegiance to management or a controlling shareholder presents opportunities for self-interested behavior, to the detriment of non-controlling shareholders, that are similar to the well know agency problems of absentee ownership.

In the context of the New Zealand banking system, the concept of independence is important, but different from the typical corporate setting. In the New Zealand banking system, the idea is for the board to monitor and control decision making in the context of the potentially divergent agendas of management, shareholders of the banks operating in New Zealand, and other stakeholders in the New Zealand financial system. For example, let us consider again the following quote:

“the composition of the board is such that it does not give rise to concerns about the bank's ability to pursue its own interests when these conflict with those of the shareholders.” (RBNZ, 2006, p 12)

In this context, we interpret the idea of ‘pursuing its own interests’ to mean things like the locally incorporated bank limiting exposures to related parties, avoiding acting in the interests of the holding company to its own detriment, and protecting the interests of its creditors. Independence in the context of the board and audit committee of a New Zealand bank therefore means independence from self-interested behavior on the part of both controlling shareholders and management. Boards and audit committees of New Zealand banks must therefore adopt a “stakeholder group” perspective to governance. In addition to shareholders and management, the stakeholder group would include financial system participants such as depositors, debt holders, customers, the RBNZ, and the more general body of beneficiaries of a well functioning New Zealand banking system. We therefore alternatively define independence as being independent enough to respond in a balanced way to the interests of this stakeholder group.

Let us now consider points 4 through 13 in Table 5. While we support the RBNZ’s requirement for a non-executive chair we believe the role that the RBNZ regulatory regime has carved out for boards suggests that an independent chair is called for. Our support for a non-executive chair is grounded in the argument presented in Jensen (1993):

“The function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO. Clearly, the CEO cannot perform this function apart from his or her personal interest” (Jensen, 1993, Pg 45).

While a non-executive chair is an RBNZ requirement, it is our view that one must go further. The RBNZ is calling upon boards to ensure value is retained in local banks in the lead up to a failure, to limit exposures to related parties, and to ensure the bank is in a position to pursue its own interests when those conflict with those of shareholders. Our hypothesis in this circumstance is that the power and influence of the chair is such that a board with an independent non-executive chair will perform better in this role in New Zealand than one with a related party as chair. In coming to this position, we are

influenced by the view expressed in Cadbury (1992), to the effect that, “The chairman’s role in securing good corporate governance is crucial.” This leads to our specification of item 4) on Table 5.

The audit committee is widely regarded as an important corporate institution for contributing to transparent financial reporting. Although a non-executive chair of the audit committee, as required by the RBNZ, is a step in the right direction, it is our view that an audit committee entirely comprised of independent directors is more appropriate. This is the standard that the Securities and Exchange Commission (“SEC”) in the United States imposes, although their definition of independence is different from ours. They are seeking independence from management. For the reasons noted above, we are looking for independence from management and the controlling shareholder. Note that the SEC also seeks to limit the influence of a controlling shareholder by preventing voting membership on the audit committee of a party linked to a controlling shareholder, although their motivation is the protection of non-controlling shareholders whereas our motivation is the protection of a larger set of stakeholders. We seek independence from controlling shareholders for the protection of our broadly defined stakeholder groups. Our view, therefore, is the following: the more independent the audit committee the better. Also, following CICA (2001) it is our view that audit committees should be comprised of a minimum of three members. This leads to our specification of items 5), 6), and 7) on Table 5.

Similar to our views concerning the audit committee, our interpretation of the role of New Zealand bank boards, and our broad definition of the stakeholder group they represent leads us to prefer a board that is independent of management and controlling shareholders and hence, leads to items 8), and 9) on Table 5.

The Reserve Bank of New Zealand Act is a quasi-criminal statute, and directors of banks in New Zealand are subject to it, which makes the issue of bank director residency more important than it might be otherwise. As Mortlock (1996b) puts it:

“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.”

Director residency outside of New Zealand throws up a potentially substantial barrier to the enforcement of this statute, and correspondingly a potentially reduced incentive to follow it. As a consequence, we consider boards with directors who are primarily or

exclusively resident in New Zealand to be more accountable than boards who do not meet these conditions. This leads to items 10) and 11) on Table 5.

There is support in the literature for boards with a moderate degree of diversity, and more particularly for boards with gender diversity, as indicated in Section 2 of this paper. Accordingly, we take the position that boards that include both women and men, and boards that present approximate gender equality are more appropriate than boards that do not meet these criteria. By ‘approximate gender equality’ we mean equality for boards with an even number of members and within plus or minus one of equal representation for boards with an odd number of members. As all boards in our study fall short of approximate gender equality we do not discuss it further in our comments on each board.

4.2 Individual Boards

Let us now consider the individual boards and audit committees in our sample.

4.2.1 Westpac Banking Corporation

It is important to note that in the Westpac case, the board and audit committee are those of the parent company, and not of Westpac’s New Zealand operations. The Westpac board is typical of large, international publicly listed companies. It meets all of our criteria except for equal gender representation on the board - there are two women on the board. Although this falls short of equal representation, it substantially exceeds the 2001 average for Fortune 500 companies.

Although the Westpac board meets many of our criteria for effective board construction, it remains that this board is ill equipped to handle a conflict between decisions that are in the best interests of its New Zealand operations and decisions that are in the best interests of Westpac in its entirety, which is specifically the problem the RBNZ would like a local board to address.

4.2.2 Bank of New Zealand (“BNZ”)

Three of BNZ’s board members are executives of the parent or itself, which, in our view, limits the independence of the board, but there remains a majority of independent directors. Eight of its ten members are resident in New Zealand and so are more exposed to the quasi-criminal aspects of New Zealand banking legislation than non-residents. The chair of the local board is also a member of the board of the ultimate parent, which, in our view, detracts from the likelihood of independent behaviour on the part of the local board.

4.2.3 ASB Bank Limited (“ASB”)

ASB’s audit committee is comprised of six individuals, one of whom is an executive of the parent. In keeping with our earlier discussion of the potential conflict of interest between the parent bank and the stakeholders of the New

Zealand banking system, and bearing in mind the importance of financial reporting transparency in an environment that depends so heavily on market discipline, we find this membership structure to be less desirable than an audit committee completely comprised of independent directors. This chair of this board is independent, which is a factor in its favour.

4.2.4 TSB Bank (“TSB”)

This is one of only two banks in our sample that is New Zealand owned. Its audit committee is comprised of three individuals, one of whom is linked to its ultimate parent. In keeping with the SEC and CICA viewpoints on audit committees, it is our view that the best audit committee is one that is independent in its entirety. Also, although the majority of the board is comprised of outside directors, it is not exclusively independent with three of eight board members lacking independence (one an executive of TSB and two linked to the parent). In its favour, this is one of only two boards in our study whose directors all reside in New Zealand.

4.2.5 ANZ National Bank Limited (“ANZ”)

ANZ is the major foreign-owned bank with the weakest board in our study. We take this view because its chair is also a board member of the parent, and therefore lacks independence⁶. Also, its audit committee is not entirely independent, and it lacks a majority of independent directors – four are independent, four are not. Finally, this is an all-male board.

4.2.6 Superbank

Although Superbank’s audit committee is comprised entirely of independent board members there are only two individuals on the committee. We subscribe to the view in CICA (2001) to the effect that audit committees should be comprised of three individuals. Aside from the additional breadth of experience and judgement this provides, we do not know how one could easily overcome a split in points of view on a committee comprised of two individuals. Of particular concern in the Superbank case is the fact that a majority of the board is made up of individuals linked to its ultimate parent, one being a director of the parent, and the other two being executives of the parent. As such, it has little apparent ability to respond should a conflict arise between decisions in the interest of the parent versus decisions in the interest of Superbank. In addition, only a minority of directors reside in New Zealand.

4.2.7 Kiwibank Limited

⁶ As at December 31, 2005, the cut-off date for determining board characteristics for the purpose of this paper, the chair of ANZ was Dr. Roderick Deane who was also a member of the board of ANZ’s ultimate parent. Dr. Deane retired as chair of ANZ on June 16, 2006 at which time Sir Dryden Spring was appointed chair. At the time of his appointment Sir Dryden Spring was not a member of the board of ANZ’s ultimate parent.

Only two of Kiwibank's three audit committee members are independent, and four of its seven board members are linked to the parent. We acknowledge that its liabilities are guaranteed by the parent, which is itself owned but not guaranteed by the New Zealand government, however, in our view, the existence of a guarantee does not justify compromising this bank's ability to act in its own interests or in the interests of the New Zealand banking system should these be in conflict with the interests of the parent, a key goal of the RBNZ's regulatory regime. Although the parent is a guarantor, the parent's asset base is only \$2.5 billion, an amount that could easily be overshadowed should Kiwibank grow to a similar size to the "big four" banks in New Zealand. In addition, the historical record of state-owned banks is dubious at best due to the tendency of governments to lack bank management talent and a predilection for using banks as tools of social policy (for a discussion see Guillen & Tschoegl, 2000). Arguably there is a greater need for state-owned banks to insulate themselves from government than there is for locally incorporated subsidiaries to insulate themselves from their foreign parents. In short, Kiwibank had an opportunity to set a good governance example, but instead has fallen victim to the usual temptations.

Another factor that would suggest Kiwibank requires a stronger board rather than a weaker one is the fact that it operates almost exclusively out of existing postal outlets. This means that the cost of retail outlets to Kiwibank and to New Zealand Post, respectively, is determined entirely by transfer pricing. An important task for an independent Kiwibank board would be to ensure that the allocation is done fairly and consistently over time, and is not used as a tool to allocate profit between the two entities. In addition, the fact that the banking operation and the postal operation take place essentially within a single notional and physical operation presents the risk of co-mingling of funds, or the use of funds or revenues of one operation by the other. For example, it is presently the case that Agency Services Fee Revenue is recorded in Kiwibank's accounts (see Note 3, June 2005 Kiwibank Annual Report) whereas these revenues were recorded in New Zealand Post's accounts prior to the formation of the bank. New Zealand Post indicates in Note 13 to its 2003 financial statements, "Agency services fee revenue and expenditure are accounted for under a management agreement whereby Kiwibank manages the agency activity of the Parent." While it is not necessarily improper to allocate activities and concomitant revenues between entities with common ultimate ownership, it underscores the fluidity of the situation. We submit that the stronger the board of the bank, the better its ability to protect the bank's interests in such situations.

5. Conclusions

The eight banks in our study have all taken a different approach to their governance mechanisms. Some have set an example, which suggests that for some, the benefits of good governance offset the alleged costs and incentive compatibility problems that some complain about. Interestingly, one of the worst governance examples is a state-owned

institution, and the two locally owned institutions in our sample have landed at the low end of the spectrum, which presents an unfortunate “do as I say, not as I do” image to the rest of the world.

The literature on the construction of effective boards seems to clearly support chairs that are independent of management. The literature comes to this conclusion because of the control a chair usually has over the agenda setting process within the firm. We submit that in the context of the boards of locally incorporated banks, and considering the regulatory role the RBNZ has assigned to boards, a sensible extension of this principal is that the chair ought to be independent of the parent and of the locally incorporated bank.

Finally, the literature favours audit committees that are independent of management. In the context of the boards of locally incorporated banks, and considering the regulatory role the RBNZ has assigned to boards, we submit that the audit committees ought to be independent of the locally incorporated bank and its parent.

References

Brown, D. A. H., Brown, D. L., and Anastasopoulos, V. (2002), *Women on boards: Not just the right thing...but the "bright" thing*, Conference Board of Canada, Ottawa, ON.

Cadbury, A., Chair (1992). *Report of the Committee on The Financial Aspects of Corporate Governance*. Downloaded from <http://rru.worldbank.org/Documents/PapersLinks/1253.pdf>, June 13, 2006.

Canadian Institute of Chartered Accountants ("CICA") (2001). *Beyond Compliance: Building a Governance Culture, Final Report, Joint Committee on Corporate Governance*.

Catalyst Census of Women Board Directors of Canada (2002). New York: Catalyst.

Crystal, J. S., Dages, G. B., & Goldberg, L. S. (2002). Has Foreign Bank Entry led to Sounder Banks in Latin America ? *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, 8, 1-6.

Dages, B. G., Goldberg, L. S., & Kinney, D. (2000). Foreign and Domestic Bank Participation in Emerging Markets: Lessons from Mexico and Argentina. *Federal Reserve Bank of New York Economic Policy Review*. 6 (3). 17-36.

De Vries, C. G. (2005). The simple economics of bank fragility. *Journal of Banking & Finance* 29, p 803 – 825.

Evans, L., & Quigley, N. (2002). *An Analysis of the Reserve Bank of New Zealand's Policy on the Incorporation of Foreign Banks*. New Zealand Institute for the Study of Competition and Regulation.

Goodhart, C., Hartmann, P., Llewellyn, D., Rojas-Suarez, L. & Weisbrod, S. (1999). *Financial Regulation: Why, How and Where Now?* London: Routledge.

Guillen, M. F. & Tschoegl, A. E. (2000). The internationalization of retail banking: the case of the Spanish banks in Latin America. *Transnational Corporations*, Vol. 09, No. 3, p. 63- 98.

Hull, L. (2002, April). Foreign-owned banks: implications for New Zealand's financial stability. *Discussion Paper Series: Reserve Bank of New Zealand*. Retrieved 25th April 2004, from the World Wide Web: www.rbnz.govt.nz/research/discusspapers

Jensen, M. C. (1993), "The modern industrial revolution, exit, and the failure of internal control systems", *Journal of Finance*, Vol. 48, pp. 831-880.

- Levine, R. (1997). Financial development & economic growth: Views and agenda. *Journal of Economic Literature*, 35(2), p. 688-726.
- Llewellyn, D. T. & Mayes, D. G. (2003). The role of market discipline in handling problem banks. *Bank of Finland Discussion Papers*. Retrieved April 13, 2004 from http://www.bof.fi/eng/7_tutkimus/index.stm.
- McIntyre, M. L., Murphy, S. A. & Mitchell, P. (2007, Forthcoming). The top team: Examining board composition and firm performance. *Corporate Governance: The International Journal of Business and Society*.
- Mortlock, G. (1996a). New disclosure regime for registered banks. *Reserve Bank of New Zealand Bulletin*, 59(1), 21-29.
- Mortlock, G. (1996b). Banking supervision: placing a new emphasis on the role of bank directors. *Reserve Bank Bulletin*, Vol 5 (4), 323 - 329. Downloaded from http://www.rbnz.govt.nz/research/bulletin/1992_1996/1996dec59_4mortlock.pdf, June 10, 2006.
- Mortlock, G. (2003). New Zealand's financial sector regulation. *Reserve Bank of New Zealand Bulletin*, 66 (4). Retrieved 30th May 2005, from the World Wide Web: http://www.rbnz.govt.nz/research/bulletin/2002_2006/2003dec66_4mortlock.pdf
- Murphy, S. A. & McIntyre, M. L., (2007, Forthcoming) Board of Director Performance: A Group Dynamics Perspective, *Corporate Governance: The International Journal of Business and Society*.
- PriceWaterhouse Coopers, (2004). *Investigation into foreign exchange losses at the National Australia Bank*. Downloaded from: <http://www.nabgroup.com/vgnmedia/downld/pwcreport.pdf>
- Reserve Bank of New Zealand (2004). *Central Banking in New Zealand. Statement of Principles: Bank Registration and Supervision*.
- Reserve Bank of New Zealand (2006, January). *Statement of Principles: Bank Registration and Supervision*, Ref #2320402. Downloaded from <http://www.rbnz.govt.nz/finstab/banking/regulation/bs1.pdf> on June 10, 2006.
- TSB Community Trust ("TSB") (2005). Chairperson's Report Year Ending 31 March 2005. Downloaded from <http://www.tsbtrust.org.nz/downloads/TSB-2005-chair-report.pdf> June 11, 2006.
- To, H. M., & Tripe, D. W. (2002). Factors influencing the performance of foreign-owned banks in New Zealand. *Journal of International Financial Markets, Institutions and Money* 12, p. 341-357.