

Treasury-MED Report: Financial System Development: Key Themes from Investment Forum and Update on Other Ideas

Date:	18 December 2007	Treasury Priority:	Medium
Security Classification:		Report No:	T2007/2397

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	Read this report and indicate your response to the recommendations	25 January 2008
Associate Minister of Finance (Hon Phil Goff)	Note the contents of this report	None
Minister for Economic Development (Hon Pete Hodgson)	Read this report and indicate your response to the recommendations	25 January 2008
Associate Minister of Finance (Hon Trevor Mallard)	Note the contents of this report	None
Minister of Commerce (Hon Lianne Dalziel)	Note the contents of this report	None
Associate Minister of Finance (Hon Clayton Cosgrove)	Note the contents of this report	None

Contact for Telephone Discussion (if required)

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Enclosure: No

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Executive Summary

The purpose of this report is to inform you of the themes which emerged from discussions at the Investment Forum on 27 November, our initial thoughts on how to take this work forward, and progress on two other ideas since we last reported to you on 9 November 2007 (T2007/2078 refers). These two ideas are: the potential for establishing financial system development as a secondary objective for the New Zealand Debt Management Office (NZDMO) and the Reserve Bank of New Zealand (RBNZ); and a programme to promote independent equity research on small, listed firms.

The Forum

The forum built on work already undertaken by officials – including research and extensive stakeholder analysis, the results of which are summarised in the report on “Improving the Investment Environment for New Zealand’s Firms” and earlier Treasury-MED joint papers (e.g. T2007/2078 and T2007/486). The forum itself was well attended by senior business and capital-market participants, along with some academics and senior staff from relevant public sector bodies. Participants were positive about government having taken the initiative to undertake work in this area and agreed with the analysis in the report. There is widespread acknowledgement that financial markets are a key part of our economy. In addition, they agree that they are part of a complicated system in which the health of one part impacts on the health and sustainability of other parts. A key recurring theme throughout the day was a willingness to engage with the government at both strategic and operational levels to advance “NZ Inc” interests. The concept of a “flying wedge”, where Ministers, officials and business work together to achieve key outcomes (cited as typical of the Australian approach), was mentioned several times as an appropriate way forward.

Many participants also expressed the view that New Zealand’s capital markets had improved over recent years, and noted the potential of the KiwiSaver and PIE changes to further boost market development. However, there was still a sense of vulnerability. To improve the depth of capital markets, a wide range of specific policy suggestions were advanced by individual participants. These included specific regulatory suggestions, tax issues or institutional changes. In addition, several participants stressed the importance of agreeing on a “vision” of what we are aiming for, as a way of judging where and how to make changes.

A Way Forward

In order to maintain the enthusiasm expressed by forum participants to continue to work with government on these issues, it will be important to demonstrate some progress and to continue to engage with them on these issues. We propose forming a steering group of senior people from the private and public sectors, and academia, to take this work forward. This group would identify projects that could be worked on jointly by the public and private sectors and find resources to undertake the work. The group would have a finite life (e.g. three to five years). A first step would be to test the willingness of the private sector to form and participate in this group and we would need to find business champions to take this work forward.

Issues to Progress

We envisage that the steering group discussed above would work together to develop a strategic agenda for capital market development. This would then determine the issues to be worked on over the medium term. Nevertheless, there are areas of work which can be advanced ahead of setting up a steering group. Many of these issues are already in train in this or related workstreams. One of the ideas in this workstream is setting financial market development as a secondary objective of the RBNZ and the NZDMO. This can be progressed without private sector involvement. Another is promoting equity research on small, listed firms. We have made useful progress on this idea and more is possible but it would be desirable to get private-sector buy-in and partnership sooner rather than later. Both ideas are consistent with the themes that emerged from the Forum.

Financial market development as a secondary objective

Officials have held discussions with the RBNZ and the NZDMO on the possibility of assigning these institutions a secondary objective to promote financial market development. Both the RBNZ and NZDMO agree that this would provide useful clarification of a role that they currently regard as implicit, and that it would not and should not detract from their respective primary objectives. Further work is required by officials with the RBNZ and NZDMO to develop proposals on an agreed and recommended way to implement financial market development as a secondary objective.

Independent equity research

A feature of New Zealand's capital markets is the relatively small scale of our listed equity market. A consequence of that, and a potential contributing factor to it, is a lack of local analysis of New Zealand's firms - beyond the top few companies listed on the NZX. Analysis by officials shows that very little research is available for around 38% of listed New Zealand companies and the research that is available on the smaller companies is of variable quality and not readily accessible to all potential investors. There are a number of reasons for this including the small scale of the equity market, the high fixed cost of producing research and the wide selection of listings needing to be covered by a limited number of research providers and analysts.

There could be a role for government in promoting independent equity research, due to the public benefits associated with the availability of good quality research contributing to the growth of the equity market. However, there are also private benefits for companies and key stakeholders in equity markets. There appears to be a case for further investigating options around the design of an equity research programme for New Zealand. Based on overseas practice this could include private provision and a partial subsidy.

Recommended Action

We recommend that you:

- a. **note** that the forum outcomes supported analysis contained in previous Treasury-MED reports and papers (and was itself based on research and consultation);
- b. **note** that cooperation between the public and private sectors with input from academia is likely to be a good approach to achieving durable progress in developing New Zealand's capital markets;
- c. **note** that officials consider the best means of progressing capital-market development in the long-term is to form a joint private-public sector steering group for a limited period (e.g. 3 to 5 years) to develop a forward work agenda and agree and resource joint projects in this area;

- d. **agree** that officials begin discussions with private sector participants in the Investment Forum to test their willingness to form and participate in such a group;

Agree/disagree. *Agree/disagree*

- e. **agree** that officials will report to joint Ministers by April 2008 with concrete proposals for the formation of a joint public-private sector steering group, including governance and accountability arrangements and potential members;

Agree/disagree. *Agree/disagree*

- f. **note** that officials will also report at that time on any resource implications of forming and supporting the group;

- g. **agree** that in the interim, officials should investigate or continue to progress:

Making it easier for New Zealand based companies to operate in New Zealand

- i. amending the definition of a foreign company in Section 7 of the Overseas Investment Act 2005 so that companies that are headquartered in New Zealand are not considered foreign companies;

Agree/disagree *Agree/disagree*

Deepening our capital market and providing for new markets

- ii. mechanisms to partially subsidise equity research on listed New Zealand companies that are not currently researched;

Agree/disagree *Agree/disagree*

- iii. investigating the rapid development of carbon trading in New Zealand;

Agree/disagree *Agree/disagree*

- iv. sponsoring research to provide evidence to Australian asset advisors and fund managers of the merits of amending their trust deeds to allow Australian funds to directly invest in New Zealand equities;

Agree/disagree *Agree/disagree*

Financial market infrastructure development

- v. New Zealand's settlement and clearing infrastructure and the possibility of a joint New Zealand-Australian settlement clearing system.

Agree/disagree *Agree/disagree*

- vi. the effect of the Approved Issuer Levy on New Zealand's corporate bond market and other tax issues raised at the forum.

Agree/disagree.

Agree/disagree.

- h. **note** that officials have held discussions with the Reserve Bank of New Zealand and the Debt Management Office and that these agencies agree that having a secondary objective to promote financial market development would provide useful clarification of a role that they currently regard as implicit, and that it would not and should not detract from their respective primary objectives.
- i. **agree** that officials continue to work with the RBNZ and NZDMO to bring back recommendations to you by the end of March 2008 about whether and, if so, how best to implement financial market development as a secondary objective of these institutions;

Agree/disagree.

Agree/disagree.

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Bryan Chapple
Chief Advisor,
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Ministry of Economic Development

Hon Dr Michael Cullen
Minister of Finance

Hon Pete Hodgson
Minister for Economic Development

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Purpose of Report

1. The purpose of the report is to discuss the result of the stakeholder forum on 27 November on improving New Zealand's investment environment and to update you with progress on the policy ideas already in train on financial market development (refer T2007/2078). The report also proposes a way forward that builds on the significant private-public sector engagement at the forum.

Analysis

Context

2. The economic performance of New Zealand firms and their location choices are influenced by a wide range of factors. The role of the financial system is one, but only one, of these factors (refer T2007/486). There is robust evidence that the level of development of a country's financial system has a positive influence on economic growth and productivity. The relationship is bi-directional with economic growth also contributing to financial system development. Financial markets and institutions are one part of an interdependent system; the level of domestic savings, the aspirations and capability of firms, and the operation of monetary and tax policies all work together with this part. Policy work falling within this wider ambit includes: economic transformation, macroeconomic policy, saving policies, productivity analysis, exporting, "hollowing out", and taxation reform.
3. A question arises as to whether there would be a net benefit for government to fill any gaps in the financial system or hasten measures that are already in progress. Any further action by government needs to be based on a good understanding of the factors responsible for under-development of the financial system, and the benefits and cost of specific interventions.

Problems/Potential Gaps in Financial Systems Development

4. Our preliminary assessment is that lack of development in certain parts of New Zealand's financial system is probably imposing a moderate constraint on the growth and performance of New Zealand firms (refer T2007/486). The level of development of New Zealand's financial system is patchy: a large, efficient and sound banking system sits alongside equity, venture capital and debt markets that in size, depth, liquidity and skill base are relatively under-developed.
5. Our analysis has shown that New Zealand's regulatory settings compare favourably with those in other OECD countries. Further research and policy measures should therefore focus on other factors that could be contributing to under-development of our financial system (refer T2007/486). Some possible factors include: New Zealand's low saving performance; high degree of foreign ownership; the lack of very large firms; and high incidence of co-operative and state-owned enterprise governance structures among the large firms that New Zealand does have. The small size of the economy causes the cost of due diligence and investment analysis to be relatively high. In addition, the cost of capital is high relative to other OECD countries. While there is little

direct evidence of capital constraints, the demand for capital could be limited due to a lack of firms' growth ambition and/or profitable opportunities.

Investment Forum

6. As well as investigating issues that Ministers agreed should be subject to further work, officials have conducted extensive consultation with financial market stakeholders and organised an "investment forum". The purpose of the forum was to bring together interested parties to debate the issues around capital markets and their role in supporting New Zealand firms. It was held in Wellington on 27 November. Hons Hodgson, Mallard and Dalziel attended parts of the forum. The forum was well attended by senior business and capital market participants, along with some academics and senior staff from relevant public sector bodies. Discussion at the forum built on the report prepared by officials on "Improving the Investment Environment for New Zealand's firms". There was wide-ranging agreement from participants that it was important for Government to be considering issues around the development of New Zealand's financial markets and their role in supporting New Zealand firms. The analysis in the report and the issues raised in it were also endorsed.
7. A key recurring theme throughout the day was a willingness to engage with the government at both strategic and operational levels to advance "NZ Inc" interests. The concept of a "flying wedge", where Ministers, officials and business work together to achieve key outcomes (cited as typical of the Australian approach), was mentioned several times as an appropriate way forward. The conditions around New Zealand ownership and location for Fonterra's capital restructuring were mentioned as examples of the sorts of practices New Zealand should adopt more often.
8. Many participants also expressed the view that New Zealand's capital markets had improved over recent years, and noted the potential of the KiwiSaver and PIE changes to further boost market development. However, there was still a sense of vulnerability. To improve the depth of capital markets, a wide range of specific policy suggestions were advanced by individual participants. These included specific regulatory suggestions, tax issues or institutional changes. In addition, several participants stressed the importance of agreeing on a "vision" of what we are aiming for, as a way of judging where and how to make changes.

A Way Forward

9. Participants expressed a clear desire to work with Government going forward to stimulate the development of New Zealand's capital markets and improve the investment environment for New Zealand firms. There is now an opportunity to capture this momentum and look for transformative change in New Zealand's investment environment. As many of the issues involve private sector practices and processes, as well as government policy settings, any substantive progress will only be possible if private and public sectors work together. In order to do this, we propose forming a steering group of senior public and private sector staff, and academia, to develop agreement on the direction ahead and sponsor work. We expect that this group would also act to bring private sector resources to the table so that any work can be jointly undertaken. The mandate of the group would be time-limited (e.g. 3 to 5 years), rather than ongoing. Officials propose reporting to joint Ministers by April 2008 with detailed proposals on the structure, governance and accountability of such a group, along with possible membership.

Issues to progress

- 10 We envisage that the steering group discussed above would work together to develop a strategic agenda for capital market development. This would then determine the issues to be worked on over the medium term. Nevertheless, there are areas of work

which can be advanced ahead of setting up a steering group. Many of these issues are already in train in this or related workstreams. Taking this work forward in the interim, jointly with the private sector where relevant, provides a clear signal that we are committed to this work and continuing the process of engagement with the private sector. Areas of work which can be worked on now include:

- *Making it easier for New Zealand based companies to operate in New Zealand:*
 - Consider amending the definition of a foreign company in section 7 of the Overseas Investment Act 2005 so that companies such as Fletcher Building that are headquartered in New Zealand are not considered foreign companies (by virtue of >50% offshore ownership) and no longer need to seek OIA permission whenever they make land purchases.
- *Deepening our capital markets and providing for new markets:*
 - Developing mechanisms to partially subsidise equity research on small, listed New Zealand companies not currently covered by research analysts.
 - Investigating the rapid development of carbon trading in New Zealand (see links to infrastructure development below).
 - Sponsoring (academic) research to provide evidence to Australian asset advisors and fund managers of the merits of amending their trust deeds to allow Australian funds to directly invest in New Zealand equities.
- *Government leadership and strategy development:*
 - Providing NZDMO and the RBNZ with a secondary objective of capital market development.
- *Financial market infrastructure development:*
 - Considering whether there are any gaps in New Zealand's settlement and clearing infrastructure and considering the possibility of a joint New Zealand-Australian settlement and clearing system.
 - Improving our understanding of the back-office, banking, settlement and custodial processes that reportedly complicate investment by Australians into the New Zealand market.
- *Tax policy:*
 - IRD and Treasury are already investigating whether and how to stimulate the development of a local corporate bond market (via changes to the Approved Issuer Levy). IRD also have work underway around some of the other tax issues raised at the forum.

11. Ministers have already commissioned work on some of these issues. These are subsidising equity research in New Zealand, a secondary objective around capital market development for NZDMO and RBNZ and tax policy work on the Approved Issuer Levy. Some work is also underway on voluntary carbon markets and on the NZX's carbon trading programme, with links to work on settlement systems. The other suggestions arose from suggestions at the forum.

12. Work around the details of the trust deeds of Australian funds and on back office systems to facilitate investment into New Zealand were raised at the forum. Subsequent discussions indicated a willingness from at least one private sector organisation to provide resources to support tackling these issues as part of a joint public-private sector working group.

Financial market development as a secondary objective

13. Officials have held discussions with the RBNZ and the NZDMO on the possibility of assigning these institutions an explicit secondary objective to promote financial market development. Both the RBNZ and NZDMO agree that this would provide useful clarification of a role that they currently regard as implicit, and that it would not and should not detract from their respective primary objectives.
14. The RBNZ already has a statutory obligation to provide advice to the Minister on matters relating to the operation of the financial system more broadly. If the RBNZ were to gain a secondary responsibility in this area, then it would be limited primarily to those areas of the capital markets in which the RBNZ has direct involvement and expertise including: the inter-bank debt, bond, securities (not equities) and foreign exchange markets. As a general principle, the RBNZ indicated that any initiatives on their part would require careful identification of the specific market failure and a rigorous cost-benefit analysis. The RBNZ would want to ensure that a role in this area could be nested within their existing statutory responsibilities without creating any serious conflicts with the Bank's primary roles both as a financial regulator and in the implementation of monetary policy. The RBNZ has indicated that this role could be undertaken within existing staff resources.
15. NZDMO's primary objective does not formally include development of New Zealand's capital markets. Informally, NZDMO regards development of several aspects of debt and associated derivatives markets as crucial to the achievement of their primary objective over the long-term. In particular, well-functioning and liquid government bond, swap and foreign exchange markets are essential to NZDMO's operations over the medium and longer term. Towards this end the NZDMO is currently actively engaged in:
 - Issuing more government bonds and bills than necessary to meet immediate Crown cash requirements (with the surplus invested in foreign fixed interest and money market securities).
 - Revising debt issuance strategies periodically to improve bond market liquidity (recent initiatives include reducing the number of bond lines on issue (from 8 to 6), and increasing the target size of bond lines (from \$3 billion to \$4.5 billion),
[Withheld under s9(2)(i)]
 - Participating actively in the swap and foreign exchange markets, either directly or on behalf of major clients (e.g. NZSF).
16. However, there are more initiatives, NZDMO could undertake including:
 - Investing in the Kauri market¹, primarily because it is expected to enhance investment returns for NZDMO, but with the added benefit of supporting a developing market in New Zealand.
 - [Withheld under s9(2)(i)]

¹ "Kauri" bonds are bonds issued in New Zealand by major supranational organisations such as the World Bank and the European Investment Bank.

- [Withheld under s9(2)(i)]

17. The NZDMO already has a strong incentive to implement these initiatives because it has a vested interest in ensuring the development of several sectors of New Zealand's capital markets, but agrees that assigning this as a secondary objective would provide useful clarification of its role. The NZDMO indicated that it would need to give further consideration to the resourcing implications.
18. Further work is required by officials with the RBNZ and NZDMO to bring proposals back to you by the end of March 2008 about a recommended way to implement financial market development as a secondary objective of these institutions, should you wish to proceed with this idea.

Independent equity research

19. A feature of New Zealand's capital markets is the relatively small scale of our listed equity market. A consequence of that, and a potential contributing factor to it, is a lack of local analysis of New Zealand's firms - beyond the top few companies listed on the NZX. Our analysis shows that very little research is available for around 38%² of listed New Zealand companies and the research that is available on the smaller companies is of variable quality and not readily accessible to all potential investors. There are a number of reasons for this including the high fixed cost of producing research and the wide selection of listings needing to be covered by a limited number of research providers and analysts.
20. In addition, given that many institutions operating in our market are Australian-owned, equity analysis is in many cases based there and New Zealand has relatively little local capacity in this area. The small scale of many of the funds under management limits the extent to which it is feasible for New Zealand institutions to research investments in the venture capital market, given the modest amount of investment they are likely to make in this area.
21. There is some anecdotal evidence from stockbrokers that they are more likely to invest in overseas companies (in preference to New Zealand companies) where equity research has been undertaken and is readily available.
22. Academic research³ in markets around the world suggests that equity research tends to have a positive impact on liquidity, the key measure of stock market activity. This may then lead to a lower cost of equity capital for listed stocks covered by equity research.
23. There could be a role for government to address the lack of equity research for smaller companies that aren't in the top tier for the following reasons:
 - In New Zealand the small scale of the equity market and the relatively large number of small listed or partially listed firms means that the lack of equity research on these firms could be constraining the growth of the equity market and the firms themselves. Good quality research is important if smaller companies are to attract the equity investment they require to grow.

² This estimate is based on a survey of equity research produced by four major brokers: ABN Amro Craigs, Macquarie, GS JBWere and Forsyth Barr. It includes New Zealand companies listed on NZX and excludes overseas listed companies and listed investment trusts.

³ The Australian Graduate School of Management is currently examining more than 50 studies from around the world that have supported the link between equity research and higher liquidity and a lower cost of capital.

- Equity research has public-good characteristics, a significant fixed cost to produce the information and a low marginal distribution cost. Potential investors require access to good quality equity research on a timely basis to ensure the efficient operation of the equity market. But because research has public-good characteristics, firms that supply it to such investors may not produce and/or price it optimally.
24. While there is a role for government, due to the public benefits associated with the availability of good quality research, there are also private benefits. Companies benefit by getting the exposure they need to raise equity capital and key stakeholders in the financial sector (i.e. NZX, brokers, investment banks, shareholders and equity research providers) stand to benefit where good quality research increases equity-market liquidity, the number of new listings and transaction volumes. Ultimately, investors themselves would also benefit. These private benefits suggest that at least some of the cost of research should be borne by the private beneficiaries.
 25. A number of countries have equity-research schemes designed to extend research availability to a wider range of listed companies. The schemes are based around connecting companies with private research providers. Some schemes are subsidised by government (e.g. Malaysia and Singapore), while others are funded by the private sector (e.g. Australia, NASDAQ). The success of the schemes relies heavily on the quality and independence of the advice and accessibility by all classes of investors.
 26. There appears to be a case for further investigating options around the design of an equity research scheme for New Zealand including private provision with subsidised funding. If a joint public-private sector steering group is established to promote financial system development this could be used to progress work with the private sector on an equity research scheme.