Ministry of Economic Development
Manatū Ōhanga

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury-MED Report: Financial System Development: Update on Policy Ideas

Date:	1 May 2008	**Report No:**	T2008/764

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	**Read** this report and **indicate** your response to the recommendations	7 May 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	7 May 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)

Name	Position	Telephone		1st Contact
Linda Cameron	Senior Analyst, Economic Performance Group, The Treasury	917 6189 (wk)	*[Withheld under s9(2)(a)]*	✓
Bryan Chapple	Chief Advisor, Economic Strategy Branch, Ministry of Economic Development	474 2933 (wk)		

Enclosure: **No**

Treasury-MED Report: Financial System Development: Update on Policy Ideas

Executive Summary

The purpose of the report is to update you with progress on work currently underway on policy ideas relating to financial market development (refer T2007/2078 and T2007/2397). This report should be read in conjunction with the joint report prepared by MED entitled 'Proposal to establish a private-public task force to develop New Zealand's capital markets' (30 April 2008).

These policy ideas are areas of work that can be advanced by government ahead of setting up the task force. By continuing to advance work on these policy ideas, the government is demonstrating its commitment to actions that will encourage development of the financial system. It should be noted that the proposed task force will be operating on an independent basis and establishing its own work programme within the boundaries outlined in its terms of reference.

The following table summarises policy ideas currently in train as part of the government's work programme on financial markets, saving and investment (FMSI). Some of these policy ideas are already being progressed through other processes.

Table one – policy ideas relating to financial system development

Policy ideas	**Problem/gap being addressed**	**Conclusion**
Partial exemption for specified class of company from Section 7 (definition an overseas person) of the Overseas Investment Act	Companies that meet certain criteria (e.g. an established listed and physical presence in NZ) would no longer be considered foreign companies, making it easier for them to operate here (e.g. acquire land). The current treatment could be prompting some NZ based firms to consider relocating offshore.	**Subject to your agreement**, Treasury could investigate the benefits and risks of providing a partial exemption from section 7 (definition of an overseas person) of the *Overseas Investment Act 2005*, as part of wider review of exemptions included in the *Overseas Investment Regulations 2005*.
Subsidised programme for independent equity research	The relatively small scale of NZ's listed equity market means that discovery costs are high for funds and retail investors.	**This idea has merit and is worthwhile considering further.** In particular, an option is to set-up a private public foundation with joint funding to undertake independent research that is made widely available. This idea could be tested with the task force.
Research to provide evidence on merits of Australian funds investing directly in NZ equities.	The trust deeds of Australian asset advisors and fund managers currently restrict Australian funds from investing directly in NZ equities.	**Research has been commissioned** which is due to be completed by the end of June 2008.
Approved Issuer Levy (AIL)	In practice AIL works to encourage NZ banks and large corporates to issue bonds offshore. This is a possible cause of New Zealand's relatively under-developed corporate bond market.	This measure is worthwhile investigating further and is being progressed by IRD and Treasury. **A separate report is being prepared for Ministers by the end of May 2008.**
New Zealand's settlement and clearing infra-structure.	Possible gap in NZ's clearing and settlement infrastructure.	**Cabinet agreement already obtained** for clearing infrastructure changes in the context of the draft Emissions Units Settlement Systems and Futures Bill.
Capital market development as secondary objective for the Reserve Bank (RBNZ) and Debt Management Office (DMO).	The current objectives and roles of the RBNZ and DMO involve them in activities that affect the financial system and they have an interest in the system functioning well.	In order to clarify its role in this area**, the RBNZ has decided to add capital market development** as one of a range of intents in its Statement of Intent. **Treasury considers that a secondary objective for DMO is not desirable**, but further work on the role of a deep and liquid Government debt market within NZ's financial system should be considered if NZ's Government debt declines significantly from current levels. **MED considers that a secondary objective would be useful.**

Recommended Action

We recommend that you:

a **note** this update on policy ideas that are currently underway and can be advanced ahead of setting up the private-public task force to develop New Zealand's capital markets;

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

b **note** that Fletcher Building has made a submission on the treatment of longstanding New Zealand companies being treated as overseas persons under the *Overseas Investment Act 2005*;

c **note** that the current treatment of established New Zealand companies as an overseas person based on aggregated foreign shareholdings may be an irritating factor (in terms of compliance costs) that could be prompting some New Zealand based firms to consider relocating offshore;

d **agree** that Treasury reports to you by 31 July 2008 scoping a wider regulatory review of exemptions currently provided within Regulation 28 of the *Overseas Investment Regulations 2005*;

A*gree/disagree.* *Agree/disagree.*

Deepening New Zealand's capital market

e **note** there appears to be a case for further investigating options for an independent equity research initiative set-up as a private-public foundation with joint private/public funding and a mission to make its research results widely available. Officials propose testing this with the private-public capital market development task force;

f **note** that a project is underway to examine whether it would be worthwhile for Australian managed funds to invest directly into New Zealand. As most Australian funds are restricted by their trust deeds to invest directly only on the ASX, the aim is to influence the trust deeds that govern Australian managed funds. The project is due to be completed by the end of June 2008;

g **note** that a separate report, to be ready by the end of May 2008, is being prepared for Ministers by IRD and the Treasury on the Approved Issuer Levy and the merits of modifying it to boost New Zealand's corporate bond market;

New Zealand's settlement infrastructure

h **note** that changes to New Zealand's settlement system have been proposed in the context of the draft Emissions Units, Settlement Systems and Futures Bill which has been consulted on by MED;

i **note** that officials will seek a meeting between the Ministers of Finance and Commerce, along with NZX, to progress the outstanding policy issues identified in submissions, including issues around New Zealand's overall settlement and clearing infrastructure;

Capital market development objective for the RBNZ and DMO

j **note** that the current objectives and roles of the RBNZ and DMO involve them in activities that affect the financial system and that they have an interest in the system functioning well;

k **note** that the RBNZ has a primary function of promoting soundness and efficiency of the financial system;

l **note** that in order to clarify its role in this area, the RBNZ is to include capital market development as one of a range of intents in its Statement of Intent - to 'promote the development of capital markets in areas where the Bank has powers and responsibilities (i.e. in money, bond and foreign exchange markets)';

m **note** the DMO's current single objective is to raise debt finance for the Crown at minimum cost and in pursuing this it contributes to the depth and liquidity of the government bond market;

n **note** that further work on the role of a deep and liquid Government debt market within New Zealand's financial system would be desirable if New Zealand's Government debt were to decline significantly from current levels;

either

o **agree** to direct the DMO to include as an intent in its Statement of Intent, an objective of promoting the development of capital markets in areas where it operates, to the extent that this does not prejudice its primary objective **(MED)**;

A*gree/disagree.* *Agree/disagree.*

or

p **agree** that it is not desirable for DMO to have a secondary objective related to capital market development **(Treasury)**.

A*gree/disagree.* *Agree/disagree.*

Linda Cameron
Senior Analyst
Economic Performance Group
for Secretary to the Treasury

Bryan Chapple
Chief Advisor
Economic Strategy Branch
Ministry of Economic Development

Hon Dr Michael Cullen
Minister of Finance

Hon Pete Hodgson
Minister of Economic Development

Treasury-MED Report: Financial System Development: Update on Policy Ideas

Purpose of Report

1. The purpose of the report is to update you with progress on work currently underway on policy ideas relating to financial market development (refer T2007/2078 and T2007/2397). These policy ideas are areas of work that can be advanced by government ahead of setting up the private-public capital market development task force. The task force was proposed at the Investment Forum in November 2007 as a way for senior people from the private and public sectors, and academia, to work together on initiatives that promote development of New Zealand's financial system. This report should be read in conjunction with the joint report prepared by MED entitled 'Proposal to establish a private-public task force to develop New Zealand's capital markets' (30 April 2008).

Analysis

2. Some of the policy ideas in this report were agreed by the Ministers of Finance and Economic Development at the Strategy Session held on 13 August 2007 (refer T2007/1678 and T2007/486). Other ideas emerged from the Investment Forum in November attended by senior business and capital market participants, along with some academics and senior staff from relevant public sector bodies.

3. The development of these policy ideas is already in train and can be advanced ahead of the private-public capital market development task force which, subject to your agreement, could be established later this year. By continuing to advance work on these policy ideas, the government is demonstrating that it is willing to act in "good faith" in the interim and is committed to actions that will encourage development of the financial system. It should be noted that the proposed task force will be operating on an independent basis and establishing its own work programme within the boundaries outlined in its terms of reference.

4. Officials will continue to provide you with advice on policy ideas related to financial system development, some of which may overlap with ideas emerging from the task force. An "academics workshop" is being organised by MED and Treasury on 20 June 2008 to form links with the academic community in New Zealand and Australia with expertise and interest in capital markets on specific issues – it is envisaged that this will be another source of ideas on ways to develop New Zealand's financial system.

Analysis and Emerging Conclusions on Specific Initiatives

Partial exemption from Section 7 (definition of an overseas person) of the Overseas Investment Act 2005

5. Fletcher Building Ltd (FBL) has made a submission that the treatment of New Zealand companies under the *Overseas Investment Act 2005* (the Act) is an inhibiting factor in conducting their business in New Zealand.

6. FBL is currently defined as an overseas person under the Act due to an aggregate foreign shareholding that exceeds 25%, despite having no individual overseas investor with either a 25% shareholding or controlling interest. Thus, despite having no overseas investor significant enough to be screened under the Act, FBL is defined as an overseas person. FBL, in their submission, state that they do not consider

themselves to be a foreign controlled company and regard FBL as a New Zealand company with an established history in this country.

7. FBL and many other New Zealand companies publicly list shares in order to source capital from international markets. They have no control over who purchases these shares and foreign investors are only screened if they acquire a 25% shareholding or controlling interest in a company. Thus a public listing may expose New Zealand companies to regulatory risk, which they are unable to control.

8. An exemption for companies in a similar situation to FBL may be possible through a regulatory amendment to the *Overseas Investment Regulations 2005* made under section 61(1) j of the Act. Under this section the relevant Ministers may exempt (on terms and conditions) any transaction or person from the definition of an overseas person. Exemptions made under section 61 of the Act are laid out in Regulation 28 of the *Overseas Investment Regulations 2005* and are currently being reviewed by Treasury. Treasury will be reporting back on this towards the end of July.

9. A suitable amendment could seek to provide a partial exemption for New Zealand companies with an established listed and physical presence in New Zealand from seeking approval to buy sensitive assets necessary to undertake their "ordinary course of business".

10. Providing an amendment like this involves a risk of undermining the intention of the Act and so would need to be heavily caveated and the exemption made subject to approval. A loosely specified exemption within the regulation could undermine the Act by allowing overseas investors with the ability to structure transactions. However, a tighter restriction may remove the number of companies caught and remove any benefits from providing an exemption.

11. The current treatment of established New Zealand companies as an overseas person based on aggregated foreign shareholdings may be an irritating factor (in terms of compliance costs) that could be prompting some New Zealand based firms to consider relocating offshore. Further investigation is needed in order to ascertain how many companies are affected and what benefits may arise from providing an exemption. Any solution would require in-depth legal analysis and a high level of consultation.

Conclusion

12. Subject to Ministers' agreement, Treasury could undertake some investigatory scoping work to ascertain whether it is possible to provide an exemption for key New Zealand companies with an established presence in New Zealand. This would be undertaken in the context of a wider regulatory review of the *Overseas Investment Regulations 2005*.

Subsidised programme for independent equity research

13. There appears to be a case for further investigating options for an independent equity research programme set-up as a private-public foundation with private and public funding. The programme would contribute to financial literacy thereby helping to support other policy initiatives aimed at developing capital markets.

14. Discussions with stakeholders[1] have confirmed that lack of critical mass, high discovery costs and lack of independent, good-quality information for retail investors are problems that are contributing to holding back the development of New Zealand's equity markets.

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[1] Bruce Sheppard (Chair, NZ Shareholders Association) and Annabel Cotton (Board Member, NZ Securities Commission).

15. 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 ten companies listed on the NZX. 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.

16. There is some anecdotal evidence from stockbrokers that they are more likely to advise clients to invest in overseas companies (in preference to New Zealand companies) where equity research has been undertaken and is readily available. Academic research[3] in markets around the world also suggests that equity research tends to have a positive impact on liquidity, the key attribute of a well-functioning stock market. By improving liquidity, equity research could then lead to a lower cost of equity capital for listed stocks.

17. 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:

- The small scale of the New Zealand 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.

- 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.

18. There is also a role for government to help up-skill the financial literacy of the population and to facilitate independent and reliable research.

19. While there are public benefits associated with the availability of good quality research, there are also private benefits for companies and key stakeholders in equity markets. This suggests that at least some of the cost of research should be borne by the private beneficiaries. Stakeholders[4] have indicted that a subsidised equity research scheme would be unlikely to crowd out private research as share brokers would still continue to focus on larger companies.

20. A number of countries have equity research schemes. The success of the schemes relies heavily on the quality and independence of the advice and accessibility by all classes of investors. The Australian experience is that it is difficult to maintain independence where the scheme is funded directly by the companies being researched as they can have an expectation that they have a right to provide editorial input. This was also the experience here in New Zealand a few years ago when an unsuccessful

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[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.

[4] Bruce Sheppard and Annabel Cotton.

attempt was made to set-up an equity research scheme based entirely on private provision and funding.

Conclusion

21. There appears to be a case for further investigating options for an independent equity research programme set-up as a private-public foundation with private and public funding. The proposed private-public capital market development task force could be used to test the proposal with the private sector.

Research to provide evidence on merits of Australian funds investing directly in NZ equities

22. A project is being commissioned to examine if investing directly into New Zealand would be beneficial to Australian Managed Funds, with a view to influencing the trust deeds that govern Australian managed funds. We understand that most of the Australian funds are currently restricted by their trust deeds, to invest directly in companies listed on the ASX. Their international exposure comes from investing in international funds (e.g. Templeton) or Australian listed companies with assets internationally based (e.g. Macquarie Group).

23. This project will examine whether there is a potential gain to Australian funds from being able to directly invest in New Zealand equities. If they could invest, it would potentially increase the liquidity in the New Zealand market and make it easier for companies to raise equity from a New Zealand base.

24. The analysis involves considering the change in the risk-adjusted return when New Zealand equities are added to the efficient frontier of Australian equities. Given funds will typically invest in only relatively liquid equities, companies in the ASX 200 and NZX 50 are being considered in the study. The study will also need to take account of currency conversion and tax issues. If the study finds that it would be beneficial in a risk/return sense for Australian funds to be able to invest directly into listed New Zealand companies, the study will be used to inform discussions with the asset-allocation advisors. They will in turn advise Australian managed funds when drafting their trust deeds to consider investing directly in New Zealand.

Conclusion

25. The timeframe for completion of this project is by the end of June 2008.

Approved Issuer Levy

26. The Reserve Bank has raised concerns that the current Approved Issuer Levy (AIL) regime provides an unintended tax advantage for New Zealand banks and large corporates to issue bonds offshore that may constrain the development of New Zealand's corporate bond market. This is due to a loophole whereby a New Zealand company can set-up a branch operation in a foreign country and use this to borrow from abroad without any AIL impost. This loophole may be used by larger corporates including the major registered banks.

27. This loophole disadvantages bond markets in two ways. In the first instance it makes offshore finance relatively cheaper for businesses which invest in branch financing operations. This may lead to lower bond issuance in New Zealand among banks and large corporates. In the second instance it may make bank loans relatively cheaper or more available as banks can use branch structures to achieve a lower cost of funding. This may lead to lower bond issuance among mid-tier corporates.

28. There are two suggested options which would neutralise the effect of the branch loophole. These options are to:

   i. Use tax legislation to try to remove the branch structure loophole.

   ii. Reduce the rate of AIL on publicly issued bonds from two percent to zero.

Conclusion

29. IRD and Treasury plan to report to Ministers in May on the relative effectiveness and fiscal risks of these options. The IRD and Treasury preliminary analysis suggests that zero-rating or removing AIL on publicly issued bonds may be more effective at promoting bond issuance and involve much less risk to the corporate tax base than attempting to remove the branch structure loophole.

New Zealand's settlement and clearing infrastructure

30. Changes to New Zealand's financial infrastructure around settlement and clearing regulation are currently being considered as part of the set of reforms requested by NZX to support the development of its emissions trading exchange. A discussion paper and draft Emissions Units, Settlement Systems and Futures Bill has been consulted on by the Ministry of Economic Development. Officials are now considering the issues raised in submissions.

Conclusion

31. The issues are complex and are fundamental for the operation of our financial system. It is particularly important to get them right in a small country such as New Zealand, where the market is only likely to support a limited number of settlement and clearing systems. Officials are due to report back to the Minister of Commerce by 31 July 2008 on the actions necessary to resolve the outstanding policy issues identified in submissions, including on issues around New Zealand's settlement infrastructure.

Capital market development as a secondary objective for the RBNZ and DMO

32. Officials have held discussions with the RBNZ and the DMO on the possibility of assigning these institutions an explicit secondary objective to promote capital market development. Both the RBNZ and DMO note that their current objectives and roles involve them in activities that affect the financial system and that they have an interest in that system functioning well. The key question is whether giving these institutions an explicit secondary objective would provide useful clarification of a role that they currently regard as implicit, and whether any downsides would be small enough to provide an overall net benefit. There is general agreement that any secondary objective should not detract from the respective primary objectives of the two institutions.

33. The Reserve Bank Act already has a requirement that the Bank *promote an efficient and sound financial system* across the RBNZ's various functions. Consequently, undertaking capital market initiatives would be consistent with this broader objective, provided that the promotion of efficiency and soundness was the guiding principle behind any initiatives in this area.

34. The RBNZ has undertaken initiatives to promote capital market development in the past (particularly in the area of the broader bond and money markets). However, there has been some uncertainty within the Bank as to how far this role should extend beyond the direct requirements of monetary policy implementation, prudential supervision, payment-system oversight or liquidity management.

35. On balance, the RBNZ has decided that there would be a modest net benefit to dispelling this uncertainty by adding capital market development as an additional issue within the Bank's Statement of Intent (SOI). It would read:

"Promote the development of capital markets in areas where the Bank has powers and responsibilities (i.e. in money, bond and foreign exchange markets)".

36. This way of giving the RBNZ a secondary objective of financial system development would not require any change to the Reserve Bank Act. Rather, the Bank sees it as a relatively small change that will make a modest but useful difference to the overall development and functioning of the broader capital markets in New Zealand. Most directly, it could potentially influence the design of the Bank's monetary operations and standing financial facilities at times when it is looking to make changes for other (core business) reasons. It may also better guide the Bank in supporting market-led initiatives.

37. Officials from the RBNZ are now playing an active role in government-wide efforts in the area of financial system development and research. The Bank will also acknowledge this involvement in its SOI.

38. The DMO is an institution with a narrower mission than that of the RBNZ. Its primary objective is to manage the government's debt requirements at least cost. This does not formally include development of New Zealand's capital markets. Informally, DMO regards development of several aspects of debt and associated derivatives markets as crucial to the achievement of its primary objective over the medium to long term. In particular, well-functioning and liquid government bond, swap, and foreign exchange markets are essential to DMO's operations over the medium and longer term. Towards this end the DMO 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 increasing the frequency of bond tenders from monthly to fortnightly, 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).

39. These activities which are solely focussed on minimising the Government's cost of funding, support the development of parts of New Zealand's financial system. The addition of a secondary objective would be unlikely to materially affect the operations of DMO. We note that a liquid market in Government debt may play a role in setting risk-free benchmarks within the overall financial system. Government debt below a certain level may lead to a gap in this area that cannot be met by other market instruments. Given this, if Government debt were to decline significantly below current levels, we think it would be desirable to undertake work to assess whether the DMO's likely debt issuance and trading activity over the next 10 years or so is likely to produce an optimal set of benchmarks. Australia undertook such a study several years ago and this informed its consequent approach to debt issuance. New Zealand could build on this Australian work taking into account any trans-Tasman differences.

Conclusion

40. The RBNZ will include capital market development as one of a range of intents in its SOI and will also acknowledge its involvement in government-wide efforts to foster the development of New Zealand's financial system. The DMO currently supports the development of certain parts of the financial system in the course of pursuing its primary objective.

41. ***Treasury considers*** that giving DMO a secondary objective of capital market development is not desirable. It would risk clouding the focus of DMO as there are likely to be circumstances where capital market and cost minimisation objectives are in conflict. However, further work on the role of a deep and liquid Government debt market within New Zealand's financial system would be desirable if New Zealand's Government debt were to decline significantly from current levels***.***

42. ***MED considers*** that a secondary objective for DMO of capital market development would be useful. As discussed above, this already occurs implicitly to some extent. However, an explicit statement in the DMO's Statement of Intent, along the lines of that proposed by the RBNZ, would encourage the DMO to take capital market development issues into account when there is no adverse impact on their primary objective.