List of appendices

Appendix One: Main regulators of financial institutions

Regulator	Statutory objectives and Functions
Registrar of Friendly Societies and Credit Unions (Administered through Companies Office, a business unit of MED)	To administer the Friendly Societies and Credit Unions Act and carry out any duties imposed upon him/her by any legislation. Functions include: • registration of documents, which includes checking for compliance with statutory disclosure requirements and accuracy of information; • maintenance of registers (maintain list of registered societies/unions and ensure the list is accessible); • resolution of disputes (where disputes cannot be resolved in accordance with rules of society or credit union); and • inspections, prosecution, suspension, cancellation and dissolution of societies and credit unions.
Registrar of Building Societies (Administered through Companies Office, a business unit of MED)	NA, no statutory objectives outlined in the Building Societies Act or other legislation. Generally charged with the supervision of building societies. Functions include: • registration of documents which includes checking for compliance with statutory disclosure requirements and accuracy of information; • maintenance of registers (maintain list of registered societies and ensure the list is accessible); and • inspection, prosecution, suspension, cancellation and dissolution of building societies.
Registrar of Companies (ROC) (Administered through Companies Office, a business unit of MED that also includes National Enforcement Unit)	NA, no statutory objectives outlined in the Securities Act or Companies Act Generally charged with the supervision of companies. Functions include: • a range of functions in relation to companies - registration, disqualification of directors, taking offences under the Companies Act etc; • registration of prospectuses; • prosecuting offences under the Financial Reporting Act; • prosecuting a range of offences under the Securities Act; • undertaking inspections under the Companies Act and Securities Act; and • a range of functions under Corporations Investigation and Management Act, Insolvency Act and Personal Property Securities Act.

Regulator	Statutory objectives and Functions
The Insurance and Superannuation Unit (ISU) (Administered through Companies Office, a business unit of MED)	NA, no statutory objectives outlined in insurance or superannuation legislation. The ISU carries out an amalgam of functions of the Registrar of Companies, Chief Executive of MED and the Government Actuary under insurance and superannuation regulation. Generally charged with the supervision of life insurers and general insurers. Functions include: • registration and review of documents; and • receipt of ratings certificates (general insurers).
The Reserve Bank of New Zealand (RBNZ)	The Reserve Bank's statutory objectives in relation to the functions set out below are to promote the maintenance of a sound and efficient financial system, and in the case of banking supervision and the designation of payment systems, to avoid significant damage to the financial system that could result from the failure of a registered bank/payment system participant. Functions include: • registration and supervision of banks; • administration of protection of "bank" name; • oversight of payment system; • designation of particular payment systems; • responding to bank distress and failure events; and • providing lender of last resort facilities (LOLR).
Government Actuary (GA) - life insurance (Administered through Companies Office, a business unit of MED)	NA, no statutory objectives outlined in insurance or superannuation legislation. Functions include: • reporting to Minister on life insurers' statements and abstracts (court appointed judicial manager can consider report); • where the insurer is in judicial management, reporting to the Court on the scheme of transfer.

<table>
<tr><th>Regulator</th><th>Statutory objectives and Functions</th></tr>
<tr><td>Government Actuary – superannuation

(Administered through Companies Office, a business unit of MED)</td><td>NA, no statutory objectives outlined in insurance or superannuation legislation.

Functions include:
registering schemes;
requiring information;
cancelling the registration of a scheme;
ordering that a scheme be operated in a specified manner;
ordering that a scheme be wound up;
exempting full compliance with Act eg on transfers of members; and
consenting to reversion of assets to employer.</td></tr>
<tr><td>Securities Commission (SC)</td><td>N/A, no statutory objectives outlined in the Securities Act.

Functions include:
keeping under review the law and practices relating to securities, activities on securities markets and recommend changes;
performing a range of functions and duties conferred on it under securities legislation (including a range of enforcement functions);
co-operating with overseas regulators;
advising the Minister of Commerce on the conduct rules of exchanges; and
promoting public understanding of securities law.</td></tr>
</table>

Appendix Two: Supervisory arrangements, by institution type [1]

	Registered Banks	Finance Companies	Building Societies	Credit Union / Friendly Societies
Institutional Structure	RBNZ – registers, supervises, and monitors banks and is Lender of Last Resort (LOLR). MOF may advise Executive Council to declare statutory management, on the recommendation of the Reserve Bank.	Supervision by the ROC under the Securities Act and the Companies Act, supervision by SC under the SA. Plus supervision by Trustee in accordance with trust deed and Securities Act. NB. Entities other than a company may offer debt securities, if any entities offering finance through debt securities are CISs the requirements listed for CISs below apply.	Registrar of Building Societies. Registrar registers building societies and monitors compliance with Building Societies Act 1965.If offer securities to the public the Registrar of Companies and the SC have monitoring and enforcement role under the SA Plus supervision by Trustee in accordance with trust deed and Securities Act.	Registrar of Friendly Societies and Credit Unions ("Registrar"). Registrar registers credit unions and friendly societies and monitors compliance with Friendly Societies and Credit Unions Act 1982 (FSCUA). If offer securities to the public the Registrar of Companies and the SC have monitoring and enforcement role under the SA Plus supervision by Trustee in accordance with trust deed and Securities Act.
Entry/Exit Standards	A range of requirements relating to governance, ownership structure, reputation and ability to do business.	Must have an appointed Trustee (must be a trustee corporation), and trust deed and any amendments need to be registered by ROC. Also entry requirements for Trustees under the Trustee Act and Trustee Corporation Act (or as set by SC where trustee is not a trustee corporation but approved by SC in accordance with Securities Act).	Must be registered by Registrar under Building Societies Act, required to submit rules for approval prior to registration. Rules must provide for manner of raising funds, shares of society etc. In the case of terminating a society, must specify date of termination.	Must be registered as credit union or society by the Registrar following approval of its rules and the fulfilment of membership requirements. Rules must provide for investment of funds, shares/membership of society, keeping of accounts, appointment and removal of officers.

[1] There are a number of protections offered to consumers by consumer laws (i.e. in relation to credit contracts) that may also be applicable to many of these institutions but these are not discussed in detail in this appendix.

	Registered Banks	Finance Companies	Building Societies	Credit Union / Friendly Societies
		Some minimal entry requirements must be met to incorporate a company under the CA.		
Governance Standards	Requirements relating to the independence, interests and suitability of directors.	Trustee Act, Trustee Companies Act, Companies Act and general trust law prescribes governance requirements. Under Securities Regulations trustee must exercise due diligence to see whether terms of deed or offer of securities have been breached and must attempt to remedy the breach, plus trustee must ascertain whether assets of the borrowing group will be sufficient to repay the amounts of the debt securities when they become due.	Certain mandatory disclosure requirements on directors of building society. Must maintain proper accounting records. Trustees subject to the requirements of the Securities Act 1978, the Trustees Act 1956 and the Trustee Companies Act 1967 and general trust law.	Governance standards may be set out in the rules of the society/union. Trustees subject to the requirements of the Securities Act 1978, the Trustees Act 1956 and the Trustee Companies Act 1967 and general trust law.
Prudential Standards	Capital adequacy and connected exposure limits.	Some limited prudential requirements in Trust Deed in relation to trustee’s duties for investments.	Some limited prudential requirements in Trust Deed in relation to trustee’s duties for investments.	Credit unions – Trust deed and FSCUA requirements (e.g., need to maintain reserve asset ratio) as well as trustees’ duties for investments. Friendly Societies – Trustee Act and FSCUA requirements (e.g., duties of trustees for investments).
Disclosure Standards	Comprehensive quarterly disclosure of financial condition and risks.	Disclosure under the Securities Act, Securities Regulations, Financial Reporting Act. This includes for debt securities information on guarantors, ranking of	All building societies must file an annual return (including audit report) with Registrar. All building societies must present to members and audited annual financial statements	All credit unions and registered societies must file annual return with Registrar. Plus subject to disclosure requirements in the Securities Act and Regulations if offering securities as well as filing audited financial statements in

	Registered Banks	Finance Companies	Building Societies	Credit Union / Friendly Societies
		securities and provisions of trust deed and other restrictions on the borrowing group.	that present a true and fair view of the financial position of the society. Plus subject to disclosure requirements in the Securities Act and Regulations if offering securities as well as filing audited financial statements in accordance with Financial Reporting Act.	accordance with Financial Reporting Act.
Compliance, Monitoring and Enforcement	RB monitors quarterly disclosures; meets with management regularly and can require further information. Auditors required to declare if a bank is serious financial difficulties. Director Attestations. The RB has the power to require a bank to supply it with a report prepared by an approved person on some aspect of the bank's operations.	ROC and SC have inspection and enforcement powers under SA, and ROC has enforcement powers for Companies Act breaches. Trustee monitors compliance with Trust deed and offer of debt securities. Required to report to Registrar in accordance with CIMA.	Registrar monitors compliances with obligations imposed by Building Societies Act, including examination of annual returns and financial statements, with particular emphasis placed on solvency of organisations and auditors' reports. Trustee monitors compliance with trust deed and offer of debt securities. Required to report to Registrar in accordance with CIMA. ROC and SC monitor compliance with the Securities Act.	Registrar monitors compliances with obligations imposed by FSCUA including examination of annual returns with particular emphasis placed on solvency of organisations and auditors' reports. For credit unions, trustee monitors compliance with trust deed, including capital ratios. When a credit union does not comply with the requirements of a trust deed, Registrar can prohibit a credit union from doing any or all of the following: • borrowing money; • accepting subscription and payment for shares; • lending money; • repaying capital; and • accepting new members. ROC and SC monitor compliance with the SA. Trustee monitors compliance with trust deed and offer of debt securities. Required to report to Registrar in accordance with CIMA.

	Registered Banks	Finance Companies	Building Societies	Credit Union / Friendly Societies
Crisis Management	The RB has extensive failure management powers. MOF may place in Statutory Management. LOLR.	Companies Act provisions for liquidations of companies. Trustee may apply to Court for directions and a range of Ct orders if it appears the deed does not give adequate protections for investors. In exceptional situations CIMA can be used, with powers including declaring corporation at risk, issuing directions to the corporation and statutory management.	Registrar (or persons appointed by Registrar) may inspect any documentation of a building society or call a special meeting to investigate the affairs of the society. The Registrar may, with approval of the Minister, cancel or suspend the registration of any building society. The Registrar may apply to the High Court for liquidation of the society, Trustee may apply to Court for directions and a range of Ct orders if it appears the deed does not give adequate protections for investors? In exceptional situations CIMA can be used, with powers including declaring society at risk, issuing directions to the corporation and statutory management.	Registrar may appoint inspectors or call a special meeting to investigate the affairs of the credit union or society. Registrar may put credit union or society into liquidation. Trustee may apply to the Court for directions and a range of Court orders if it appears the deed does not give adequate protections for investors. In exceptional situations CIMA can be used, with powers including declaring society at risk, issuing directions to the corporation and statutory management.

	Collective Investment Schemes	Registered Superannuation Schemes	Life Insurance	General Insurance
Institutional Structure	• Unit Trusts (UT): Manager and Trustee plus Registrar of Companies (ROC); • Group Investment Scheme (GIS): Trustee Company or Public Trust and ROC and SC; • Contributory Mortgages (CM): ROC and SC; and • Participatory securities (PS):Statutory supervisor or Stat Trustee, SC and ROC.	Government Actuary (GA).	GA, Registrar of Companies, ISU, Minister of Commerce and Court	Registrar of Companies, ISU, Minister of Commerce.
Entry/Exit Standards	• UT: manager must be company and Trustee must be a statutory trustee or trustee company or bank approved by Minister, must lodge bond, trust deed, trustee may set eligibility requirements for manager; • GIS: entry requirements under Trustee Act, trust deed must be registered; • CM: must be registered by the ROC, must provide certain information with application, have nominee company, trust account and auditor; and • PS: Statutory supervisor approved by Commission entry criteria, or Statutory Trustee corporation, register deed of participation.	To be a registered scheme, certain information is required, trust deed, one resident trustee, documents must be registered, entry requirements for trustees in Trustee Act.	Deposit on entry.	Deposit on entry, ratings.
Governance Standards	• UT: stds and liability under the Trustee Companies Act, Trustee Act and general law. Securities Regulations impose standards of care, diligence and a fiduciary duty on Manager; • GIS: duties and obligations prescribed under Trustee Companies and Trustee Act and general law;	Trustee Act and general Trust Law.	Depends on type of institution (e.g. if a company then it is regulated under the Companies Act).	Depends on type of institution (e.g. if a company then it is regulated under the Companies Act).

	Collective Investment Schemes	Registered Superannuation Schemes	Life Insurance	General Insurance
	• CM: Securities Act (Contributory Mortgage) Regulations regulate receipt and disbursement of contributions and prescribe duties and obligations of brokers and auditing of accounts; • PS: duties and liabilities specified in SA and Regs plus Trustee Act.			
Prudential Standards	Some limited prudential standards in trust deed.	GA must be satisfied the scheme's financial position, security of benefits and management are adequate.	No.	General insurers subject to prudential oversight of their ratings agency and members of Insurance Council (20 insurers who write approx. 95% of NZ's insurance business) must meet its solvency test.
Disclosure Standards	For collective schemes (except contributory mortgages) disclosure under the Securities Act and Securities Regulations, Financial Reporting Act and some disclosure requirements in relation to Trustees under law depending on type of CIS. Contributory mortgages: disclosure requirements under the Securities Act (Contributory Mortgage Broking) Regulations.	Annual audited accounts, actuarial report every three years for schemes operating on the principle of unallocated funding or providing benefits dependent on contingencies of human life; members have right to specified information. Investment statement under Securities Act, disclosures under Superannuation Schemes Act, members of ISI must comply with disclosure requirements in its manual of practice standards.	Securities Act where investment element, GAAP, FRA, audited statements, Actuarial Report.	Audited statements, FRA and GAAP.
Compliance/ Monitoring/ Enforcement	• PS-Statutory Supervisor provides monitoring role. SC can revoke approval of Stat Super; • All CIS Manager, Stat trustee company,	Various officers discovering serious problem with scheme must disclose to GA.	GA and MED examine returns and monitor compliance. ROC examines returns and monitors	ROC examines returns and monitors compliance. ROC can appoint inspectors under Insurance Companies (Ratings

	Collective Investment Schemes	Registered Superannuation Schemes	Life Insurance	General Insurance
	Public Trust etc provide monitoring; • all CIS file audited financial statements with ROC given to SC and ASRB. ROC and SC have broad inspection powers and enforcement functions; and • ROC and GA responsible for registering Trust Deeds and ensuring form and structure of requirements observed.	GA may require trustees or administration or management to supply information in respect of scheme. GA may cancel registration if scheme ceases to have a NZ resident trustee or if satisfied on reasonable grounds the scheme is no longer for the principal purpose of retirement benefits.	compliance. ROC can appoint inspectors under Insurance Companies (Ratings and Inspections) Act where concerns over solvency of insurer. The ROC can obtain information under CIMA. The ROC has powers under the Companies Act. In addition, where life insurer is an issuer (as a result of policies containing an investment component), ROC and SC monitor compliance with the Securities Act.	and Inspections) Act where concerns over solvency of insurer. The ROC can obtain information under CIMA.The ROC has powers under the Companies Act. In addition, where insurer is an issuer, ROC and SC monitor compliance with the Securities Act. General insurers must comply with reporting requirements under their rating agreement.
Crisis Management	Companies Act provisions for liquidations of Companies. Unit Trusts Act contains provisions for winding up Unit Trusts. Under SA Stat Super may apply to Court for directions if it appears the deed does not give adequate protections for investors. In some situations CIMA used.	If GA has reasonable cause to believe the scheme is failing to comply with regulation, or its financial position, security of benefits, or management is inadequate, he may cancel the registration of the scheme, or give directions as to its operation, or order that the scheme be wound up. Trustees winding up a scheme must tell GA and lodge audited final	The Minister of Commerce can apply to the Court to put a life insurance company into judicial management. The Governor-General on the advice of the Minister of Commerce in accordance with a recommendation of the Securities Commission may put an insurer into statutory management. In exceptional situations CIMA can be used, with	The Governor-General on the advice of the Minister of Commerce in accordance with a recommendation of the Securities Commission may put an insurer into statutory management. ROC can apply to court to liquidate insurance company. In exceptional situations CIMA can be used, with powers including declaring corporation at risk, issuing directions to the corporation and statutory management.

	Collective Investment Schemes	Registered Superannuation Schemes	Life Insurance	General Insurance
		accounts.	powers including declaring corporation at risk, issuing directions to the corporation and statutory management. The Court, may, if it thinks fit, reduce the amount of the contracts of an insolvent life insurance company, in place of putting the company into liquidation. The Registrar (of FSCU, Companies, Incorporated Societies, etc., as the case may be) can apply to place a NZ body corporate, partnership or unincorporated association into liquidation, if it is unable to pay its debts, or it is otherwise fair and equitable to do so.	The Registrar (of FSCU, Companies, Incorporated Societies, etc., as the case may be) can apply to place a NZ body corporate, partnership or unincorporated association into liquidation if it is unable to pay its debts, or it is otherwise fair and equitable to do so.

* Note: insurers other than life insurers are governed by the Insurance Companies' Deposits Act 1953 and the Insurance Companies (Ratings and Inspections) Act 1994. These are primarily general insurers. But under the latter Act, insurers not insuring property (such as health insurers, credit contract insurers, fidelity guarantee insurers etc) need not get ratings, although they are otherwise subject to those Acts.

Appendix Three – Summary of FSAP recommendations and actions being taken in response.

Principal Recommendations

Issue	Recommendation	Action being taken (if any)
Disclosure-based regime	Maintain the quality, scope, and timeliness of disclosure to ensure it continues to meet best international practice.	Late last year the RBNZ released a revised set of proposed amendments to the bank disclosure regulations for a final round of consultation with banks and other interested parties. The amendments are designed to facilitate banks' adoption of international financial reporting standards from 1 January 2005 (for those banks choosing to do so) and to implement amendments to the disclosure requirements relating to earlier banking supervision policy changes. The amendments also make a number of tidy-up changes to the disclosure regime. It is expected that the disclosure amendments will come into force in the first quarter of 2005. The RBNZ plans to undertake a broader review of the bank disclosure regime in the next two years. That review will include an assessment of the changes that may be required to the disclosure regime in order to implement the disclosure elements of Basel II.
Importance of independent directors	Fit-and-proper criteria should continue to apply in a comprehensive manner. The RBNZ could offer independent bank directors the possibility of discussing areas of concerns without absolving directors of their statutory responsibilities.	The policy framework for "fit and proper" review of appointees to positions as senior managers or directors of registered banks, and bank applicants, has been finalised and implemented. A new condition of registration was imposed on all registered banks from 1 July 2004, requiring that

		no such appointment shall be made unless the RBNZ advises that it has no objection. The RBNZ released to all registered bank boards earlier last year a summary of the survey we conducted of bank boards in 2003, as part of the preparation for the FSAP. In the covering letter to that survey summary we highlighted a number of issues that we plan to consider in reviewing corporate governance in banks. One of those issues was the role of independent bank directors and the possible efficacy of seeking to enhance their role on bank boards. The next step is to release a discussion paper to banks and others in 2005. The RBNZ has given thought to the possible benefits of developing a closer liaison with the directors of banks, particularly independent directors. This issue will be canvassed in the broader corporate governance review and is likely to be covered in the proposed Discussion Paper on bank governance matters.
Surveillance	For banks, monitor more regularly liquidity and large exposure early warning indicators. Consider commissioning third-party reports and establish a small specialist team to make focussed on-site visits on particular aspects of credit and operational risk.	The RBNZ has established an Issues Section in its Financial Stability Department, which is now at full complement. This section will have responsibility for developing, implementing and administering the framework for independent bank reviews (together with other functions). It is likely that a Discussion Paper will be released to banks and others in early 2005, with a view to implementing the framework and commencing selected bank reviews, as appropriate, later in the year.

		Work on policy regarding banks' liquidity management and large exposure control has been deferred given other priorities.
Bank resolution and crisis management	Review possible approaches to bank resolution, and the operational and legal consequences that might arise, with a view to establishing internal operational guidelines.	The issues section is also responsible for pulling together a comprehensive work programme on financial crisis management, including developing options for responding to bank failures, implementing a crisis management toolkit, operationalising the Bank's capacity to implement lender of last resort, and developing a crisis management simulation exercise. Substantial progress is expected in all of these areas in 2005.
Nonbank supervision	Review practices and resource needs for the government agencies involved in oversight, especially the offices of the Registrar and the Government Actuary, with a view towards enhancing public access to timely and comprehensive data.	The reviews underway relating to securities and insurance (see appendix four) will re-examine the requirements relating to publicly available data and resourcing.
Securities markets regulation	Enhance regulatory framework by including minimum standards of conduct for collective investment scheme operators, improving reporting mechanisms, strengthening standards and penalties relating to market abuse, and strengthening oversight of market intermediaries that are not exchange members.	These matters are being considered as part of the reviews underway relating to securities (see appendix four, in particular the Review of the Securities Act and the Securities Legislation Bill).

Recommended Action Plan to Improve Observance of the Basel Core Principles

Reference Principle	Recommended Action	Action being taken (if any)
Powers to Address Safety and Soundness Concerns and Remedial Measures (CPs 1 and 22)	Finalise a crisis-management strategy. Explore possible forms of cooperation with the Australian authorities, as appropriate.	The Reserve Bank is advancing a major work programme covering financial crisis management, including identification of crisis management options, implementation of procedures and processes required to respond to crises, crisis simulation exercises and coordination with APRA and RBA.
Permissible Activities (CP 2)	The ability of non-bank institutions to accept deposits does create a potential loophole for regulatory arbitrage, and this matter should be kept under review in light of reputational risk issues.	This report recommends that the review of the Securities Act, any reviews of insurance resulting from the Law Commission report, and the reviews of the supervisory arrangements governing finance companies, credit unions, building societies and friendly societies should be considered together, and take into account policy settings in the banking sector.
Credit Policies (CP 7)	Consider selective and focused use of Section 95 powers to verify banks' credit procedures and controls. This could take the form of an independent third-party report. Alternatively the Bank could establish its own small risk review team to carry out such reviews. This would probably require the Act to be amended to give the Bank the explicit power to carry out routine on-site inspections.	The Reserve Bank is developing a framework for implementing section 95 independent bank reviews. It is likely that a framework will be implemented in 2005 and specific bank reviews will commence in the latter part of the year. Reviews could cover a number of areas, including elements of banks' risk management systems, accounting systems, internal controls and governance arrangements.
Large Exposures (CP 9)	Consider obtaining more frequent data directly from the banks. This could form part of a set of early warning prudential indicators, which could also include liquidity.	

Reference Principle	Recommended Action	Action being taken (if any)
Market Risks (CP 12)	As CP 7.	
Other Risks (CP 13)	As CPs 7 and 9. In these areas, the information which the RBNZ gets from disclosures and consultations needs to be supplemented, as it is not comprehensive or current.	The Reserve Bank plans to consider a possible prudential requirement for banks in respect of liquidity. If implemented, this might require banks to meet minimum liquidity requirements and to disclose more data on their liquidity positions.
Money Laundering (CP 15)	The RBNZ's role in this area should be reviewed as part of the current intergovernmental examination of anti-money laundering measures.	The Reserve Bank's role in the anti-money laundering (AML) area is being addressed in the context of the wider review of AML policy being led by the Ministry of Justice.
On- and Off-Site Supervision (CP 16)	Off-site work could be complemented by setting up a specialist risk-review team for themed visits to banks and by up-to-date early-warning indicators (CPs 7 and 9 above).	The section 95 review project covers this issue. The Reserve Bank will not be using its own staff in on-site visits, but is likely to implement a programme in which the Reserve Bank requires banks to undergo a review on specified matters by a person approved by the Reserve Bank.

Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code Practices – Banking Supervision

Reference Practice	Recommended Action	Action being taken (if any)
Practices 5.2 and 6.1.5	Details of the MOU between domestic regulatory agencies should be made public.	The Reserve Bank website contains MOU information. The MOU between the Securities Commission and the NZX is also available to the public.

Appendix Four: Financial Sector Reviews

Topic	Description	Timeframe est.
Single economic market (SEM) work generally (Tsy led)	Cabinet agreed to further work developing a detailed strategy for engagement after Australian election (9 October) and to consider a more ambitious and broader approach, including joint institutions and possible trade-offs across areas. The MoF reported back to Cabinet with an update in December 2004.	Cullen/Costello meeting in Feb 2005.
Review of the Banking and Insurance Sector	Cabinet has agreed to the development of a Treasury, RB, MED Steering Committee and Working Group which will report on how regulation can best support the contribution of financial institutions (particularly banking and insurance) to growth while maintaining system stability; and how trans-Tasman arrangements could improve the contribution of financial institutions to growth in NZ while maintaining stability. The insurance focus for the Review is only on developing the framework and Trans-Tasman issues.	The Group will report back to Ministers with recommendations by 31 January 2005.
Review of Life Insurance (MED)	Law Commission reviewed the framework for the regulation and supervision of life insurers and life insurance products. Its report was submitted to the Minister of Commerce and tabled on 2 December 2004. The report recommended strengthening actuarial requirements and regulating all financial products similarly. It also recommended requiring incorporation but exempting many foreign insurers, including Australian insurers, from this requirement. The Government is currently considering the Commission's report.	Govt response within six months (by June 2005).
General Insurance (MED)	In June 2002, Cabinet agreed that the Insurance Companies' Deposit Act and the Insurance Companies (Ratings and Inspections) Act be amended to require unrated non-life insurers to obtain and publish ratings. However, these changes have been delayed until the implications of the review of life insurance for non-life insurers, if any, can be ascertained to avoid the risk of any changes being undone.	Work on general insurance will be undertaken in conjunction with the review of life insurance.
Financial Intermediary Taskforce (MED)	Focus on the provision of financial advice (e.g., financial advisers, brokers etc) and identification of whether any occupational regulation is required to ensure effective consumer protection for investors in New Zealand's securities markets. Review being undertaken by six person external Task Force. An initial issues paper and request for public input made.	Report back by June 2005.
Securities Legislation Bill	The review of the securities trading law is designed to increase the effectiveness and efficiency of securities trading law (i.e., the law relating to the trading of	Select Committee Report back due June 2005.

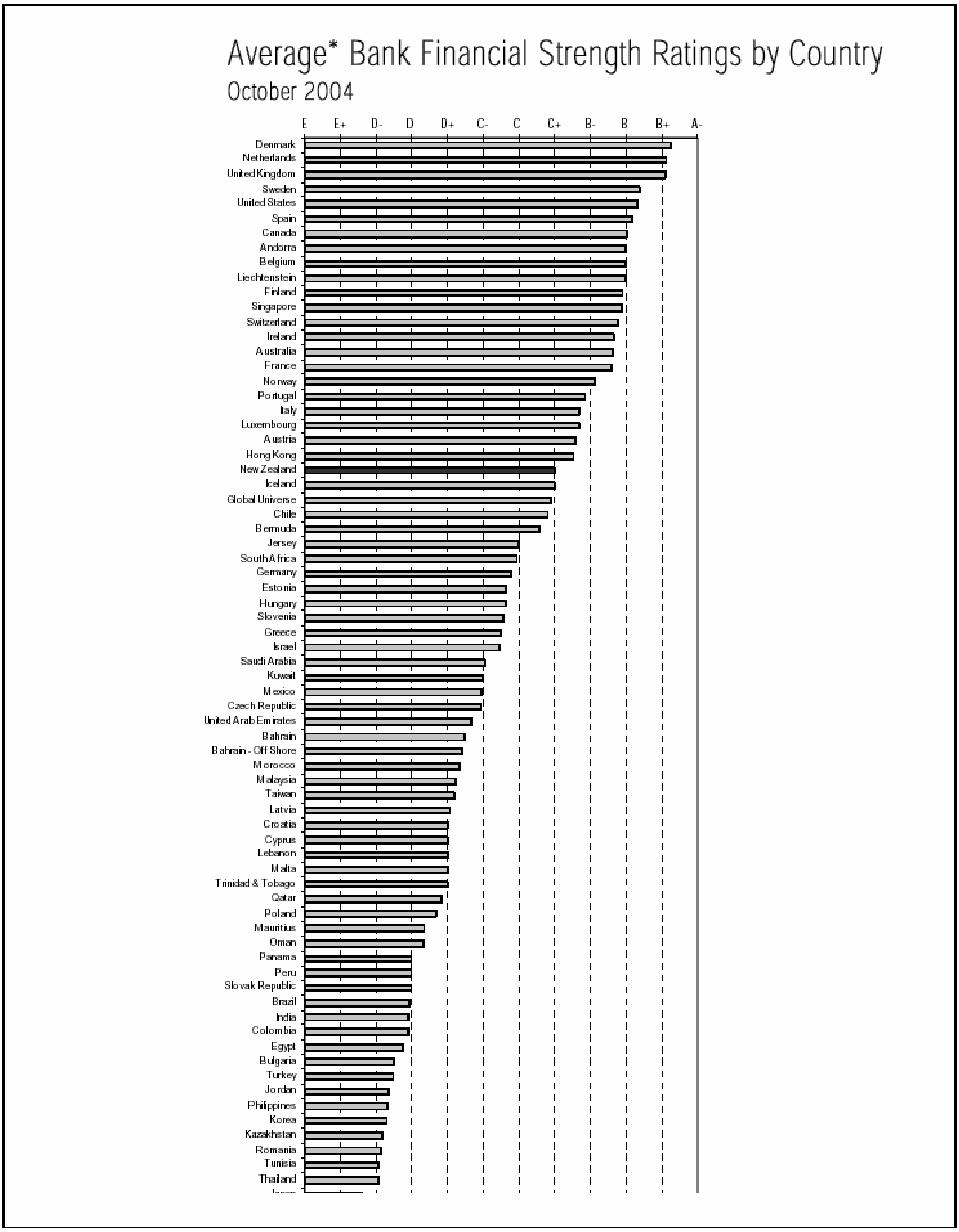
(MED)	securities and futures on registered securities exchanges and authorised futures exchanges). In particular, MED is seeking to strengthen the insider trading and market manipulation provisions, improve disclosure in relation to investment advisers and improve penalties and remedies. The Securities Legislation Bill incorporating these improvements has been introduced and referred to the Commerce Select Committee.	
Securities Act and other issues (MED)	The Securities Act review is the final part of MED's securities law reform programme and addresses all other areas of securities law not considered in the preceding reviews. Issues to be considered include the way in which securities are offered to the public, whether specific regulation of clearance and settlement facilities is needed, the regulation of financial intermediaries and collective investment vehicles, and the role of trustee corporations and trust deeds.	Will begin once resources permit.
Access Brokerage	The Securities Commission investigation into the collapse of Access Brokerage will consider systemic issues relating to the failure and may result in findings that call for improvements to the regulatory regime. This may lead to pressure to include any changes (likely to be in relation to clearing and settlement and minor improvements to the co-regulatory model) in available legislative vehicles.	N/A.
Mutual Recognition of Securities Offerings (MED)	Agreement on a framework for mutual recognition of securities offerings for New Zealand and Australia should be completed soon. Once agreement is reached Australia will progress legislation to implement the regime and New Zealand will also develop regulations to give effect to the regime.	TBA once agreement reached on timeframes with Australia.
Trans-Tasman Accounting Standards Advisory Group	The Advisory Group has been established with the purpose of advising the Australian and New Zealand accounting standard and oversight bodies on strategies to: *Establish a single set of trans-Tasman accounting standards within the broader context of both jurisdictions' objective of adopting international accounting standards; *Maximise the influence of Australia and New Zealand in the development of international accounting standards and the international accounting standard setting process.	Ongoing.
Review of the Financial Reporting Act	New Zealand is currently reviewing the Financial Reporting Act 1993 to ensure New Zealand's financial reporting requirements are appropriate for New Zealand circumstances. Following this review, it is intended that New Zealand's financial	This review is currently at an early stage and no legislative drafting has yet

	reporting regime will be sufficiently [flexible to take into account international standards and developments, in particular, the global trend towards International Financial Reporting Standards.	taken place. Discussion document issued late 2004, seeking submissions by Feb 2004. It is tentatively estimated that a Bill will be introduced by mid-2005.
Review of Auditor Regulation	Auditors are currently self-regulated, with the Professional Practices Board of ICANZ being responsible for setting entry and ongoing competence standards, considering complaints and carrying out disciplinary functions. ICANZ will be setting up a group of stakeholders to review this approach and recommend an appropriate path forward. MED has been invited to be a member of this group.	No timetable established yet.
Review of the Taxation of Investment Income (IRD)	The review of investment taxation, both onshore and offshore, has been submitted to the Government. This review sought to attain a greater degree of consistency in the taxation of investment, which would reduce distortions to investment decisions and address disincentives to save.	Timing of Government decisions early 2005.
Review of Credit Unions (MED)	Review is long running and in response to industry proposals to reduce the restrictions of the activities of credit unions relating to membership, capital raising and prudential management. Cabinet has agreed on a set of amendments to the FSCU Act. MED will be reviewing possibility of outstanding changes.	Report back to Cabinet in March 2005 **[Information withheld under section 9(2)f(iv) and 9(2)g(i) of the OIA 1982 – maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials, and maintain the effective conduct of public affairs through the free and frank expression of opinions]**
	New Zealand is likely to be found non-compliant with several key AML and counter terrorist financing (CTF) recommendations by the OECD and IMF. Work is being undertaken to address the serious deficiencies, including the lack of an effective	Decisions in mid 2005.

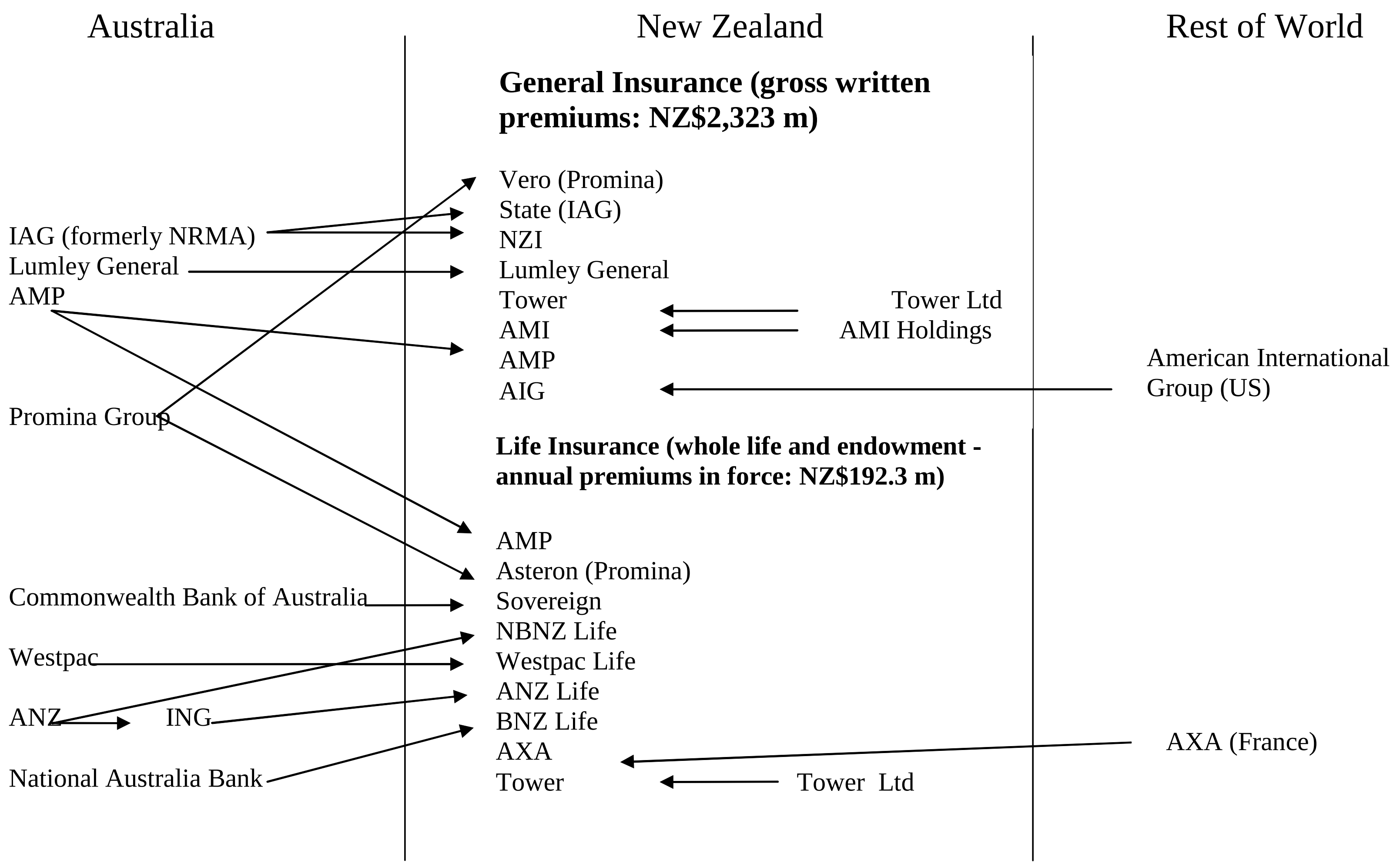
	AML/CTF regulator. This regulatory role could require registration, monitoring and enforcement roles for a range of institutions, including financial institutions. It is likely to raise issues of compliance costs, relationship with other financial regulation and interaction with similar Australian policies. Cabinet agreed in principle to address the main areas where New Zealand was non-compliant. An interdepartmental committee, led by MoJ, is working on developing options for Government consideration in early to mid 2005.	
Review of Insolvency Law including cross border insolvency (MED)	An Insolvency Bill containing a new voluntary administration regime for companies and the United Nations Commission on International Trade Law's model law for cross-border insolvencies. Australia has also signalled that it will adopt the model law and both countries have agreed to develop a more extensive mutual recognition arrangement under the framework of the model law. This will simplify both business rehabilitation and winding up proceedings where a debtor has assets in both countries	NZ proposes to introduce laws into the House in mid 2005.
Court Proceedings and Regulatory Enforcement (Justice led)	A joint working group of Australian and New Zealand officials is reviewing the existing arrangements for trans-Tasman court proceedings and regulatory enforcement to consider areas for future cooperation to reduce barriers to commercial activity and assist in dispute resolution. Led by Justice, but MED representation.	In early stages.
Developments in the provision of banking services across the border (NZTE)	NZTE has been working with the major banks to improve the ability of a NZ firm to set up an Australian bank account and borrow in AUD. Already some progress made by some institutions .	
Fast Growing Companies Joint-Agency Project	The aim of this group is to develop policy measures to improve access to debt, equity and internal finance for fast growing firms.	Joint-agency paper on high-level policy options by early October. Paper containing policy detail yet to be completed.
Maori Corporate Governance (MED and TPK)	The Ministry is working with Te Puni Kokiri on a project to develop a new high level governance entity to manage settlement assets.	Cabinet with detailed policy proposals 9 February. Introduction mid-year.

Savings Product Working Group (IRD/Tsy/MED)	The Savings Product Working Group reported to Dr Cullen. The government called for further submissions and officials are working on developing proposals for savings vehicles for announcement in the Budget 2005. These proposals cover savings for tertiary education, housing and retirement.	Budget 2005 announcement. Longer-term implementation.
Limited Partnerships Project (MED/IRD/MORST)	To facilitate venture capital investment, the government decided to amend venture capital taxation rules and the special partnership provisions of the Partnerships Act. The preliminary tax amendments have been made and MED has identified the major changes to special partnerships required to bring the regime into line with limited partnership laws preferred by the VC industry. These include the creation of a hybrid entity (incorporated entity with flow through tax treatment) which raises new tax issues. IRD and MED aim to complete policy recommendations by November.	Cabinet paper on the Partnerships Act to Cabinet March 2005.

Appendix Five: World comparison of average bank financial strength ratings



Appendix Six: Ownership of New Zealand insurers



Appendix Seven: Letter from RBNZ to APRA and RBA re crisis management coordination (November 2004)

1 November 2004

Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW
AUSTRALIA **By Fax:**

Reserve Bank of Australia
GPO Box 3947
Sydney NSW
AUSTRALIA **By Fax:**

Dear

PROPOSED COORDINATION BETWEEN AUSTRALIA AND NEW ZEALAND ON BANK CRISIS MANAGEMENT

In our recent conversations, I have noted that it would be desirable for the Reserve Bank of New Zealand (RBNZ) to work together with the Australian Prudential Regulation Authority (APRA) and Reserve Bank of Australia (RBA) to exchange views on responding to banking distress and failure events, with a view to identifying areas where closer cooperation and coordination would be feasible and desirable. As you know , I have exchanged letters with on issues APRA and the RBNZ could progress under our so-called 'enhanced home-host' relationship. is awaiting some clearer instructions from his Minister before proceeding too far down this path. However, we have sent a RBNZ staff member to work with APRA on Basel II issues, which we hope is a step in the right direction.

In that context, this letter sets out the main elements of the RBNZ's work programme as it relates to financial crisis management. It also indicates the issues we think could usefully be explored in joint discussions between the RBNZ, APRA and RBA.

RBNZ financial crisis work programme

The RBNZ has been developing its thinking on a range of financial crisis management issues for some time now. Our objective is to build on our existing capacity to respond effectively and efficiently to a single or multiple bank failure or liquidity event in ways that maintain a sound and efficient financial system, while preserving market disciplines on banks and other market participants and minimising moral hazard risks and the cost to the New Zealand taxpayer. In that regard, our work programme involves a number of initiatives that relate to different aspects of financial crisis management in the following areas:

- Pre-positioning
- Preparedness and capacity-building
- Emerging distress management
- Liquidity crisis management
- Bank failure management

I will briefly summarise the main initiatives in each category.

Pre-positioning

Our policies in this area are designed to facilitate effective crisis management by ensuring that the systemically important banks in New Zealand can be placed into statutory management or otherwise managed effectively in a crisis situation. This requires several attributes, including: reasonable legal certainty of the balance sheet in New Zealand for the registered bank and its banking group; unambiguous legal and operational ability of a statutory manager to assume control of a bank and its banking group in New Zealand; and the capacity to maintain essential banking functions on a stand-alone basis.

The main policies we have established to achieve this pre-positioning are:

- **Local incorporation.** We require all banks of systemic importance (defined to be those banks with funding net of related party funding of NZ$10 billion or more) to be incorporated under the New Zealand Companies Act. As you know, currently the only systemic bank not yet meeting this requirement is Westpac. We are currently considering a "buttressed branch" option as a possible alternative to local incorporation for Westpac, but have not yet reached decisions on this matter.

- **Outsourcing/stand-alone capacity.** We are about to release a paper for consultation, setting out the RBNZ's proposed outsourcing and stand-alone policy. The objective is to ensure that systemically important banks, and possibly some other categories of banks, have assured access to functionality (including systems, data and people) that enables the local board, or a statutory manager if the bank has been placed in statutory management, to maintain the bank's essential functions on a stand-alone basis. We have already established principles for outsourcing policy and have applied those to ANZ National Bank upon approval of its merger. A similar framework is currently being applied to Westpac. The consultation paper will formalise these principles and set out a policy framework for application to all systemic banks and probably some other categories of banks.

Preparedness and capacity-building

We are building on our existing resources to further enhance the RBNZ's preparedness for, and capacity to respond to, a financial crisis. This involves a number of initiatives, including:

- **Development of a crisis management toolkit.** Although we already have documentation setting out elements of procedures for responding to financial crises, we are now in the process of pulling these together into a toolkit. The aim is to have a relatively comprehensive, but user-friendly, set of policies and procedures to assist in responding to a financial crisis. The toolkit will cover a wide range of areas, including:

    - a framework for determining bank solvency;
    - guidance on the assessment of the feasibility and efficacy of different failure management options, and procedures for implementing them;
    - guidance on the internal administrative steps to invoke various crisis management options (eg preparation of directions to banks, preparation of statutory management Orders in Council);
    - identification of possible names of statutory managers and advisers for crisis situations;
    - checklists and decision trees for responding to particular crisis situations;
    - procedures for actioning our lender of last resort powers;
    - guidance on communications with various external parties in a crisis situation (including the Minister of Finance, parent supervisors, other banks, the public, the rating agencies, etc);
    - guidance on the nature of the directions to be given to a statutory manager in particular crisis situations.

- **Crisis simulation exercises.** We are planning to hold a crisis simulation exercise in 2005 to test the crisis management toolkit and to further hone the RBNZ's capacity to respond to defined crisis situations. The crisis simulation will probably be an in-house event, but where we draw on suitable external expertise to help design and facilitate the crisis simulation. If it proves to be a useful exercise, we may make it a regular feature of our crisis management capacity-building programme and possibly extend it to involve other parties. In time, there may be value in holding a trans-Tasman crisis management simulation exercise, involving the RBNZ, APRA, RBA and possibly other relevant government agencies.

- **External expertise.** In recognition that an important part of responding effectively to a crisis is being able to tap into requisite expertise quickly, the RBNZ is extending its contacts with relevant external experts. We are building up a network of experts who can be called upon to assist us in different aspects of the financial crisis management project, including those with expertise to advise on the design of crisis simulation exercises, aspects of bank functionality, legal issues and technical aspects of managing the failure of a large bank.

Emerging distress management

Another aspect of the RBNZ's financial crisis management work programme is reviewing and developing the RBNZ's capacity to respond effectively to an emerging bank distress situation, such as when a bank is in breach of conditions of registration, is under-capitalised (but still solvent) or is conducting its affairs imprudently (but not to the point of posing an immediate threat to its viability).

In this area, our work programme includes a number of initiatives:

- **Prompt corrective action framework.** The RBNZ has maintained a form of "prompt corrective action" framework since the mid 1990s. This sets out pre-defined actions when a bank's risk-weighted capital falls below defined triggers. We plan to review this framework to ascertain whether it is still appropriate or whether there may be scope to make it more workable and better suited to its objectives. Although we have yet to undertake any detailed work on this, it is likely that the review will include consideration of the nature of the triggers for corrective action (including whether the sole trigger should continue to be capital, or whether additional triggers may be appropriate), the level of the triggers, and the nature of the regulatory responses.

- **Direction-giving powers.** Under the Reserve Bank of New Zealand Act 1989 (the Act), the RBNZ has the authority to give directions to a bank with the consent of the Minister of Finance. The directions can be given in a wide range of circumstances, but only if the grounds set out in the Act have been satisfied. By and large, these mainly relate to the circumstances in which a bank is in a perilous condition, such as where it is severely under-capitalised or otherwise conducting its affairs imprudently, but not in statutory management. Directions can also be given when a bank has breached its conditions of registration.

  We plan to review and develop our policies and procedures for giving directions to banks in particular circumstances, with a view to having a greater capacity to act quickly and effectively when required. This work will include:

  - identifying the nature of the triggers for invoking our direction power (eg breaches of particular conditions of registration and defining the basis on which we might contend that a bank is conducting its affairs in an imprudent manner);
  - identifying the types of measures that might need to be taken by a bank or its shareholder in order to obviate the need for a direction from the RBNZ (eg the nature of the assurances that we would require from a bank's CEO and board, from a parent bank, from a parent supervisory authority, etc);
  - identifying the type of directions the RBNZ might make in response to particular triggers;
  - preparing the procedures for the invoking of directions (including identifying the legal checks required, the consultation steps required, the measures needed to protect the RBNZ's legal and reputation risks, etc);
  - identifying the nature of the communications required in particular circumstances; and
  - identifying possible contingency measures that might be required once the fact of a direction has become publicly known.

Liquidity crisis management

The RBNZ has the statutory authority to act as lender of last resort (LLR) to the financial system (and, in effect, to individual financial market participants) where the RBNZ is satisfied that this is necessary to maintain a sound financial system. Although the RBNZ has done a lot of thinking in this area, and has broadly determined the circumstances in which it may be prepared to act as lender of last resort, there is a need to develop a number of policies and procedures to operationalise lender of last resort policy. We are therefore planning to undertake work in this area, including on such matters as:

- identifying the situations in LLR might be appropriate;
- identifying the pre-conditions for acting as LLR;
- determining when LLR would be secured or unsecured;
- identifying the nature of the statements on solvency required from a bank's CEO and board, and the nature of parent bank solvency support;
- the nature of parent supervisor or central bank support required;
- identifying the nature of the security the RBNZ would be prepared to take, including in respect of portfolios of normally illiquid assets (such as residential mortgage loans or commercial loans);
- identifying the nature of any pre-positioning that might be required for secured lending – eg the nature of repurchase agreements, the nature of pre-positioning of asset portfolios, legal issues relating to the taking of security, etc;
- the types of terms and conditions that might be appropriate in different circumstances, including when lending might appropriately be done on above-market rates;
- the public communication aspects of LLR;
- the exit strategy in situations when the RBNZ has provided liquidity support to a bank in distress.

Some of the above work will tie into separate work we plan to undertake at some stage in the next year or two on possibly requiring banks to hold minimum levels of liquidity.

Bank failure management

Much of our work in the financial crisis management area relates to the development of the capacity to respond quickly and effectively to a bank failure. This involves a number of projects, including:

- **Bank creditor recapitalisation (BCR).** BCR is one of the main techniques we have identified to respond to a bank failure situation, particularly where the bank is systemically important. This is a mechanism that would enable the Reserve Bank to respond to a bank failure – including the failure of a systemically important settlement bank – in a manner that avoids or minimises the cost to the taxpayer, while still maintaining systemic stability. It comprises a number of elements, including:

  - applying a "haircut" to depositors and other creditors of the failed bank at a level assessed to be sufficient to absorb likely losses;

  - giving depositors access to the non-haircut portion of their deposits within a very short period of the failure occurring, but providing a government guarantee of those deposits so as to encourage depositors to keep their funds at the bank; and

- facilitating either the recapitalisation of the bank or some other resolution option that is consistent with maintaining a sound financial system. For example, BCR could enable a major bank to be recapitalised by a third party and its operations maintained largely intact, where the bulk of the losses are absorbed by creditors (the shareholders having already lost the value of their investment).

Much has been done to advance this project, including pilot testing of some IT pre-positioning at one of the major banks. We are confident that, from an IT technical perspective, BCR is likely to be feasible. However, substantial work remains to be done. This includes the need to clarify the treatment of banks' derivatives in a failure situation, clarify some of the legal elements associated with BCR, determine the process for estimating the size of the haircut required, determine the range of liabilities that would be subject to a haircut, consider the treatment of small depositors (including whether a de minimus exemption from the haircut might be appropriate), assess the efficacy of using a haircut to recapitalise a bank (as opposed to merely absorbing losses) and determine appropriate exit arrangements after implementation of BCR. A significant part of the remaining work associated with BCR will also need to be done for other failure management options.

- **Other failure management options.** Although we want to have BCR as a viable option for dealing with a large bank failure, we recognise that it is only one of a number of options available. We are therefore developing our thinking on other failure management options, including assessing the costs, benefits, feasibility and technical requirements of the following failure management options:

  - ***Good bank/bad bank split.*** This option would involve placing a bank in statutory management and then splitting out the viable parts, with a view to recapitalisation and subsequent release from statutory management, with the non-viable parts being disposed of in statutory management, liquidation or by way of sale.

  - ***Partial sale of failed banks' assets and liabilities.*** This option would involve selling parts of a failed bank's portfolios of assets and liabilities, with the remainder of the bank being liquidated in statutory management or through conventional liquidation.

  - ***Government bail-out.*** This option would involve the government recapitalising a failed bank (either in its entirety or only the viable parts of it), with remaining parts of the bank being liquidated.

  - ***Industry support.*** This option would involve encouraging survivor banks to provide capital support to a failed bank, possibly with government support.

Trans-Tasman cooperation and coordination

Although much of the crisis management work being advanced at the RBNZ is predicated on the assumption of maintaining a stand-alone crisis management capacity, we recognise that the nature of the New Zealand banking system suggests the need for close cooperation and coordination with parent supervisors and central banks where possible. In particular, as you know, we attach considerable importance to developing, and formalising if possible, cooperation and coordination arrangements between the RBNZ, APRA and the RBA.

In respect of financial crisis management, we see a number of areas which would benefit from close cooperation and coordination, including:

- Trying to achieve greater certainty in the exchange of information between the relevant authorities, particularly APRA and the RBNZ, on bank-specific and overall banking system data, in the lead-up to and during a financial crisis, so as to facilitate better-informed decision-making in both countries.

- Developing a stronger understanding of each other's public policy objectives, powers, policies and techniques for responding to financial crises.

- Identifying any legal conflicts or uncertainties relevant for responding to bank distress or failure events and seeking appropriate solutions.

- Developing an agreed understanding on the allocation of responsibilities between the RBNZ, APRA, RBA and the treasury departments of New Zealand and Australia in responding to financial crises involving banks domiciled or based in Australia with operations in New Zealand. Specific areas that would benefit from clarification and hopefully agreed positions would include:

  - Protocols for determining when and how a joint home/host bank resolution strategy could be used to resolve a cross-border crisis and on the circumstances in which it may be necessary for each country's authorities to respond separately to a crisis.

  - Agreeing on the allocation of responsibility for the provision of liquidity support between the home and host central banks in defined circumstances. This would include assessing the nature of undertakings (such as to the solvency of the bank in question) that the RBNZ or RBA might reasonably expect to receive in agreeing to provide liquidity support to an Australian-domiciled bank, the nature of possible loss-sharing arrangements, and possible guarantee arrangements associated with the provision of emergency liquidity support.

  - Agreeing on mutual commitments on the ongoing provision of essential management, technical and support services between the Australian and New Zealand operations of Australian-domiciled banks, so that the banks' operations could be maintained without disruption in a failure situation.

  - Agreeing on a framework for determining the extent to which the New Zealand bank subsidiaries of Australian-domiciled banks could draw on support from the Australian parent operations in a crisis.

- Facilitating coordination of public communication between the home and host authorities in responding to a cross-border financial crisis, where appropriate.

- Exchanging views and information on crisis management issues and cooperating in policy development and implementation, where appropriate. This might include cooperating in the development of crisis management toolkits, techniques and strategies.

- Exploring the possibility of coordinated crisis simulation exercises, with a view to testing coordination arrangements in responding to trans-Tasman crisis situations.

- Formalising some of the above by way of an amended and strengthened MOU between the RBNZ and APRA and implementing an MOU between the RBNZ and the RBA.

We would like to advance these issues with the RBA and APRA, with a view to making progress in developing and implementing crisis management cooperation and coordination arrangements over the next 12 months if possible. To that end, we think it would be desirable if the three institutions could have a preliminary meeting (in Sydney) perhaps early in the new year, if possible, to scope the nature of the project and map out future steps. I have asked [

], to contact the appropriate persons in APRA and RBA to explore the possibility of holding a meeting later this year for that purpose.

Should the appropriate staff in APRA and RBA wish to contact [ ] in the meantime, his contact details are:

Telephone: [ ]
Facsimile: [ ]
Email: [ ]

As a first step in promoting closer cooperation between the RBNZ, APRA and RBA, I have attached to this letter a list of key contacts in the Financial Stability Department of the RBNZ. It would be appreciated if you could arrange for similar contact lists to be sent to us at your convenience.

We look forward to working with the RBA and APRA on these issues.

Best Regards

Appendix 8: RBA response to RBNZ letter on crisis management coordination (November 2004)

RESERVE BANK OF AUSTRALIA

65 Martin Place
GPO Box 3947
SYDNEY NSW 2001

Telephone (61 2) 9551 8500

Financial System Group

http://www.rba.gov.au
Facsimile (61 2) 9551 8054
Email lowep@rba.gov.au

12 November 2004

Reserve Bank of New Zealand
PO Box 2498
Wellington
NEW ZEALAND

Dear

PROPOSED COORDINATION BETWEEN AUSTRALIA AND NEW ZEALAND ON BANK CRISIS MANAGEMENT

Thank you for your letter of 1 November providing us with an outline of the RBNZ's work programme as it relates to financial crisis management – it looks a challenging set of tasks!

As we have previously discussed, the RBA is happy to participate in further discussions on trans-Tasman co-operation with respect to banking crises. As you know, given the strong interconnections between our banking systems, our view is that problems with a bank on one side of the Tasman are likely to affect materially the bank on the other side of the Tasman. As a result, in most cases, a co-ordinated response is likely to deliver the best outcome for both countries.

In terms of timing, it would seem sensible from our perspective to co-ordinate trans-Tasman discussions as best we can with the work that is now underway in Australia under the auspices of the Council of Financial Regulators. The Council has established a Working Group of APRA, ASIC, Treasury and RBA officials to review current crisis management arrangements with a view to identifying potential improvements. The Working Group, which is chaired by will be reporting back to Council in December. Following those discussions, perhaps a sensible next step would be for to contact to see where the Council's and the RBNZ's work programs overlap. In the meantime, if would like some further background, he should of course feel free to be in touch with

Finally, in response to the contact details you provided for the RBNZ, please find attached details for key personnel in the RBA's Financial System and Financial Markets Groups. You will see we have also provided out-of-hours contact numbers in case a crisis spills beyond our normal working day!

Warm regards

Appendix 9: Letter from APRA to RBNZ on enhanced home/host supervision (September 2004)

Australian Prudential Regulation Authority

400 George Street (Level 26)
Sydney NSW 2000

GPO Box 9836
Sydney NSW 2001

T 02 9210 3100
F 02 9210 3102
W www.apra.gov.au

CS-100-OC

OA

RECE... 2 SEP 2004

FAXED 15/9/04

15 September 2004

— Plse put on record

Reserve Bank of New Zealand
PO Box 2498
WELLINGTON NEW ZEALAND

Dear

Thank you for your letters of 11 August and 3 September 2004.

WITHHELD UNDER SECTION 6 OF THE OFFICIAL INFORMATION ACT 1982

We in APRA are also committed to maintaining a strong and cooperative relationship between our two agencies. Your letter of 3 September outlined a number of ways in which you saw the relationship moving forward, and I have asked my senior front-line and policy staff to come back to me with their views. Before offering a substantive comment to your letter, however, think it proper that our political masters have the opportunity to digest and respond to the broader range of options discussed in the working group's paper. For our part, we have had no indication of the Treasurer's views and, given the election, we are unlikely to for some little time.

Nonetheless, one area where I am hopeful we can make quick progress is, as we have discussed, a secondment from the RBNZ to our Basel II team, aimed at providing hands-on exposure to Basel II issues. We think both agencies would benefit most if the secondee was around middle-management level and had an understanding of regulatory capital issues, banking practices and, desirably, some quantitative skills. Presumably, the RBNZ would see the secondee as someone who would take on a senior role in its Basel II team on return.

If you had a suitable candidate in mind for such a secondment, we would be ready to welcome that person as soon as the administrative arrangements are sorted out.

I look forward to your thoughts on a secondment, and to further discussions on the relationship between APRA and the RBNZ.

Yours sincerely,

Banking Sector Advice

Report prepared for:

The Treasury

Client contacts:

Burleigh Evatt contacts:

Date: 9 November 2004

Contents

Status

This document is confidential and is intended for The Treasury internal use only.

burleigh evatt report for mfirg - oia version.doc

Summary

Introduction

This report comments on the activities of Australian owned trading banks in respect of the following:

- Barriers to seamless provision of trans-Tasman banking services.
- Transfer of entrepreneurial decision-making and core processing functions from New Zealand to Australia.

These issues are discussed in separate sections of the report.

Our comments on barriers to a seamless market are based on a static comparison of current trans-Tasman business activity and banking services. Centralisation of decision-making and processing is analysed in terms of the influences driving centralisation and the impact of the different bank strategies on future centralisation initiatives.

What we did

Our report focused on preparing a qualitative response to the issues based on the experiences and observations of former bankers.

These comments are supplemented by information from a cursory review of the available literature and movement in bank expense to income ratios.

Seamless market

Australian and New Zealand banking services do not interact at a customer level due to differences in banking practices. The differences in banking practices reflect structural differences between the economies and legal systems of the two countries.

Our analysis has focused on payment and lending products[1]. The lack of a common currency is the primary barrier to integrated payment services.[2] Differences in commercial law, and the lack of a common currency are the primary universal barriers to integrated lending products. In addition differences between local markets and industries inhibit centralisation of lending decisions.

We have not found any evidence of a significant unmet demand for integrated trans-Tasman banking services. We have also not found any evidence of initiatives to improve the integration of banking services.

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[1] The comments made are also applicable to deposit and wealth management products but they are not discussed in this report. Demand for these products comes mainly from personal customers. These customers have less incentive and capacity to work through legal and taxation differences between the two countries than firms operating in New Zealand and Australia.

[2] If there was a common currency, differences between the core payments systems would be a non-trivial barrier to establishing common payment systems. This barrier would probably be overcome by designing a specialised processing layer available to a small number of customers through desk banking products rather than a global change to the payment processing system.

Hollowing out	Centralisation of decision-making and outsourcing of processes reduce the responsiveness of subsidiaries to local market conditions. There is strong anecdotal evidence of a significant transfer of high-level and entrepreneurial decision-making to Australian head offices. The evidence of out-sourcing of processing functions is ambiguous. The extent to which centralisation and out sourcing of core information technology (IT) and back office processing has achieved a common process for trans-Tasman operations or a sustainable cost advantage is unclear.
Different strategies	Individual banks have adopted markedly different centralisation strategies. These strategies have been modified if have they failed to deliver adequate results[3]. However, the recognition of the need for strategy modification is heavily dependent on comparison with the strategies and results of the other Australian owned banks.[…………] **[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information]**
Impact of centralisation	Centralisation increases uncertainty and volatility in the response of bank subsidiaries to changes in local market conditions and exposure to spill-over effects from changes in the performance of the Australian parent bank and the Australian economy. Under centralisation local knowledge is heavily discounted and Australian business models are assumed to apply to the New Zealand market. This combination tends to make local branches less responsive to local market conditions where there are sectoral differences between the Australian and New Zealand economies (such as rural lending and food processing). We have not found any evidence that centralisation generates significant economies of scale or that these economies are passed onto branch customers.
Conclusion	Barriers to a seamless trans-Tasman banking market are due to fundamental differences between the two economies. There is little evidence that differences in banking systems are a fundamental impediment to trans-Tasman banking activity. Centralisation of decision-making and processing functions is expected to reduce the predictability of local branch management decisions. There is no evidence that centralisation reduces the cost of provision of local services.

[3] **[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information]**

1. Introduction

Introduction

The comments in this report are a contribution to Treasury's report on harmonisation and in particular the question:

"How well is the financial system performing in delivering financial services that support growth and economic development in New Zealand?"

The report comments on the following issues:

- Barriers to the seamless provision of financial services in Australia and New Zealand and the relative size of these barriers.
- Influence of re-location of management and technological capacity from New Zealand to Australia on the quality, type, and efficiency of financial services provided in New Zealand.

We have answered these questions in separate sections. Our approach is described below.

Discussion and interviews

The analysis in this report relies primarily on the observations of ex-bankers i.e. our experience in the banking sector and the experience of the ex-bankers we interviewed.

[………] **[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information]**

As the brief precluded direct contact with the banks, the comments are based on employment experiences that are two to three years old. However these observations are the best available indicator of the changes in local bank decision-making processes.

The influences of centralisation on bank decision-making are subtle and closely entangled with global performance improvement strategies. This entanglement hinders the accurate attribution of efficiency improvements to centralisation.

Literature search

Our experience-based observations were supplemented by a brief review of the available literature comparing the New Zealand and Australian economies and on strategies for improving bank efficiency.

The purpose of the literature review was to test our observations against available qualitative and quantitative evidence.

Research on the differences between Australian and New Zealand business practices is sparse and fragmented. We have cited reports on interdependence between the Australian and New Zealand economies[4], hurdles to export growth faced by small and medium enterprises (SMEs)[5], and bank attitudes to financing SMEs[6].

There is substantial international research on strategies for improving bank efficiency through process redesign, out-sourcing and off-shoring. However this research is not directly relevant to the centralisation questions in the brief. The available literature on New Zealand bank efficiency suggests that local process re-design initiatives have made a much larger contribution to efficiency than centralisation, off-shoring or out-sourcing.

Further research

The analysis in this report was constrained by the limited time available to complete the report and the restriction on consulting with banks.

The comments in this report suggest the following directions for further analysis:

- Testing of the comments in this report against the recent management decisions of banks and the attitudes they have indicated in consultations with the Treasury and Reserve Bank of New Zealand (RBNZ).

- Analysis of the changing dynamics of competition and strategy between the major Australian owned banks operating in New Zealand.

[………..]**[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information]**

Conclusion

Our report is based on the experiences and observations of former bankers supplemented by a cursory review of the available literature.

The report describes a starting point and directions for analysis of how the banks approaches to seamless markets and centralisation may change collectively and vary individually over the next three to five years.

In the next section, we discuss the barriers to a seamless market.

[4] "New Zealand –Australia Economic Interdependence", 4 May 2004, prepared by LECG and ACIL Tasman for the Ministry of Economic Development.
[5] "Growing Pains: New Zealand Qualitative Evidence on Hurdles to Exporting Growth", New Zealand Treasury Working Paper 02/10 June 2002, by Geoff Simmons.
[6] "Bank Lending Practices to Small and Medium Sized Enterprises", July 2003, by Price Waterhouse Coopers for the Ministry of Economic Development.

2. Barriers to a seamless market

Introduction

The brief sought to *"better understand the barriers to the seamless provision of financial services in Australia and New Zealand and the relative size of these barriers"*.

The brief included the following specific questions:

- *"How well do bank operating systems in New Zealand and Australia interact?*
- *If badly, what impact does this interaction of operating systems have on New Zealanders wishing to access banking services in Australia? That is:*
  - *who will be most affected;*
  - *why will they be affected; and*
  - *how are they affected?*
- *Are New Zealand firms operating in Australia (or wishing to) adversely affected by the way in which commercial decisions are made in Australia in relation to banking i.e., why is it more difficult for a small New Zealand firm operating in Australia to raise financing from an Australian bank than a small Australian firm? How important is the relationship factor?*
- *Will any of the barriers identified above self correct over time? What, if anything, would provide the impetus for change?*
- *How, and to what extent, do legal and regulatory differences prevent a seamless market (e.g., privacy law, tax, different currencies other regulatory barriers)?*
- *Are there any other impediments to the seamless provision of banking services across the Tasman?"*

These questions are discussed in the following paragraphs. Our analysis has focused on payment and lending products[7]. The lack of a common currency is the primary barrier to integrated payment services.[8] Differences in commercial law, and the lack of a common currency are the primary universal barriers to integrated lending products.

[7] The comments made are applicable to deposit and wealth management products. However these products are not particularly relevant to the questions raised in the brief

[8] If there was a common currency, differences between the payments system would be a non-trivial barrier to establishing common payment systems.

How well do operating systems interact	For most services and transactions the banking systems of the Australian parents and the New Zealand subsidiaries operate independently. Linkages do exist for internal accounting, taxation, audit, credit risk, global exposure, interbank settlement and transfer of foreign exchange, financial market derivative positions. The limited interaction between the systems is a function of the following fundamental differences between New Zealand and Australia: • Separate currencies with independent monetary policy and different economic structures[9]. (Volatility in the cross rate between the two currencies is a significant source of risk for organisations operating between the two countries.) • Differences in local market conditions and business performance. (Loan decisions for small and medium sized enterprises are based on judgement of the credibility of local management. These decision processes rely on local knowledge and are difficult to centralise in Australia.) • Jurisdiction of commercial law and enforceability of loan security instruments is effectively limited to the country in which the security is registered. Despite common legal foundations there are many subtle differences in the legislation and surrounding case law precedent for the establishment and realisation of security. In Australia there are also significant differences between state commercial laws. • Disconnection of the payments systems for businesses. There is no simple or effective method for SMEs to make same day cross border payments. The available methods are based on telegraphic transfer technology, which requires several days to execute the transaction.
Payment system caveat	Personal customers and large corporates do have access to payment methods that offer a more integrated service than payment methods available to SMEs. Personal customers can use credit cards[10] issued in one country to withdraw cash and pay "merchants" in the other country. This reflects the fact that credit card systems[11] are equipped with interbank and cross currency settlement functionality. However, there are limits on transaction size and delays in the determination of the exchange rate applied to the transaction that make this payment method in-appropriate for business transactions. Similarly, large corporates have access to "set-off" arrangements, customer foreign currency accounts and the "wholesale" foreign exchange market that allow major trans-Tasman payment risks to be managed in one country at low cost.

[9] We were unable to identify a recent comprehensive structural comparison of the New Zealand and Australian economies.
[10] This also partially meets the needs of personal customers for unsecured personal credit.
[11] This functionality is available on debit cards issued that use international credit card systems.

Banking relationships	Our impression is that customer relationships with the Australian owned parent and the New Zealand subsidiary are treated as independent relationships. Banks do not go out of their way to harmonise provision of services (except for large corporate accounts). For SMEs, banks are only willing to provide letters of referral and facilitate introductions between the parent and subsidiary. Online and desk[12] banking products can be used by customers to obtain a combined overview of their bank account positions in both countries. Large corporates are offered limited integration of services through the "account level" co-ordination by the relationship management team that deals with the corporate. However this is designed to co-ordinate provision of stand-alone local services in distinct (banking) regions and does not amount to a "fully integrated service". For most customers, banks will value and manage relationships independently in each country according to the usage of banking products in that country rather than consider the aggregate relationship across the Australian parent and New Zealand subsidiary banks. These comments are consistent with the responses from banks reported in the report on New Zealand-Australia economic interdependence quoted[13] below: *"banks say that they can afford to provide seamless services (which require substantial human intervention) only to larger customers (say over $100 million turnover per year); for smaller customers (e.g. under $10 million turnover per year) the integration of banking services is limited to what can be done by systems; middle sized customers get mixed service. This is confirmed by some of their clients we interviewed."*
Who is affected?	Based on the above comments, SMEs are the group most likely to have an un-satisfied demand for integrated bank services. Personal customers have access to an integrated payment service which meets the main requirement for integrated service needs[14]. Corporate requirements for service integration are met through tailored relationship management.

[12] Desk banking products were offered to large business customers to provide a secure electronic link for initiating and authorising intra-day transactions. However, the payment instructions and monitoring provided by these products were implemented by and reconciled through the banks' core payment processing systems. These systems preceded internet banking and still contain richer functionality than internet banking offerings.
[13] Source: "New Zealand –Australia Economic Interdependence", 4 May 2004, prepared by LECG and ACIL Tasman, p33.
[14] Examples of other potential sources of demand are finance for trans Tasman investment property purchases and access to investment products or online share trading. Markets for these services appear to be relatively small.

Affected firms	Customers most likely to be affected by the lack of integrated services are those operating production and distribution networks in both Australia and New Zealand but without significant trade relationships outside the two countries. This is likely to be a small subset of firms that trade goods and services with Australia which is itself a small subset of the population of firms in both countries. Research by the New Zealand Treasury on hurdles to export growth[15] estimated the following: • Approximately 4 percent of both New Zealand and Australian firms were involved in export activity. (Trade destination statistics suggest that approximately 20 percent of New Zealand trade is with Australia.) • Exporting by New Zealand firms is tightly concentrated among large firms. (Approximately 1.6 percent of New Zealand firms account for 76 percent of New Zealand exports and firms with more than 50 employees, have a much higher propensity to export than smaller firms.) • The majority of New Zealand exports are resource based (mainly in the form processed food products). The rationale for the limited relevance of integrated trans-Tasman banking services to businesses involved in trans Tasman trade but not operating production and distribution networks in both Australia and New Zealand is outlined below.
Limited relevance to traders	Firms that operate primarily in either New Zealand or Australia, and trade with the other country, are unlikely to be significantly affected by the lack of integrated services. For these firms, it would be logical to operate their core business financing and payments services in the country in which their core business is located. Trade finance products could adequately meet the financing and payment requirements for the "foreign" market in which these firms are trading. Foreign exchange risk management products can provide these firms with a far richer range of risk management options than dividing their banking business between the two countries. (Research on bank lending to SMEs does not suggest that access to finance in New Zealand is a constraint on business growth, or that SME borrowing costs are lower in Australia[16]).
Limited relevance to multinationals	Firms that are multinational enterprises (MNEs) trading beyond Australia and New Zealand or are branches of multi-nationals would gain little benefit from integrated trans-Tasman financial services. Processes for cross-border transactions have to be established within these businesses as part of their multinational operations. Access to capital markets and

[15] "Growing Pains: New Zealand Qualitative Evidence on Hurdles to Exporting Growth", New Zealand Treasury Working Paper 02/10, p 6
[16] Source: "Bank Lending Practices to Small and Medium Sized Enterprises" July 2003 by Price Waterhouse Coopers for the Ministry of Economic Development

borrowing arrangements are heavily influenced by the funding decisions and credit rating of the parent. (The concentration of New Zealand exports with large firms suggest that their need for "integrated" banking services is more likely to be met through the tailored relationship management offered to corporates than through generic "mass market" services.)

Nature of affects

The lack of integration in financial services is a consequence of fundamental differences between the New Zealand and Australian economies.

These differences are the primary cause of "additional" transaction costs between the two countries and cannot be mitigated by the integration of banking services.

For example, an integrated payments system offers little benefit to businesses as long as the both countries operate independent currencies. The primary driver of cross currency payment risk and cost is the uncertainty in the exchange rate. Similarly an integrated trans-Tasman loan application and approval processes is of little benefit to business without harmonising commercial law and taxation regimes to remove the need for separate documentation.

Estimating the additional transaction costs attributable to separate trans Tasman financial services while these fundamental barriers exist is difficult. At most the additional costs would include the cost of duplicate accounting systems and loan arrangements[17].

We have not found any evidence that the barriers are used to systematically restrict customer access to financial services in either country or extract "rents" for accessing cheaper or more efficient services.

Will barriers self-correct

Market pressures are unlikely to generate integrated provision of financial services over time. As discussed above the processes for providing the services are a symptom but not the root cause of geographical boundaries in the provision of financial services.

Furthermore the affected group of businesses is too small relative to the population of firms or size of banking operations in either country to justify the cost of developing "mass market" integrated services.

Any move towards provision of more integrated trans-Tasman payment services is likely to be at the presentation rather than the core processing layer of services and to be driven by marketing or political rather than classical supply and demand pressures.

Desk banking or internet banking products allow customers to view account positions in the New Zealand and Australian banks[18]. These systems could possibly be extended to accept simple payment or transfer instructions between the

[17] The word "arrangements" is intended to cover the registration of an acceptable borrowing entity in Australia, application process, legal costs of establishing the loan and related security, and ongoing management of the loan such as rate reviews, financial reporting, and compliance with covenants etc.

[18] We have not been able to identify how widely these services are used by the "affected" businesses.

	two countries. This change would only be "presentational" as the mechanism for fulfilling the instruction would still be based on existing payments processes (including currency conversion).
Legal and regulatory barriers	As discussed above, the absence of a common currency and differences in commercial law and economic structure are the main drivers for distinct and independent banking services in Australia and New Zealand. The lack of a common currency and independent monetary policy are direct barriers to the provision of integrated banking services. Effectively the unit of measurement for banking products i.e. dollars, and the main "price" i.e. interest rates are different in each country. Therefore any integrated service will always need to be a dual currency/dual interest rate offering. The attendant exchange and interest rate volatility risk of the dual offering need to be allocated between the customers and banks before other standard banking service issues can be considered. Differences in commercial law[19], economic structure and taxation indirectly discourage the provision of integrated banking services by reducing demand for these services. These differences discourage firms in New Zealand and Australia from establishing production and distribution activity in both countries that could increase demand for integrated financial services.
Other barriers[20]	Variation between state laws and taxation of financial transactions create another tier of impediments to seamless trans-Tasman markets.
Conclusion	In the absence of a common currency and the related economic and legislative harmonisation, there is unlikely to be any development of integrated services. The economic rationale for development of integrated services is weak. A small number of firms are affected and the costs that could be avoided through an integrated service are unlikely to be significant. Some banks may attempt to offer presentational integration of payments services for marketing or political reasons. In the next section, we discuss the centralisation of banking decisions.

[19] Privacy law requirements have been suggested as a barrier to integrated financial services because of differences in principles and practice. These differences would make it difficult for banks to unilaterally extend integrated services to all customers. However, if banks offered a new integrated service to a small group of "informed" customers, the risk of privacy law complaints could be mitigated by these customers accepting terms and conditions that "re-contract" how these provisions are applied.
[20] The complexity of non-resident with-holding tax has also been cited as an impediment to demand for trans-Tasman banking services but we have not been able to establish if this is still a significant perceived barrier.

3. Hollowing out

Introduction

The brief sought information on how *"relocation has influenced the character (e.g., quality, type, efficiency) of financial services provided in New Zealand."*

The brief included the following specific questions:

- *"What are the key factors behind re-location in either direction (e.g., labour costs, dynamic efficiency)?*
- *What is the impact of the re-location seen to date on the provision of financial services in New Zealand? In particular:*
  - *has there been any impact on credit allocation in the New Zealand economy? (e.g., relationship lending to SMEs);*
  - *has the relocation of banking activities led to a more efficient provision of particular services in New Zealand;*
  - *has the relocation had implications for the quality, range and price of services provided in New Zealand (e.g., speed of decision making, tailoring of products to the New Zealand market)*
- *Which customers are most affected by the effects of relocation (both those potentially advantaged and disadvantaged)?*
- *What costs, if any, is this relocation imposing on New Zealand households, firms and the wider economy?"*

There is strong anecdotal evidence of a significant transfer of high-level and entrepreneurial decision-making to Australian head offices as well as attempts to out-source processing functions. These strategies have been superimposed on a common strategy which has included the following:

- Reducing cost through process redesign and rationalisation of branch networks.
- Diversifying product ranges and increasing non-interest income.

In the following paragraphs, we summarise our impressions of centralisation before commenting on the questions in the brief.

Observations on differences between NZ banks

The current market positioning and behaviour of New Zealand banks is a function of significant divergences in strategy since the early to mid nineties. Key differences are due to the extent of centralisation in Australia and approaches to local mergers and acquisitions.

A detailed description of these strategies and collection of supporting evidence is beyond the scope of this paper. Our impression of the key strategies pursued by each bank is listed below:

- **[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information]**
- **[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information]**
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Bank strategy decisions including centralisation are made in the context of trading off long term business sustainability against short term improvement in financial indicators. The linkages between strategy and outcome are complex, difficult to measure and affected by unpredictable feedback loops and shocks. Banks respond to this complexity by attempting to apply simple metrics to their business and to compare their operations with the other major Australian owned banks.

Relocating decision-making

Relocation of decision-making has been achieved through transfer of reporting lines for New Zealand executives from New Zealand CEOs to the Australian parent, application of Australian business models and performance metrics [21] and requirements to demonstrate alignment with Australian parent (IT) architecture and strategy.

Relocation of entrepreneurial decisions is usually driven more by corporate philosophy and competition between the “centre” and subsidiary management than

[21] Recruitment of New Zealand CEOs from the Australian parent and the need for ambitious New Zealand executives to win credibility in Australia to advance their own careers provide practical impetus to the adoption of Australian parent models.

	by rigorous economic[22] justification. Typically, the centre view is based on the following: • A philosophy that centralisation will enable cost cutting and lower risk. • An initial assumption that the centre understands the branch markets as well as the parent's "home" market. (Local expertise is discounted particularly where the local expertise conflicts with the approach advocated by the centre.) • A preference to apply the "home" market business model and strategy to the branch in the belief that this will limit the risk of a surprise failure.
Consolidation of accounting functions	The consolidation of accounting, taxation and risk management processes and decisions in the parent has important implications for the management decisions of the subsidiary. Accounting consolidation increases the potential for divergence between the management accounting on which the branch management is measured and the financial accounting which is used in reporting. The divergence can also potentially obscure transfer pricing methodology and the allocation of "efficiency gains". There may also be reduced capability on the part of branch management to meaningful contest accounting treatment or debate interpretations of local accounting standards. Similar comments apply to taxation and the management of risk areas such as operational, credit and financial market risk management decisions.
Moderating influences	"Excesses" of centralisation are strategies are moderated by adverse impacts on the sustainability of the branch business. Differences in local branch performance expose differences in the strategy of the parent banks and can create pressure for remedial action. For this mechanism to operate, differences in strategy have to exist and be recognised. Our impression is that the variation in the strategies and autonomy of New Zealand has diminished over the last five years. Arguably this increases the risk of a mismatch between New Zealand branch service offerings and local requirements and the "volatility" New Zealand branch responses to credit "shocks" in Australia or New Zealand. This may create opportunities for other banks or non bank finance providers specialising in lending to particular sectors to expand their presence in sectors where the banks are not competing effectively.

[22] High level banking strategy decisions are heavily influenced by competitor behaviour and grand "visions". The complexity of the linkages between business processes, systems, and short and long term customer behaviour are extremely difficult to model. This makes it very difficult to allocate process redesign or systems development costs to revenue streams or customer groups or to develop counterfactuals.

Process and IT re-location	Re-location arguments for processing and core IT activities are often ostensibly driven by economies of scale. However the difference in business process systems and the relative size of the operations raise doubts about whether centralisation achieves scale economies Recent studies of New Zealand branch efficiency suggest that efficiency gains are due to “x efficiencies” i.e. re-combining inputs more efficiently to produce a given set of outputs rather than scale effects. A superficial comparison of the income expense ratios for New Zealand branches over the last five years suggests that have remained tightly grouped but have all fallen significantly. This seems to contradict the view that centralisation was necessary or sufficient for significant improvement sin efficiency.
Other incentives	Other factors[23] typically considered in re-location decisions include the following: • Quality of infrastructure and other resource costs[24]. (Processing centre costs in Australian cities other than Sydney or Melbourne are not dis-similar to those in Auckland.) • Starting point for the relocation decision i.e. is the function “new” or in need of substantial transformation and upgrading. • Australian state government incentives for location of processing functions[25].
Moderating influences on IT re-location	Re-location of IT processes is constrained by difficulties in connecting new and modified systems to existing legacy systems without reducing operational effectiveness and reliability. Addition of new systems increases the complexity of the existing network of systems exponentially. Technical solutions are available to manage this complexity. However, there is continual tension between ensuring rapid implementation of single applications and maintaining an infrastructure that avoids complexity and enables ongoing rapid implementation. These tensions are exacerbated when attempting to synchronise system upgrades for the Australian and New Zealand divisions of the same bank. System upgrades are often designed for different business requirements. Even if the upgrades are similar, they are seldom implemented at the same time. Therefore, it is unusual for the divisions of the same bank to be operating the same version of given platform at the same time.

[23] Labour costs are likely to be lower in New Zealand but the labour market is not as deep.
[24] Comparison of the cost of back-office service and process operations are significantly higher
[25] This attracts processing activity. Australian federal and state government attitudes to economic intervention discourage removal of processing activity from Australia. Recent questions to Australian banks on their consideration of off-shoring call-centre functions were answered defensively.

	Centralisation tends to create a feedback loop where priority is given to system changes required by the parent particularly where business impacts are difficult to compare. The consequences of "failed" centralisation are usually absorbed into the cost structure of doing business and seldom crystallise around a particular product or process. [26]
Impact of re-location on provision of services	Centralisation of decision-making does not appear to have reduced the range of services offered to New Zealand customers. However centralisation increases uncertainty and volatility in the response of banks to changes in local market conditions and to spill-over effects from changes in the performance Australian parent bank and the Australian economy. Centralisation decisions involve a complex trade-off between optimistic estimates of short term cost and risk reduction and poorly understood customer responses[27]. The following paragraphs discuss examples in payment processing and loan decisions to illustrate these points.
Payments system innovation	Payments system innovation was limited in the late nineties by centralisation of decision making. Previous innovations in the payments system such as EFTPOS relied on relatively rapid decision-making between the CEOs of the New Zealand subsidiaries of the Australian banks (irrespective of how they decided to respond to individual proposals.) The approach of the New Zealand payment system was based on multi-lateral arrangements operating in a single tine zone. The approach of the Australian payment system was based on bilateral arrangements across multiple time zones. […………….] **[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information]** Arguably this has permanently lowered the capability of subsidiaries to initiate payment system changes. Innovations such as EFTPOS are less likely occur in this environment because decisions cannot be made quickly and because they represent a "risky" departure from the Australian model.

[26] The reference in the latest BNZ profit announcement to a write-down of $75 million as the New Zealand division's share of the cancellation of group wide systems initiative is an interesting example of this issue. The basis for the sharing of the write-down was not stated and the allocation of the write-down to New Zealand raises interesting question about the tax deductibility of this expense. [……..]**[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information]**

[27] The recent decision by the National bank to retain core IT processing for in New Zealand provides an example of how the rationale for these decisions is varied. The initial intention to centralise was based on economies of scale. The reversal of the decision was apparently based on the judgment that the analysis had not considered the potential loss of revenue from disaffected customers. Source: "Two into one just won't go, says ANZ" Gareth Vaughan, The New Zealand Herald, 27 October 2004.

Credit allocation decisions	Centralisation of the credit policy and global exposure allocation steps in credit decisions can reduce the responsiveness of banks to local market conditions even if the loan approval authority is retained in New Zealand. Credit decision-making processes include four key elements: • Authority of local decision-makers. This is based on personal the reputation and skill of the individual rather than the organisational structure. • Approval process. The process for making SME credit decisions is likely to remain New Zealand based due to the reliance on "local knowledge". • Credit policy. This function is responsible for establishing the broad parameters for lending decisions and identifying generic risks and requirements for servicing capability and loan security. This function is tends to be centralised reducing potential for tailoring of the credit policy to differences in local conditions. • Global exposure management. Local branch lending tends to be treated as part of the portfolio of the parent loan products for similar product type or industry sector. Global exposure limits are often determined on the basis of the parent's portfolio composition and initially applied on pro-rata basis to branches. In the absence of either informed management at the parent or competent local management it is difficult to vary the pro-rata global exposure limits imposed by the parent.
Centralising credit policy and exposure management	Centralisation can increase uncertainty in the outcomes of credit decision through the interaction of credit policy and global exposure limits. These factors constrain ability of local banks to meet market opportunities or respond quickly to crisis and restructuring requirements. This approach does not necessarily introduce more cost to the New Zealand banking sector but does imply that the response to lending demand and shocks will be different. Volatility is most likely to be increased where the composition of the Australasian economy is different or sectors are behaving differently. Recent examples include: • [………….]**[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information]** • […………]**[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information]** • […………]**[Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably**

prejudice the commercial position of who supplied or who is the subject of the information]

There is also potential for different policies to be adopted for housing lending and lending to SMEs secured against housing if the Australian housing loan market is perceived to be overheating. (New Zealand's population tends to be less urbanised than Australia. Accordingly concentration policies for housing loans that limit loans to towns with populations below certain limits cannot be readily applied to the New Zealand market without modification.)

Which customers are most affected

The immediate direct impacts of centralisation on customer groups are difficult to identify and are unlikely to be significant. The main influences are likely to be on the costs of the provision of services and reduced predictability of lending decisions.

The customer groups most likely to be affected by changes in credit policy are industries that are not well represented or understood in Australia. Vulnerable industries and customers could be identified by:

- comparing the industry composition of the loan portfolios of Australian and New Zealand banks,
- analysing the concentration of lending to New Zealand industries by bank to identify sectors that are heavily dependent on lending from one or two Australian owned banks.

What costs is relocation imposing on NZ

Assessment of the impact of re-location costs requires consideration of the following elements:

- Change in the costs of services due to relocation. (As discussed above we have not found compelling evidence that centralisation results in economies of scale or scope[28].)
- Allocation of process cost savings. (We have not found any evidence of robust methods for agreeing, in advance, the allocation of anticipated cost or project risk between the branch and the parent. Cost/benefit allocation is likely to be asymmetric with cost allocation based simple metrics such as relative business size while benefit allocation is based on negotiation.)
- Capacity to innovate in response to local market conditions. (This is likely to be reduced under a centralised structure particularly for payment processes. This may be partially offset by)
- Volatility in banking response. (Initial adjustment to local credit shocks and changes in lending policy are likely to be less predictable and driven by local conditions than previously. The adjustment process is likely to require a longer and more "public" learning phase for bank management as they

[28] Some New Zealand corporates may benefit from access specialised industry expertise that can be supported at parent but not at branch level. However the comments in the previous section on seamless markets suggest that this will only apply to a small number of firms i.e. MNEs operating primarily in New Zealand and Australia.

	formulate their response to credit shocks. The likelihood that “exit” or “significant reduction in exposure” is the initial response to local credit shocks is increased.)
Cost allocation complexities	The bundled, relationship and annuity nature of banking services make it very difficult to allocate direct distribution costs to income streams let alone allocate costs of systems and infrastructure. Bank income streams are earned on products at account level that are distributed to customers through a common sales network using a hybrid of product and common systems[29]. Activity based costing analysis can be used to allocate costs directly related to selling a product or providing a service. However a significant proportion of the costs are “indirect” and relate to building the customer relationships and system interfaces necessary to package bank products into an offering that can be sold to customers. This makes it difficult to plan the full allocation of costs to products and tends to encourage allocation of indirect costs based on “capacity” to pay. In principle similar transfer pricing tensions exist in other industries. However banking arguably is more vulnerable to transfer pricing tensions leading to a skewed allocation of costs than industries where the steps in the value chain are more precisely delineated.
Competitive pressure	Evidence of competition between the Australian owned banks is mixed. There are many anecdotes of price competition between the banks. However, the steady fall in expense to income ratios and robust profitability suggest that the banks are capable of resisting competitive pressure. The payments system theoretically has open entry but in practice is expensive for new providers to enter both in terms of the overhead of complying with process rules and the inability of new entrants to influence the cost of payment services. Access to the payment system and the ability to monitor business cash-flows provides banks with an important first-line of defence in monitoring and managing lending risk. Lending operations of (non-Australian owned) banks do not appear to have sufficient size and breadth to compete directly with the Australian owned banks except potentially in some specialist markets such as rural lending. In our view, competition from other (non-Australian owned) banks and financial service providers is a weak source of market discipline for the main banks.
Conclusion	Centralisation of decision-making and processing functions is expected to reduce the predictability of local branch management decisions. There is no evidence that centralisation reduces the cost of provision of local services.

[29] There a handful of exceptions to this comment such as credit cards. Although credit cards are distributed through bank retail networks and card systems are linked to other core systems the product and systems are sufficiently independent for most banks to be operated as a standalone business unit.

Centralisation strategies have been superimposed on global strategies to reduce cost and increase non-interest income. These strategies are likely to be more important drivers of local bank efficiency than centralisation itself.

Confidential

The Performance of the New Zealand Banking Sector

Report to the Reserve Bank of New Zealand

26th November 2004

Ref #1500968 v1.1

Preface

NZIER is a specialist consulting firm that uses applied economic research and analysis to provide a wide range of strategic advice to clients in the public and private sectors, throughout New Zealand and Australia, and further afield.

NZIER is also known for its long-established *Quarterly Survey of Business Opinion* and *Quarterly Predictions*.

NZIER was established in 1958.

Authorship

This report has been prepared at NZIER by Brent Layton. The assistance of Preston Davies, Simon Hope, Sharon Pells, Rebecca Schrage, Vickie Evans, Jo Schofield and Sarah Spring is gratefully acknowledged. Clive Thorp, Dean Minot and James Twaddle of the Reserve Bank of New Zealand also provided assistance with accessing data and information.

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Executive Summary

An inter-departmental working group is examining the performance and regulation of major financial institutions in New Zealand. To assist the working group the Reserve Bank of New Zealand (RBNZ) commissioned NZIER to undertake an analysis of the extent to which the New Zealand banking institutions match, or do not match, the levels of development, innovation, and service delivery found in the financial systems of other high-performing economies especially Australia.

NZIER was specifically asked to report on:

- Levels of development, innovation and service delivery in the New Zealand banking system relative to Australia in particular, and other comparable countries where data permits.
- Indictors of competition within the banking system as the driver of innovation and development over at least the last decade and compared with banking systems in other comparable countries, and particularly Australia.

In relation to development, innovation and service delivery NZIER reports:

- New Zealand bank customers are not currently disadvantaged in the range of products and services available to them compared with bank customers in Australia, Canada and the United Kingdom;
- New Zealand's level of ATMs per head of population started out ahead of Australia's but the rate of increase has been slower and the density relative to population in New Zealand is now well below that in Australia. However, this is not reflected in lower levels of ATM transaction per person per year. New Zealand usage is high by international standards and high compared with Australia;
- EFTPOS is more heavily used in New Zealand than any other country in the group for which data was found and usage in this country is considerable higher than in Australia;
- New Zealand was a relatively early adopter of internet banking and the penetration of use of this service has been rapid and quite deep. Australia was also been an early and rapid adopter compared even with North America and Europe as a whole. There are pockets in Europe where adoption appears to have been even more rapid, but other areas, such as in the south, where it has been much slower;
- Taken overall, there is nothing to suggest that New Zealand is being left behind in the move to electronic banking. In fact, New Zealand is near the forefront among the countries for which we have data on the adoption of electronic banking. Despite this, New Zealand is unusual because it has recently also had an increase in the number of bank branches in

absolute terms and relative to population due to new entry into the retail end of the banking market;

- The banking sector provides New Zealand business with a comprehensive range of currency and interest rate risk management products;
- Bank customer satisfaction declined in New Zealand during the 1990s and recovered thereafter. The evidence from other countries we have been able to assemble suggests that New Zealand was not alone in this experience; and
- In surveys conducted by one organisation using the same methodology in each country customer satisfaction among New Zealand bank customers is currently quite a way behind the levels recorded in the United States, and a little behind the level in the United Kingdom, but is ahead of levels recorded in Australia.

On service delivery and innovation, NZIER concludes:

- There are no grounds for concern that New Zealand consumers and business are missing out in the current round of technological innovations in the banking sector;
- Nor does the evidence suggest there are grounds for concern that the banking sector is continuing to decline in terms of achievement of what is desired in the eyes of its customers; and
- The one internationally comparable satisfaction study located does, however, suggest there is considerable room for improvement in performance relative to expectations if satisfaction levels here are to reach those in the United States, but the trend in New Zealand is up and the level is ahead of Australia.

On the question of competition in the New Zealand banking sector, NZIER reports:

- New Zealand has a relatively concentrated banking sector when compared with other major economies, including Australia. Recent literature does not support a positive relationship between concentration and competition in banking, however;
- A test of bank competitiveness in the provision of intermediation using the Panzar-Rosse methodology suggests that despite the high concentration the New Zealand market is competitive. Issues with this test mean its results should be treated with considerable caution, however;
- The broad similarity of product offerings, easy availability of market information, and general presence of excess capacity identified in the New Zealand banking sector are consistent with it being generally competitive;
- The complexity of pricing structures, minor variations in the terms attached to broadly similar product offerings and degree of price

variation for identical services are consistent with the banking sector not being perfectly competitive;

- Data on switching by personal, small business and rural customers is hard to interpret but there have been no clear trends in the rates of switching;
- Other evidence on switching suggests that bankers in New Zealand are not in a position to assume that customers will not move banks if dissatisfied with prices or services;
- The rate of switching among major organisations uncovered in a simple investigation of a sample of Annual Reports was surprisingly high, but not inconsistent with governance practices now widely adopted by New Zealand directors;
- No significant barriers to entry into banking markets were identified;
- The ingredients for collusion – forums to meet, ease of detection of breaches of collusive arrangements and the capacity to punish breaches – are all present in New Zealand banking markets for personal and small business customers. The second ingredient – ease of detection – is not present in the market for banking services to larger customers;
- We found no evidence of collusion actually occurring;
- The trend in bank charges to consumers since 1999 has actually been down in nominal terms, and sharply down in real terms. It appears that the decline in loan approval fees has more than offset the rise in transaction charges. Bank charges to businesses rose sharply around 1999 but otherwise have been relatively static;
- There is considerable variation among banks in the charges they levy for very similar services suggesting they are not actively colluding on these charges and also that the market for these services is not the classic perfectly competitive market with one price;
- New Zealand banks are particularly profitable in terms of accounting return on equity compared with other businesses and banks in other countries;
- Accounting return on equity probably overstates the “economic” return on equity of banks because several key “assets” of banks – reputation and brand value, systems and knowledge - are missing from their balance sheets. The level of overstatement could be very significant;
- The relatively high recorded profitability of New Zealand banks numerically owes a little to the lower reported capitalisation they tend to have, but New Zealand banks are not reported to be capitalised at lower levels than Australian banks. The parents of most New Zealand banks are Australian. Drawing economic or prudential conclusions from comparing reported capitalisation internationally is difficult due to countries applying different standard;

- The high recorded profitability does not seem to be due to New Zealand banks having either unusually high interest margins or other operating revenue;
- New Zealand banks have significantly improved their operating efficiency over the 1990s as measured by their cost to income ratio. This has fallen from over 70 percent to around 50 percent;
- New Zealand banks have gone from the highest cost to income ratio of the 5 countries covered in 1996 to the lowest in 2002; and
- On a cost to income basis New Zealand banks are now significantly more efficient than their Australian, Scandinavian, Canadian, Irish and United Kingdom counterparts.

As regards competitiveness, NZIER concludes:

- As with innovation, there are no grounds for major concern about the relative competitiveness of the New Zealand banking sector. The ingredients for collusive behaviour are present for some segments of the market, but no evidence of actual collusion was found; and
- The banking markets are not characterised by perfect competition but in the key areas of intermediation, transactions processing and currency and interest rate risk management the evidence suggests a reasonable degree of competition between the banks and/or contestability from non-bank entities and potential new entrants.

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1. Introduction

An inter-departmental working group is examining the performance and regulation of major financial institutions in New Zealand. They have been asked to report to a steering committee comprising senior officials from the Treasury, Reserve Bank of New Zealand (RBNZ) and the Ministry of Economic Development on the following[1]:

- Assessment of the performance of New Zealand's financial system
  - How well is the financial system performing in delivering financial services that support growth and economic development in New Zealand?
- Policy implications for banking and insurance
  - How well does the regulation of banking and insurance companies in New Zealand contribute to the delivery of the desired outcomes that have been identified?
  - What changes, if any, may be warranted to improve the effectiveness and efficiency of regulation in delivering on these outcomes?
- Would different institutional arrangements for the regulation of banking and insurance contribute to a better outcome for New Zealand in terms of the provision of financial services and the stability of the wider financial system?
- Could the provision of financial services or regulation in New Zealand be enhanced through a joint trans-Tasman approach?

To assist the inter-departmental working group, the RBNZ commissioned NZIER to undertake an analysis of the extent to which the New Zealand banking institutions match, or do not match, the levels of development, innovation, and service delivery found in the financial systems of other high-performing economies especially relative to Australia in particular. NZIER was specifically asked to report on:

- Levels of development, innovation and service delivery in the New Zealand banking system relative to Australia in particular, and other comparable countries where data permits.
- Indictors of competition within the banking system as the driver of innovation and development over at least the last decade and compared with banking systems in other comparable countries, and particularly Australia.

[1] http://www.rbnz.govt.nz/banking/supervision/0158458.html

While the formal letter of engagement focused mainly on NZIER gathering and assembling information it was also made clear that the RBNZ expected NZIER to use its experience in policy analysis and its knowledge of the banking sector to provide its interpretation of the information in relation to the policy issues the inter-departmental working group is expected to address.

In regard to the second aspect, indicators of the level of competition, we have interpreted the term “competition” broadly to include not just several firms competing in a market but also the potential threat from new entrants and from alternative services to fulfil customers’ requirements. In other words, we have interpreted the brief as requiring us to focus on what economists refer to as contestability.

In the next section, in order to provide more context to our report and particularly the interpretative aspect of the brief, we make some general comments about the economic role of the banking sector and the standard objectives of specific banking regulations. Section 3 deals with the development, innovation and service delivery of the New Zealand banking sector in an international context and section 4 deals with indicators of competition. NZIER’s interpretations of the policy implications of the material are discussed at the end of each of sections 4 and 5.

2. The Role and Sector Specific Regulation of the Banking Sector

2.1 The Role of Banks

Banks fulfil a range of roles in a modern economy. Principally, however, they provide:

- The transaction mechanism by which businesses and consumers are able to make and receive payments for goods and services and exchange financial assets and liabilities;
- Intermediation between those wishing to save and those wishing to borrow to make investments or to finance consumption;
- Intermediation between the generally short-term of commitment desired by savers and the generally longer-term of commitment desired by borrowers;
- Specialist monitoring and management of the credit risks associated with borrowers and the opportunity for savers to effectively invest in a diversified pool of loans supervised by a specialist in credit risk assessment which has its own equity at stake underwriting the pool; and

- Interest rate and currency risk management services to parties engaged in transactions or holding assets or liabilities that give rise to these forms of risk.

2.2 Sector Specific Regulation of Banks

A financially stable and efficient banking system is important for achieving economic growth. The standard objectives of sector specific bank regulation, therefore, are:

- Financial stability; and
- Efficiency.[2]

2.2.1 Stability

Banks have traditionally been considered to be more prone to financial instability than most other businesses for a variety of reasons:

- Banks are usually very highly leveraged; equity only represents a small proportion of their total assets. This can make them prone to risky behaviour because if the risk taking comes off the shareholders benefit most and, if the risk taking does not, the depositors bear a significant part of the loss. The fact that depositors are often small and dispersed and may not be well informed about a bank's risk profile exacerbates this agency problem;
- The usual mismatch between the terms of commitment desired by depositors and borrowers generally leaves a bank with a balance sheet consisting of shorter-term deposits as liabilities and longer-term loans as assets. The result is that a bank can be vulnerable to runs on deposits;
- As a corollary of the role they play in the transaction mechanism of an economy, banks tend to have significant liabilities to one another. A failure by one bank results in losses by others and so increases the probability of other banks failing also. This phenomenon is known as contagion; and
- Contagion can also occur if one bank fails, or appears likely to fail, and depositors at other banks become fearful that their bank will become insolvent and be unable to pay them in full, or on time. This fear can lead depositors of other banks to attempt to withdraw their funds, regardless of whether their fears are well-founded or not. In this situation, an otherwise solvent bank may be required to sell assets to meet the demand on its liquidity and, as a result, may suffer fire-sale losses that, in the extreme, may push it into insolvency.

The central role that banks play in a modern economy as repositories of wealth and in facilitating the transactions that allow economic specialisation

[2] Section 68(a) of the Reserve Bank Act requires the Reserve Bank to exercise its banking supervision and regulation powers for the purpose of promoting the maintenance of a sound and efficient financial system.

means that bank failures can have significant economic impacts; hence the strong policy interest in stability.

2.2.2 Efficiency

The other standard interest of bank regulators has been efficiency. The regulators' focus has traditionally been on all three aspects of economic efficiency – productive, allocative and dynamic. In the 1980s and 1990s in many countries state-owned and other non-commercial banking institutions where corporatised and/or privatised. This has reduced the interest of regulators in the productive and dynamic efficiency of banks – whether the banks are operating at as low a cost as is optimal and innovate when socially beneficial.

The presumption is that corporatised and privatised institutions with profit objectives have incentives to be productively and dynamically efficient, even if they have market power. It does not matter whether an entity is a monopoly or in a perfectly competitive market, profit maximization requires it to produce at as low a cost as possible, and to innovate when it is efficient for it to do so. The absence of competition may reduce the external drivers and amount of pressure on the monopoly to actually minimise costs and innovate, but the internal driver of profit maximization produce incentives in the same direction.

As regards allocative efficiency, the interests of policy makers continue and they tend to still be on the question - are banks using market power or colluding to restrict output, raise prices and extract monopoly profits in one or more of the services they provide?

There are a number of factors about banks that lead bank regulators to be particularly interested in this question:

- The concentration ratio[3] is often high in the bank sector compared with most other sectors in an economy;
- Bank mergers and acquisitions are common and frequently involve well established and profitable entities on both sides, and are not just the strong and well managed swallowing the weak and poorly managed;
- The market is characterised by a number of alleged barriers to entry:
  - Economies of scale in processing;
  - Strong brand values;
  - Extensive branch and ATM networks raising the costs of establishing a viable competitor;

[3] The proportion of funds under management (FUM) or some other measure of size concentrated in the top 3 (CR_3), five (CR_5) etc. banks.

  - High costs for customers switching banks in terms of re-establishing payment arrangements and relationships;
  - Restrictions on access by new market entrants to inter-bank payment arrangements and joint organisations; and
  - Legal restrictions on becoming a bank.

- The three ingredients for successful collusion – opportunities for agreement, detection and retaliation - are generally present in the banking sector, at least in relation to services provided to smaller customers:

The interest of regulators in dynamic efficiency is now focused around whether the banking system allocates the optimal amount in loans at the optimal prices given risk to new and potentially high growth businesses, or more generally, is credit being provided to the most productive investment project first?

There was a time, however, when the interests of regulators in how banks allocated loans was very different. New Zealand's banking history illustrates this clearly. The second wave of trustee savings banks were formed in the early 1960s in part because of local concerns that insufficient funds were being allocated by the financial sector to local government infrastructural projects, such as sewers, water supply systems and roads. The public sector ratios which were applied to most classes of financial institution until the 1980s were to ensure sufficient investment in government (and local authority) debt to finance the needs of government at low interest rates. The tiered lending rules which applied to the trading banks until the mid-1980s were designed to ensure "sufficient" funding to export industries at low costs. Today these interventions appear crude and misguided.

To us it seems likely that in 20 years time the suggestion by some that it is necessary to restrict competition in banking to ensure that funding of new but high growth businesses is optimal will share the same fate. The argument put forward is that restricting competition is necessary so banks have the incentives to allocate the optimal resources to screening and relationship banking so that they lend optimally to the so-called opaque borrowers – those with little track record.[4] The empirical evidence to support these views is not convincing because it is based on equating the level of concentration in the banking system with the level of competition,[5] and it is known that this is not correct.

Another argument found in the literature is that there is a trade-off between the degree of competition in banking markets and financial stability; large

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[4] Northcott (2004), pp. 5-7.

[5] Northcott (2004), pp. 7-9

banks are better able to withstand negative shocks and are less prone to risky behaviour because they have more value at stake, and large banks have market power. The evidence to support these arguments is also not convincing.[6]

3. Levels of Development, Innovation and Service Delivery

3.1 Service offerings

In order to test whether the product and service range offered by New Zealand's banks matches the product and service range offered by banks in other developed countries we conducted Goldstein-type research using the web; we searched the webpages of major banks in New Zealand and Australia and of selected banks in the United Kingdom and Canada. Branches of most of the New Zealand banks covered in this survey were also visited to ensure that their product and service offerings were fully captured by the contents of their webpages.

The conclusions from this research are that:

- Banks generally describe their products and services and charges in great detail on their webpages; and
- There are currently no material gaps in the bank products and services available in New Zealand to consumers and businesses compared with those available in Australia, the United Kingdom and Canada.

Appendix B sets out the detailed information showing the range of services and products identified at each bank.

3.2 Innovation

3.2.1 ATM's

Table 1 compares the number of ATM terminals per million population in New Zealand with the corresponding data for Australia over the last eleven years. The data show that growth in New Zealand has not kept up with growth in Australia. In the mid-1990s the density of ATM's relative to population was greater in New Zealand than in Australia, but it is now under half the level. Table 2 puts the New Zealand and Australian ATM densities in international context and shows that whereas Australia has a relatively high number of ATM terminals for its population; New Zealand now has a relatively low density.

[6] Northcott (2004), pp.15-16.

Table 1 ATM density – Australia and New Zealand

ATMs per million people

Year	New Zealand	Australia
1993	309	312
1994	363	331
1995	383	355
1996	399	408
1997	398	468
1998	397	505
1999	408	531
2000	437	615
2001	468	682
2002	475	832
2003	468	1,026

Sources: ATMs: Australia – Australian Payments Clearing Association; NZ – New Zealand Banker's Association and KPMG. Populations: Australia – Australian Bureau of Statistics; NZ - Statistics New Zealand.

Table 2 International ATM density
ATMs per million people

	1992	1995	1998	2000	2003
Belgium	109	360	562	657	681
Canada	509	600	774	1037	1394
France	305	395	499	580	683
Germany	235	436	556	580	620
Italy	245	378	482	551	671
Japan	870	1013	1127	922	872
Netherlands	261	354	419	435	465
Singapore	..	..	..	446	371
Sweden	254	267	281	295	299
Switzerland	386	532	722	675	722
United Kingdom	324	358	416	563	783
United States	342	466	692	967	1221[7]
Australia	306	355	505	615	1026
New Zealand		383	397	437	468

Sources: International - BIS and RBA Bulletin April 1998; Australia - ATMs - Australian Payments Clearing Association and – population - Australian Bureau of Statistics; NZ – ATMs -New Zealand Bankers' Association and – population - Statistics New Zealand.

When it comes to usage per person, however, New Zealand has the highest rate of the countries listed and has had that rate since the mid-1990s. For most other countries the rate has risen over time. In 2003 Australia's annual usage of ATMs per person was only 76.7 percent of New Zealand's. Back in 1995, however, it had only been 53.2 percent.

[7] Data for 2002 not 2003.

Table 3 International ATM Usage

ATMs transactions per person per year

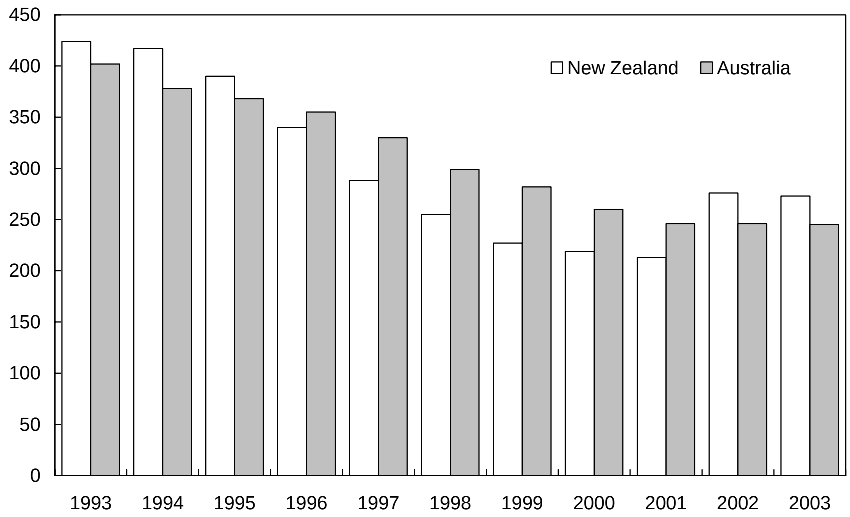
	1995	1998	2000	2003
Belgium	14.3	15.6	19.8	25.4
Canada	46.3	53.0	48.4	43.0
France	15.8	20.5	17.9	20.3
Germany	13.4	17.1	21.0	39.6
Italy	5.8	8.4	9.1	11
Japan	3.8	5.8	3.2	2.7
Netherlands	22.3	27.2	29.5	30.4
Singapore	..	..	2.1	1.6
Sweden	31.8	37.6	36.2	36.6
Switzerland	10.0	11.3	13.5	15.8
United Kingdom	25.2	31.3	34.6	40.0
United States	36.9	41.4	45.3	36.8
Australia	25.8	27.4	30.2	38.1
New Zealand	48.5	46.2	46.4	49.7

Sources: International - BIS; Australia – ATM usage - Australian Payments Clearing Association and – population - Australian Bureau of Statistics; NZ – ATM usage - New Zealand Bankers' Association and - population - Statistics New Zealand..

The relatively slow growth in the number of ATMs in New Zealand compared with Australia does not reflect a slower rate of decline the number of bank branches in this country. Figure 2 shows that during the 1990s New Zealand's branch numbers fell slightly faster than Australia's. On a per person basis New Zealand had slightly more branches than Australia in the early 1990s but by 1996 the number of branches per person was lower in this country than in Australia and remained lower until the last couple of years. The establishment of Kiwibank in February 2002 explains the recent rise in the total number of branches and in the number per person. Kiwibank now has nearly 300 branches throughout the country.

Figure 1 Number of bank branches per million persons

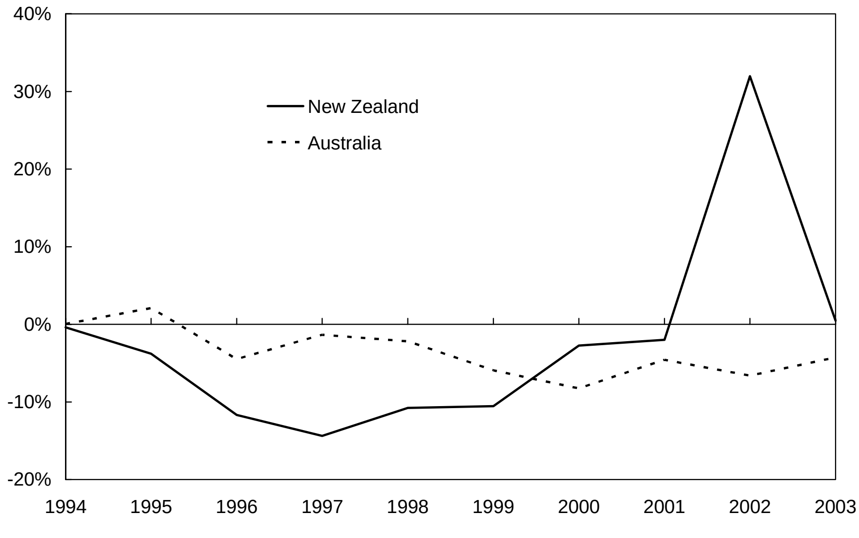
Branches in Australia and New Zealand



Sources: Australia – RBA and Australian Bureau of Statistics; New Zealand – NZ Bankers' Association & KPMG and Statistics New Zealand

Figure 2 Growth in the number of bank branches

Branches in Australia and New Zealand – annual percent change



Sources: Australia – RBA; New Zealand – NZ Bankers' Association & KPMG

3.2.2 EFTPOS[8]

EFTPOS was first introduced into New Zealand in 1984, a year before it appeared in Australia. Initially the take up of the service was quite slow as there were few places the cards could be used. However, adoption accelerated in the late 1980s and by the early 1990s the penetration in New Zealand was very high compared with Australia and all other developed countries. It has remained relatively high, although other countries have been catching up in terms of terminal density and usage. This is shown in Table 4 and Table 5. New Zealand is still well ahead in terms of usage, however, from Australia and other countries. In 2003 there were 4.7 million debit cards on issue to slightly over 4 million people in New Zealand.

The widespread and high intensity use of EFTPOS in New Zealand has not been rigorously explained, but it is not due to lower use of credit cards and other non-cash payment methods. According to an RBA study published in its July 2003 Bulletin[9] the average number of retail credit card transactions per person in New Zealand was the second highest in 2000 at 51. The United States topped the list with 60 transactions and the number for Australia was 43. For total non-cash transactions in 2000 New Zealand came out on top with 341, almost twice Australia's 172 and over 4 times Singapore's 76 transactions per head. These figures include not only those through ATMs and EFTPOS terminals but also in-store use of credit cards not involving EFTPOS terminals.

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[8] Electronic Funds Transfer at Point Of Sale.

[9] Reserve Bank of Australia, "The Changing Australian Retail Payments Landscape", RBA Bulletin, July 2003.

Table 4 International EFTPOS Terminal Density
EFTPOS terminals per million people

	1995	1998	2000	2003
Belgium	7,174	9,124	11,364	10,900
Canada	6,448	12,960	14,231	16,416
France	9,394	9,949	13,848	16,267
Germany	856	2,816	7,194	6,008
Italy	2,683	5,977	9,878	15,945
Japan	200	127	..	..
Netherlands	4,736	8,569	9,774	11,466
Singapore	..	..	4,851	6,679
Sweden	6,160	8,405	9,821	12,062
Switzerland	3,499	7,167	9,369	10,803
UK	8,647	10,304	12,533	14,508
United States	2,009	6,289	10,978	12,267
Australia	4,874	12,291	17,360	21,871
New Zealand	7,748	17,039	21,779	24,378

Sources: International - BIS; Australia - RBNZ & Australian Payments Clearing Association; NZ - New Zealand Bankers' Association & RBNZ

Table 5 International EFTPOS Terminal Usage

EFTPOS transactions per person per year

	1995	1998	2000	2003
Belgium	20.8	32.7	39.8	53.2
Canada	13.4	44.6	63.7	81.7
France	32.3	36.8	54.3	70.6
Germany	1.8	4.4	13.8	20.2
Italy	2.1	5.6	5.5	10.5
Japan	.007	.004	Neg	0.1
Netherlands	16.5	37.9	50.3	71.2
Singapore	..	..	19.1	25.3
Sweden	10.4	19.0	28.9	74.6
Switzerland	8.0	14.9	23.9	33.1
UK	..	..	39.9	56.7
United States	6.1	21.2	33.8	54.1
Australia	19.3	28.5	32.5	43.9
New Zealand	39.9	104.8	124.9	152.9

Source: International- BIS; Australia - RBNZ & Australian Payments Clearing Association; NZ - New Zealand Bankers' Association & RBNZ

The most plausible explanation for the high penetration of EFTPOS is that two banks vigorously promoted it to merchants and consumers in the late 1980s and early 1990s. Both ASB Bank and Trust Bank had emerged from the trustee savings bank in 1988 as part of the widespread reform of the financial sector undertaken at the time. Prior to the reforms their predecessor organisations had large retail client bases with heavy concentrations of moderate to low income clients, no business clients and geographic holes in their branch networks.

The vigorous promotion of EFTPOS suited the business strategies of both banks. It gave them opportunities to establish relationships with small to medium retail businesses, helped fill the holes in their networks, lowered the costs of servicing their heavy concentration of moderate-balance high-transaction clients and provided a point of difference from the more established banks. This latter aspect was especially exploited by ASB Bank which has continued to this day with basically the same approach. In the late 1980s, both banks made very rapid progress in acquiring a commercial client base in their respective core areas of the South Island and Waikato for Trust Bank and Auckland for ASB, partly due to this strategy. The other factors in their success were that some of the former trading banks were preoccupied at this time with doubtful and bad debts from property lending and their success in promoting to the small business sector loans which used residential property as security.

3.2.3 Phone Banking

Phone banking was introduced in New Zealand in the mid-1990s. Data on total numbers of customers able to use the facility and the number of times they access the service is not publicly reported on a national basis. ASB Bank has recently reported that it receives 360,000 phone banking calls each month. On the basis that ASB Bank has 398,000 of the 3,158,000 customers of the main banks in New Zealand[10] and assuming that ASB Banks ratio of calls to customers is the industry average, this translates to 2,856,000 phone banking calls per month in New Zealand, or 34.3 million per year or 8.6 per year per person. This is very small compared with the number of EFTPOS and ATM transactions.

Data on phone banking customers and calls for Australia and other countries have not been found.

3.2.4 Internet Banking

Internet banking which permits the customer to make payments to third parties was introduced into New Zealand by ASB Bank in early 1997. The first web banking site in the world had been launched in May 1995.[11]

The growth in the number of internet customers in New Zealand has been strong. By the end of December 2003 there were 1.36 million customers in a population of just over 4 million.

Growth in internet banking has been strong in Australia also. At the end of June 2003 there were 3.5 million users 14 years and over who had accessed internet banking in the past month out of a population of just over 20 million. This figure was up from 1 million at the end of December 2000.[12] The sources and natures of these figures are different, so a direct comparison between New Zealand and Australia on the basis of them is not appropriate. However, they do point to rapid and widespread adoption of internet banking in both countries with no grounds to suspect New Zealand has been lagging

[10] Merrill Lynch , p.17.

[11] http://www.onlinebankingreport.com/resources/sr7.html

[12] Australian government, National office for the Information Economy, The Current State of Play: Online Participation and Activities, 2003, p.26.

Table 6 Number of internet banking customers
As at 31 December each year

	2000	2001	2002	2003
ANZ	91,956	181,970	233,222	283,497
ASB	83,474	149,133	229,590	310,000
BNZ	42,000	72,000	115,176	165,941
NBNZ	60,700	129,432	187,625	257,305
Westpac	67,000	148,062	258,545	343,860
Total	345,130	680,597	1,024,158	1,360,603

Source: KPMG

Evidence from other sources also suggests that New Zealand and Australia are not lagging behind in their adoption of internet banking.

- Forrester Research reported in early 2003 that one in five (i.e. 20 percent) of Europeans are already banking online and predicted that the number will double to 40 percent or 130 million in 2007. Forrester also recorded that less than 5 percent of Italian and Greek adults were banking online at that time.[13]
- Gartner Group reported that 17 percent of Americans used online banking services at the end of 2002 and predicted that by 2007 30 percent of Americans (67 million) will be using the service.[14]
- NFO CFGroup reported in early 2003 that 25 percent of Canadians had made an internet banking transaction in the month prior to being interviewed compared with 22 percent who made a phone banking transaction.[15]

3.2.5 Derivatives

The New Zealand banking system provides its customers with the standard range of risk management derivatives – Forward Rate Agreements (FRAs), swaps and options for interest rate risks and forward contracts, currency swaps and options for currency risks. Reliable quantitative data on the provision for New Zealand businesses of these over the counter (OTC) products have not been found. Data on derivatives are gathered by the Bank for International Settlements (BIS) and it publishes some data relating to OTC currency and interest rate derivatives in New Zealand dollars.[16] New Zealand is, however, not a respondent to the surveys from which these data

[13] http://www.forrester.com/ER/Press/Release/0,1769,788,00.html

[14] http://www.nua.ie/surveys/index.cgi?f=VS&art_id=905358738&rel=true

[15] http://www.nfocfgroup.com/news/03.01.22-banking.pdf

[16] http://www.bis.org/statistics/derstats.htm

are obtained and the statistics appear to only cover New Zealand currency derivatives reported by banks in other countries covered by the surveys, and so are very incomplete measures of the availability and use of these products.

3.2.6 Other Services and Products

The survey of products and services reported on in section 3.1 underlined that there is little if anything offered by banks overseas that is not available in this country. Most of the innovations in service delivery and product that have been developed overseas appear to have been adopted here quite quickly: mobile mortgage managers; pre-approved finance; pre-approved lending limits for mortgage borrowers; revolving credit loans; cap rate loans for home-owners; personal banking services; retirement products and funds management products have all quickly found there way here quickly after they were introduced overseas.

3.3 Customer Satisfaction

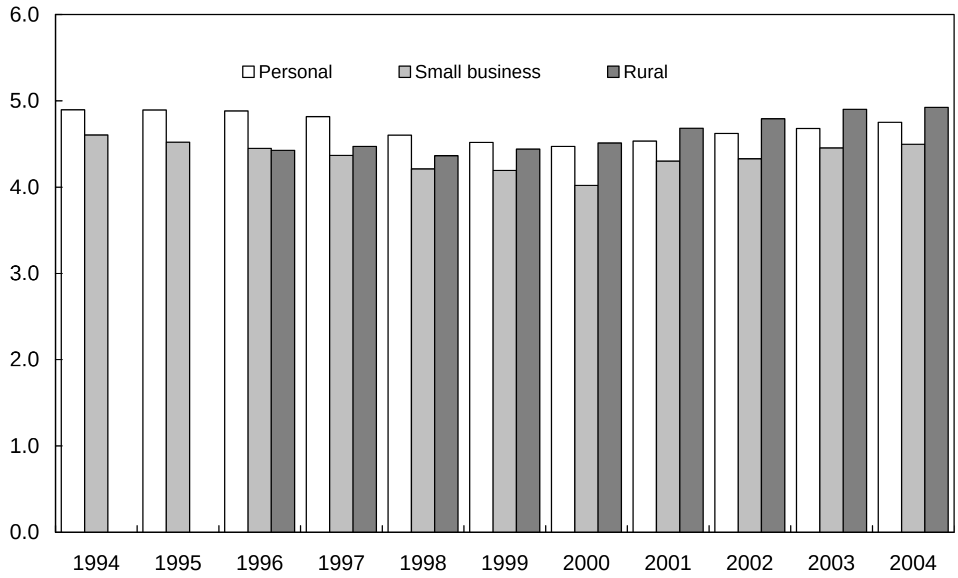
3.3.1 New Zealand

ACNielsen has conducted surveys of New Zealand bank customers for a considerable period of time. It has only recently undertaken surveys in Australia, however. On the other hand, Roy Morgan Research has conducted surveys of bank customer in Australia for a considerable period of time, but has only recently started to undertake surveys in New Zealand.

We have used the ACNielsen customer satisfaction data for New Zealand to provide us with a longer term perspective. ACNielsen use a six point scale for their customer satisfaction surveys. For consumers the ratings are from “Excellent” to “Very Poor”. This same rating is now used for the small business and rural customer surveys. Prior to 2002 the six point rating scale for these consumer groups was from “Extremely Satisfied” to “Extremely Dissatisfied”. We have converted the six point scales into weighted average scores by taking the top of the scale as equal to 6 and the bottom as equal to 1. These results are reported in Figure 3.

Figure 3 Customer satisfaction

Mean satisfaction score; 1 = lowest level, 6 = highest level of satisfaction. Annual average score



Source: ACNielsen

What these show is:

- Relatively high levels of customer satisfaction with banks – around 75% of the maximum. The maximum on the scale will only occur if every respondent reported the highest of the six levels of satisfaction.
- The scores for personal customers are generally slightly above those for small businesses and below those for rural customers.
- Satisfaction declined during the 1990s quite noticeably. It reached its bottom in 2000 for personal customers and small businesses. For rural customers the bottom was reached slightly earlier. This decline was roughly correlated with the decline in bank branches in New Zealand.

For customer satisfaction Roy Morgan Research use a five point rating scale from “Very Satisfied” to “Very Dissatisfied”. Of the respondents to the December 2003 survey in New Zealand 74 percent stated they were either “Very Satisfied“ or “Fairly Satisfied” with their bank. National Bank (84 percent) and ASB Bank (83 percent) achieved the highest ratings with Westpac (69 percent) and ANZ (65 percent) the lowest rated. BNZ was in the middle (75 percent).[17]

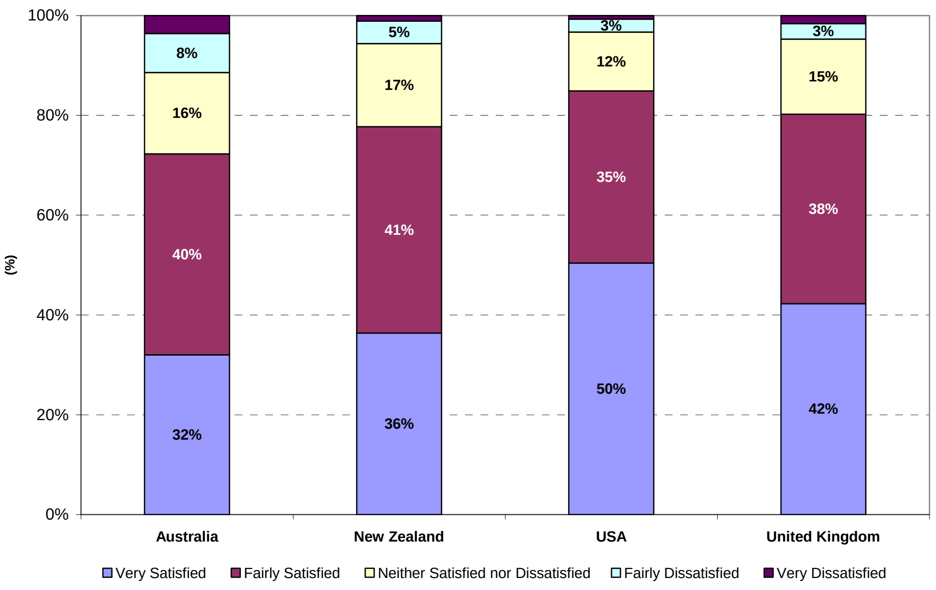
By the April 2004 Roy Morgan Research survey the percentage of New Zealand respondents that was in the top two categories of satisfaction had risen to 77 percent. Figure 4 compares the satisfaction levels recorded by the Roy Morgan Research in the latest survey in New Zealand with those in the

[17] Merrill Lynch (2004), p. 6.

latest surveys they have conducted by it using the same methodology in Australia, the United States and the United Kingdom.

Figure 4 Satisfaction with main financial institution (MFI)

International comparison



Source: Roy Morgan Research

According to these data, which were collected at the same time by the same organisation using the same methodology, bank customer satisfaction levels in New Zealand are considerably behind those in the United States, a bit behind those in the United Kingdom, but ahead of those in Australia.[18]

3.3.2 Australia

The Australian Consumers' Association surveys its members about banks and other financial institutions. It uses a four point scale from "Very Satisfied' to "Very Dissatisfied". In 2002, on average 73 percent of respondents were either "Satisfied" or "Very Satisfied" with their bank if it was one of the four main banks. The corresponding figure in 1998 was 74% and in 2000 it had dipped to 70%.

Satisfaction was significantly higher for smaller financial institutions and respondents were particularly hostile to banks, like the Bank of Melbourne, that had recently had ownership changes and were being restructured. Poor value for money was given as a reason by 63 percent of "Dissatisfied" and "Very Dissatisfied" customers.[19]

[18] These data have been especially collated for this paper by Roy Morgan Research.

[19] http://www.choice.com.au/viewArticle.aspx?id=103412&catId=100210&tid=100008&p=2

3.3.3 International

The American Customer Satisfaction Index (ACSI) has been developed in the United States but franchised to a number of other countries in Europe and South Africa. This index links customer satisfaction to factors likely to determine it: customer expectations, perceived quality and perceived value. The index was first calculated in 1994 and covers a wide range of sectors as well as individual organisations. The ACSI index for the banking sector tends to sit in the middle of the sectors covered. In a pattern reminiscent of what the ACNielsen survey shows for New Zealand, the banking sector index fell from 1994 to 1999 and has subsequently improved.[20]

An index based on the same methodology has been developed for Europe. It covers five sectors - banking, insurance, fixed phone, mobiles and supermarkets. Of these, banking comes second after supermarkets, but for banking value for money rates the lowest amongst the attributes measured. The overall level was lowest for banking in 2001. No data are provided for 2000.[21]

The same methodology is used for an index for South Africa. Customer satisfaction expectations are relatively high in the banking sector compared with other sectors surveyed and value for money rates relatively poorly. The survey only started in 2001, but satisfaction with banks and the banking sector has risen since then.[22]

The methods by which the New Zealand data from ACNielsen, the Australian data and the data for the other countries plotted in Figure 5 have been collected are not all the same. This means that comparisons need to be treated with caution. Despite this it is interesting to note that the data generally show a reasonably consistent pattern. Customer satisfaction with banks generally declined during the 1990s but has rising in the last few years. Presumably it was the changes in delivery mechanisms for services, including branch closures, that undermined satisfaction in the 1990s and the recovery is occurring now that much of the change has ended.

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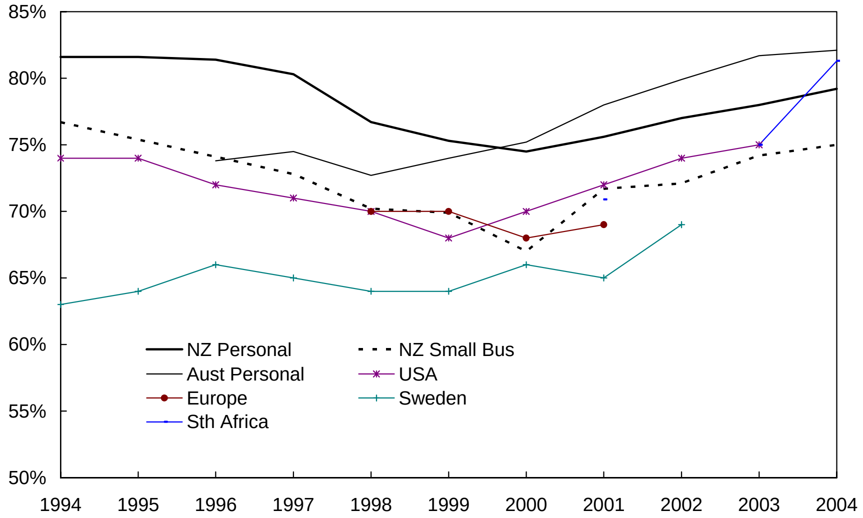
[20] http://www.theacsi.org/fourth_quarter.htm

[21] http://www.epsi-rating.com/files/European_final_revised.pdf

[22] http://www.thedti.gov.za/article/2004SASIndexMediaBrief.pdf

Figure 5 International customer satisfaction measures



Source: See footnotes

3.4 Innovation: Summary and Policy Implications

While the data has necessarily been drawn from many sources, the overall picture that emerges is:

- New Zealand bank customers are not currently disadvantaged in the range of products and services available to them compared with bank customers in Australia, Canada and the United Kingdom;
- New Zealand's level of ATMs per person started out ahead of Australia's but the rate of increase has been slower and the density relative to population in New Zealand is now well below that in Australia. However, this is not reflected in lower levels of ATM transaction per person per year. New Zealand usage is high by international standards and high compared with Australia;
- EFTPOS is more heavily used in New Zealand than any other country in the group for which data was found and usage in this country is considerable higher than in Australia;
- New Zealand was a relatively early adopter of internet banking and the penetration of this service has been rapid and quite deep. Australia was also been an early and rapid adopter compared even with North America and Europe as a whole. There are pockets in Europe where adoption appears to have been even more rapid, but other areas, such as in the south, where it has been much slower;
- Taken overall, there is nothing to suggest that New Zealand is being left behind in the move to electronic banking. In fact, New Zealand is near the forefront among the countries for which we have data on the adoption

of electronic banking. Despite this, New Zealand is unusual because it has recently also had an increase in the number of bank branches due to new entry into the retail end of the banking market;

- The banking sector provides New Zealand business with a comprehensive range of currency and interest rate risk management products;
- Bank customer satisfaction declined in New Zealand during the 1990s and recovered thereafter. The evidence from other countries we have been able to assemble suggests that New Zealand was not alone in this experience; and
- In surveys conducted by one organisation using the same methodology in each country customer satisfaction among New Zealand bank customers is currently quite a way behind the levels recorded in the United States and a little behind the level in the United Kingdom but is ahead of levels recorded in Australia.

There are no grounds for concern that New Zealand consumers and business are missing out in the current round of technological innovations in the banking sector.

Nor does the evidence suggest there are grounds for concern that the banking sector is continuing to decline in terms of achievement of what is desired in the eyes of its customers.

The one internationally comparable satisfaction study located does, however, suggest there is considerable room for improvement in performance relative to expectations if customer satisfaction levels here are to reach those in the United States, but the trend in New Zealand is up and the level is ahead of Australia.

4. Competition

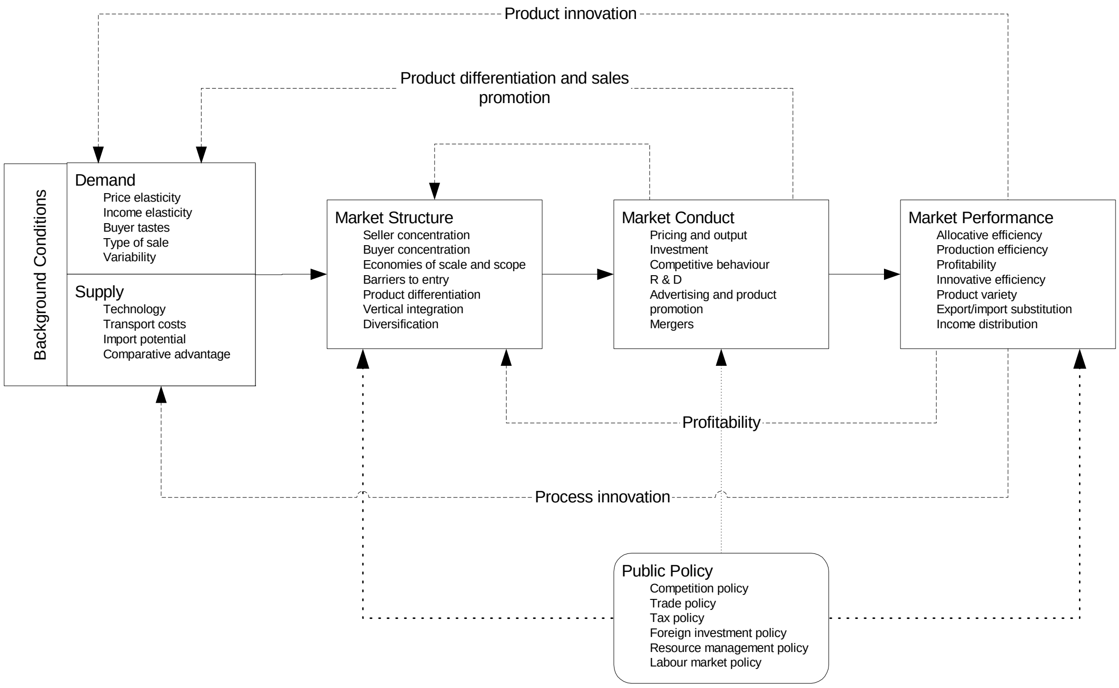
4.1 Standard Competition Analysis

4.1.1 The S-C-P Paradigm

The standard approach to competition analysis has been the so-called structure-conduct-performance (S-C-P) paradigm. This holds that a market's performance, including efficiency, follows from the market's structure and the conduct of the market's participants; competitive structures will produce competitive conduct and drive competitive and efficient outcomes. Uncompetitive structures will induce uncompetitive conduct and result in uncompetitive and inefficient outcomes.

Figure 6 provides a summary of the elements of the S-C-P paradigm.

Figure 6 The structure-conduct-performance paradigm



Source: NZIER

As can be seen from the figure, market structure and conduct are what determine the performance of the market within the basic conditions of supply and demand. Allocative, productive and dynamic efficiency are driven by the competitive forces imposed by the market structure and the conduct of participants in the market. Where the structural conditions promote competitive conduct, it is more likely that a market will perform efficiently.

4.1.2 Market Structure

a) The Structure for Competition

The structural conditions for competition and efficiency in markets are usually stated in the following terms. All other things held equal, a market is likely to be more competitive where:

- Sellers exist in large numbers and market concentration is low – a large number of sellers and low concentration makes it less likely that any firm could unilaterally influence prices. It also makes it less likely for sellers to reach understandings, whether overtly or tacitly, that reduce competition. Furthermore, even if such understandings can be reached, with more sellers, the scope for detection and retaliation to enforce agreements is less.
- Consumers perceive products and services to be relatively homogeneous. In markets in which products are largely undifferentiated, competition,

especially price competition, is likely to be stronger. Buyers are also less likely to develop brand preferences and loyalties that would cause stickiness in buyers switching in the event of unilateral price movements by the supplier.

- Relevant market information about the offerings of alternative suppliers is widely available at little cost. Switching by buyers is more likely in these circumstances.
- Excess capacity exists. Where fixed costs are present in an industry, and excess capacity in the markets for its output exists, the incentive to cut price and increase demand, volume and market share is greater.
- Barriers to entry are low. The absence of high barriers to entry in a market will increase the potential for new competition to enter the market in the event that any seller accumulates market power and attempts to exercise it by raising prices above the competitive level.

b) Importance of Entry

Contestability or the potential for competition to arise is often an important factor in providing competitive discipline to market participants. Thus, the examination of barriers to entry is often a significant factor in competition analysis in New Zealand.

Barriers to entry can be either structural or behavioural. The sources of structural barriers to entry include:

- The presence of significant economies of scale;
- Limits on access to essential resources, facilities, services or networks;
- Patents or other intellectual property rights;
- The presence of significant sunk costs in items like capital, brand strength and reputation; and
- High costs of obtaining and complying with regulatory approvals to participate in the market.

Behavioural barriers to entry include entry deterring strategies such as predatory pricing.

4.1.3 Conduct

In order for a market to be competitive it must be free of conduct that would reduce the level of competition between participants and deter efficient entry. The market should be free of the kinds of behaviour that contravene Part II of the Commerce Act 1986. This prohibits contracts, arrangements or understandings that have the purpose or effect of substantially lessening competition in a market, fixing prices, excluding market participation, maintaining resale prices and using a dominant position in a market for anti-competitive purposes. The likelihood of such behaviour depends on the structure of the market and, in particular whether:

- There are opportunities for the parties to collude, even tacitly;
- Detection of deviant behaviour breaching a collusive "understanding" is possible and easy; and
- The opportunity for retaliation to discipline deviants exists.

4.1.4 Implications for indicators

The implication of the standard S-C-P paradigm for the identification of indicators of competition is that we should seek indicators of structure and conduct in the following areas:

- Measures of concentration;
- Homogeneity of products and services;
- Availability of market information;
- Ease for customers to switch suppliers;
- Presence of excess capacity;
- Effectiveness and height of barriers to entry as evidenced by such factors as:
  - The extent of economies of scale;
  - Limitations on access to limited resources like networks;
  - Patents and other intellectual property rights;
  - The presence of significant sunk costs;
  - The importance of reputation;
  - Regulatory restrictions on entry and high compliance costs;
- Evidence of collusive or anti-competitive behaviour, including the presence of the conditions for it to occur:
  - Opportunity to agree;
  - Detection of breaches easy; and
  - Retaliation against deviants possible.

4.1.5 Application of paradigm by the Commerce Commission

The New Zealand Commerce Commission, like many other regulatory bodies around the world, utilises the standard S-C-P paradigm in its adjudications on mergers and acquisitions. It applied this approach in its September 2003 determination to each of the 19 banking related markets it identified as relevant to the application for clearance of the acquisition of

NBNZ Holdings Limited (the National Bank) by ANZ Banking Group (New Zealand) Limited (ANZ).[23]

The Commerce Commission's report on this application is potentially of valuable assistance in preparation of our report. Two factors, however, mean it is not a perfect substitute. Firstly, a considerable amount of the data the Commission relied upon in making its decision is confidential and has not been released to the pubic. Secondly, the question addressed by the Commission in relation to each component of the banking market was subtly different from the question here. What the Commission was required to determine was whether the merger of National Bank and ANZ would be likely to "substantially lessen competition" in the market. The question we are asking is whether or not there is sufficient effective and workable competition in the market to ensure efficient outcomes. The Commission was interested in the change in the level of competition as a result of the merger; we are interested in the level *per se*. Despite these two caveats, however, the Commission's report is still of considerable interest to the current study.

4.2 Indicators

4.2.1 Concentration

a) Concentration Ratios

The most basic measure of industry or market concentration is the concentration ratio:

CR_k = the combined share of the market of the k largest firms in the market.

Thus, CR_3 is the combined share of the three largest firms and CR_5 is the combined share of the five largest firms. The maximum value of CR_k is 1.00 – the k largest firms cannot have more than the whole market. The minimum at the limit is 0.0. The higher the figure the more concentrated is the market.

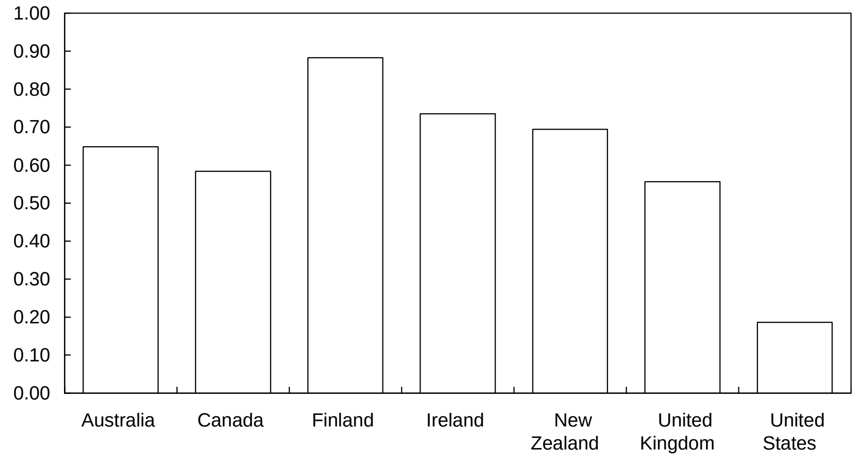
There are a number of recently published studies that have calculated concentration ratios for the New Zealand banking sector and compared them with corresponding ratios in other countries.

[23] http://www.comcom.govt.nz/publications/GetFile.CFM?Doc_ID=429&Filename=507.pdf Herein after we refer to the report in footnotes as Commerce Commission (2003).

Cetorelli (2003)

Figure 7 CR3 Average 1990-1997

Assets

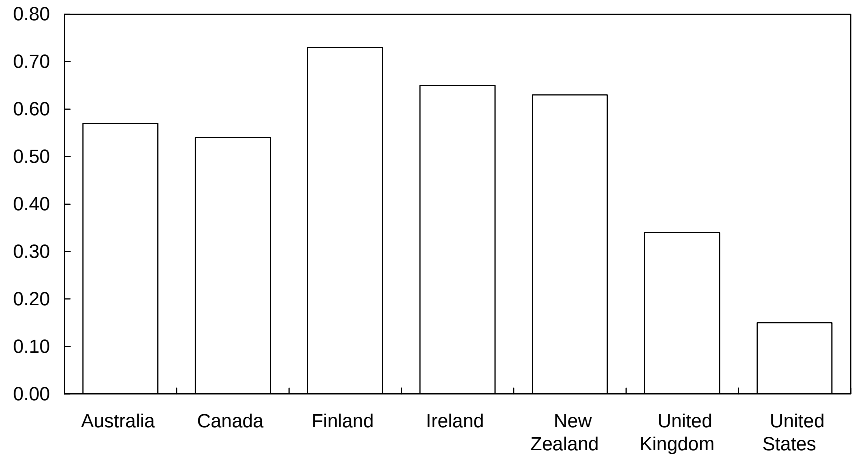


Source: Cetorelli (2003)

Bikker and Haaf (2001)

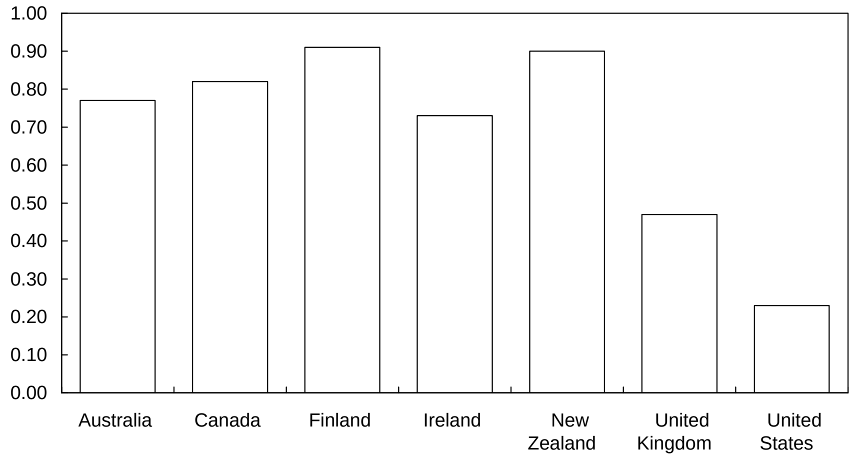
Figure 8 CR3, 1997

Assets



Source: Bikker and Haaf (2001)

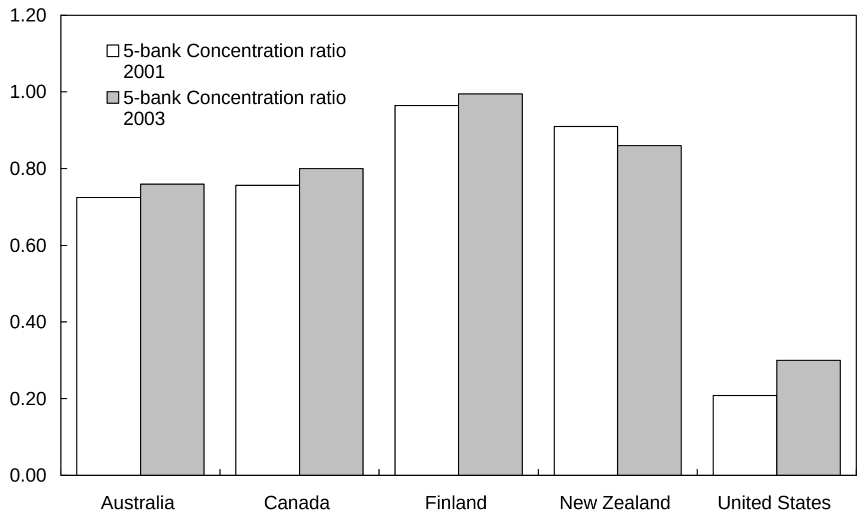
Figure 9 CR5 1997
Assets



Source: Bikker and Haaf (2001)

World Bank (2004)

Figure 10 CR5 2001 and 2003
Assets



Source: World Bank Banking Regulation Database

These all suggest that the New Zealand banking sector has a relatively high concentration ratio compared with other countries, including Australia, although the World Bank study indicates that the CR_5 ratio in New Zealand declined slightly between 2001 and 2003. Probably this reflected the establishment of Kiwibank and Superbank. With the merger of NBNZ and ANZ this year the CR_3 and CR_5 ratios would have risen again.

NZIER Product-based Data 2003

One criticism of these studies is that they have treated the banking sector as a single market, but as the recent Commerce Commission decision points out it is in fact several markets. We have accessed 2003 major bank market share information for a range of bank products and services. The CR_3 concentration ratios of these are shown in Figure 11. Concentration is least acute in home loans and most acute in credit card merchant servicing and rural banking but is high for all segments identified.

Figure 11 CR3 in detailed markets

[………] [Information withheld under section 9(2)b(i) and 9(2)b(ii) of the OIA 1982 – would disclose a trade secret and unreasonably prejudice the commercial position of who supplied or who is the subject of the information.]

b) The Hirfindahl-Hirschmann Index (HHI)

Another criticism of concentration ratio studies is that they only take into account the market share of the k largest entities and not the total distribution by size in the market. The HHI index was developed to address this criticism.

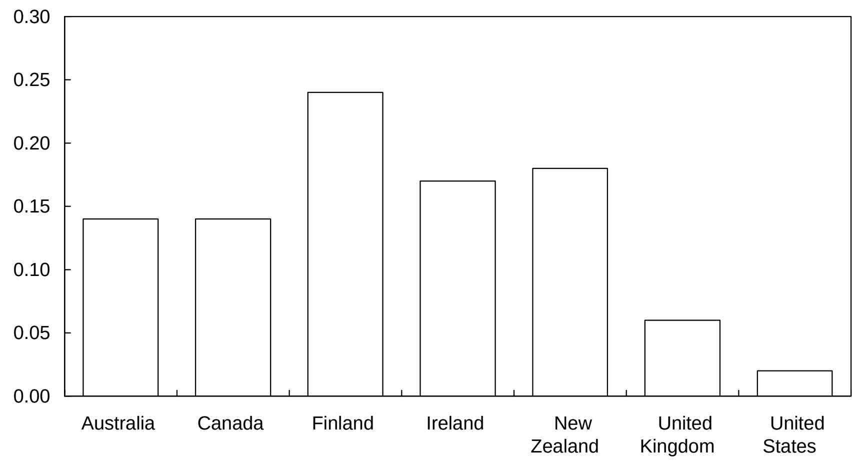
$HHI = \Sigma_{i=1}^{n} s_i^2$ where s_i = market share of the ith entity in the market

HHI ranges between 1/n and 1 and is at its lowest value, the reciprocal of the number of firms, when all firms in the market are of equal size. It reaches its highest value, 1, when there is a single monopoly firm.

Bikker and Haaf (2001)

Figure 12 HHI 1997

$HHI = \Sigma_{i=1}^{n} s_i^2$ where s= market share



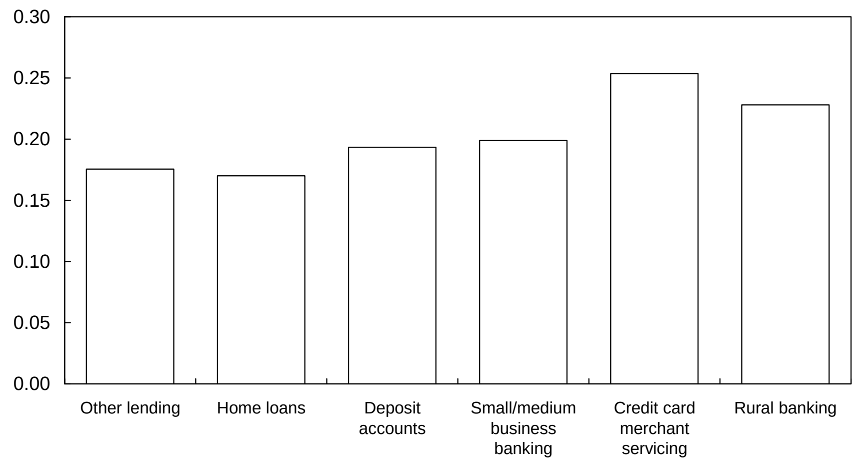
Source: Bikker and Haaf (2001)

This suggests the HHI for New Zealand banking was relatively high in 1997 when compared with the values for other countries, including Australia.

NZIER Product-Based Data 2003

Figure 13 HHI for main banking markets 2003

Constructed from market share data. Source differs from figure 6.



Source: NZIER

Again the data suggests the least concentration in home loans and the most in credit card merchant servicing.

c) Concentration and Competition

One issue with both concentration ratios and the HHI is that they require the definition of the relevant product and markets. All products and services that are substitutes should conceptually be included in the market definition. This is nearly impossible in the banking sector because of the presence of many products and services that are potential substitutes, many of which are provided by non-bank firms.

There is, however, an even more fundamental objection to concentration ratios and the use of the HHI in banking; that the number of participants in a banking market is not a good measure of the level of competition in the market. This is because in banking the threat of entry, or contestability, may be an important source of competition. Empirical research conduced by Claessens and Laeven using data from 50 countries, but not including New Zealand, found that:

- Banking system contestability was positively related to the presence of foreign banks, less severe entry restrictions, and few activity restrictions.
- Banking system contestability was positively related to concentration and negatively related to the number of banks.[24]

d) Panzar-Rosse Methodology

The Methodology

To establish these results, Claessens and Laeven used the Panzar and Rosse methodology. This approach measures the competitive conduct of firms without using explicit information about the structure of the industry and market. It relies on the insight that in a collusive environment, assuming profit maximisation, an increase in the prices of inputs will increase marginal cost, reduce the equilibrium level of output and reduce the firm's total revenue. On the other hand, under perfect competition, an increase in input prices increases marginal costs and marginal revenue by the same amount as the initial cost increase because all firms are equally affected. Thus, the nature of the competition in a market can be observed by looking at how revenue responds to changes in the costs of funds, labour and capital, or proxies of these prices.

The sum of the elasticities of revenue to the input prices is called the H-Statistic.

- If H is negative or zero then each bank is operating as if it monopoly profit maximising. There is a perfect cartel.

[24] Claessens and Laeven (2003)

- If H is one or greater then each firm is operating as if there is a free entry equilibrium with full efficient capacity utilisation.
- If H is between zero and one firms are behaving as if there is a monopolistic competition free entry equilibrium.

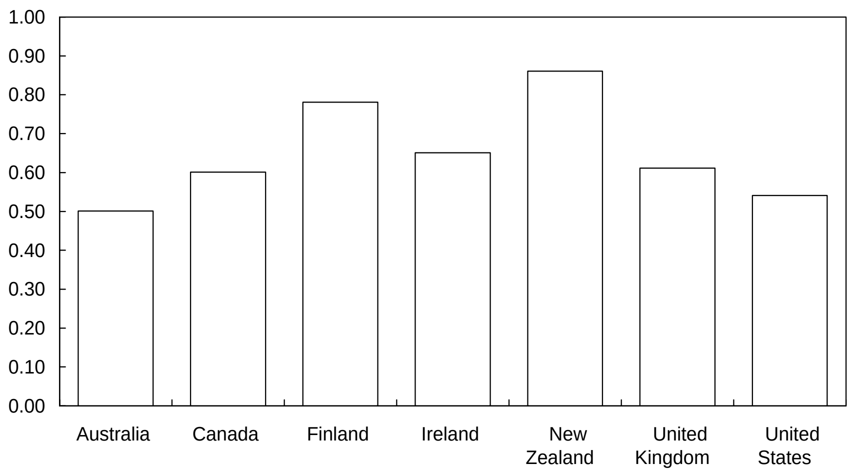
Some Results

While Claessens and Laeven did not include New Zealand among the 50 countries they studied, Bikker and Haaf have included New Zealand in a study using the Panzar-Rosse methodology and H-Statistic.

While banking markets in all countries shown (and all 23 in Bikker and Haaf's paper) are characterised as monopolistically competitive (i.e. the null hypotheses H=0 (perfect cartel) and H=1 (perfect competition) are both rejected at the 95% confidence level) New Zealand is seen as particularly competitive, as is Finland. Both these countries also exhibited high relative concentration ratios and HHIs. However, the variability of H-statistic over time and between studies suggests that not too much should be read into these relativities. [25]

Figure 14 H-statistics 1991

H=1 (perfect competition), H=0 (perfect cartel)



Source: Bikker and Haaf (2001)

The Bikker and Haaf study using the Panzar-Rosse methodology suggests that despite a highly concentrated banking sector, the New Zealand banking market is relatively competitive. The variables used in this study means it really only attempts to test the core financial intermediation activities of the banking sector and the results, if they are accepted at all, can only be taken

[25] Michael Gordon of the RBNZ has done a useful comparison of the H-statistics for the countries dealt with in both Bikker and Haaf's paper and Claessens and Laeven's paper. It shows that the statistic varies quite considerably between the two studies.

as applying to this aspect. While Claessens and Laeven's study did not investigate New Zealand its results, if accepted, suggest the relative competitiveness of intermediation in the New Zealand banking market reflects the presence of foreign banks, minimal entry barriers and minimal restrictions on the activities of banks, and, one might suggest, minimal restrictions on other non-bank financial institutions that compete with banks for one or more services. However, given the variability of the H-statistics observed and some of the uncertainty that inevitably attaches to econometric studies using surrogate and proxy variables, not much weight should be placed on these results.

4.2.2 Homogeneity of Products and Services

The webpage research of the products and services offered by banks, which is reported in Appendix B shows that the offerings of each bank are broadly very similar. While market research does show that the image of each bank is different[26] it is unlikely these difference amount to enough to allow one bank to sustain a non-trivial increase in prices without it eventually impacting adversely on its market share.

4.2.3 Availability of Market Information

The Goldstein-type research we conducted revealed a very large amount of information available on webpages and in branches on products and services and prices and charges. According to ACNielsen, at the end of 2002, 72 percent, or 2.3 million New Zealanders aged 10 plus, have access to the internet and 53 percent had used it within the four weeks prior to being interviewed.[27]

4.2.4 Ease of Switching

One of the common allegations about banking is that it is very difficulty and costly for customers, and particularly, small to medium-sized business customers to switch banks.

Figure 15 shows ACNielsen's data on main bank switching among personal, small business and rural customers. Throughout the period the criteria used for personal customers was whether they had the same bank now as 12 months-ago. Until 2000 for small business and until 2001 for rural customers the cut-off was 24 months. Subsequently, the 12 months-ago criterion has been used for all three groups. We have converted the earlier data to annual rates by dividing them by two.

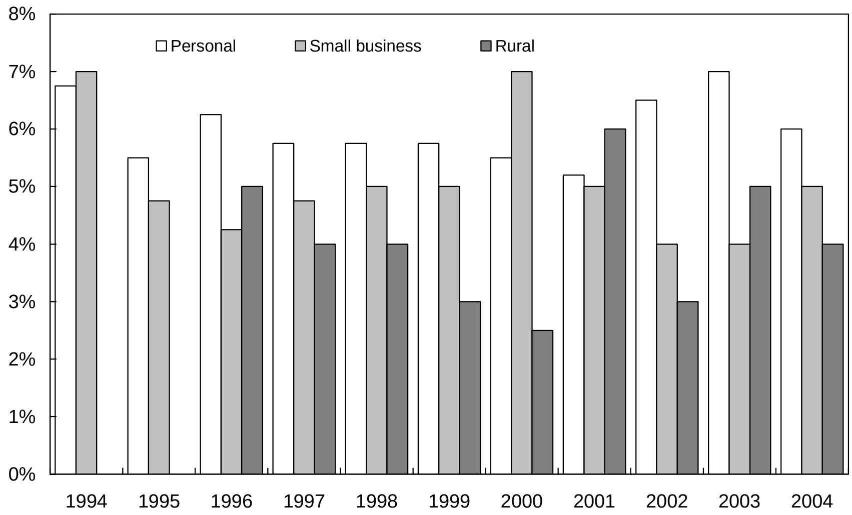
[26] Merrill Lynch and Roy Morgan Research.

[27] http://www.smartmarketer.co.nz/articles.asp?issue=0204&au=aw

- For personal customers the percentage of customers changing main bank in any one year has generally been between 5 and 7 percent over the last decade. There has been no appreciable trend.
- For small business the annual rate of switching has been slightly lower on average at between 4 and 7 percent with again no clear trend during the period surveyed.
- For rural customers the annual rate of switching has been slightly lower still on average at between 3 and 5 percent with again no trend. Surveys started in 1996 for rural customers.

Figure 15 Switching banks

Percentage who have switched main bank in the last 12 months



Source: ACNielsen

Data provided by Roy Morgan Research for 2003 on New Zealand bank customers is broadly consistent with the ACNielsen data. It shows that customer acquisition and attrition rates in the twelve months to December 2003 averaged 7 percent.

The Roy Morgan Research data also gives reasons stated for switching. In descending order for all customers these were:

- High fees and charges (42 percent)
- Better deals elsewhere (36 percent)
- Poor service (30 percent)
- Don't care about loyal customers (27 percent)
- Took out new loan (23 percent)

However, for the top 20 percent of customers, the most important reason was "Took out a new loan" with 47 percent in this category.[28]

Do these statistics indicate it is difficult to switch main banks or not? International comparative data is not available but what inference could be drawn from it if it were is hard to determine. If the switching rate was significantly higher, would this indicate greater or lesser difficulties in New Zealand or greater of more dissatisfaction or just that New Zealander's act when others just think about it?

There is another New Zealand sector for which switching statistics are readily available and which has almost the same client base as the banking sector – electricity supply. There are approximately 1.85 million points of connection (ICP's) for electricity in New Zealand. After an initial flurry which last a few years, the monthly rate of switching has settled to be around 14,000. On an annual basis this converts to 9.1 percent of ICPs switching electricity retailer.[29] This rate is about 50 percent higher than the rate of switching main banks recorded by ACNielsen. Again, however, the question arises as to what this really indicates. We know that from time to time banks and electricity retailers are both subjected to public criticism for their service levels and pricing so what does the higher rate of switching in electricity retailing mean for the difficulty or otherwise of changing banks and the ability of a bank to act in an uncompetitive manner?

What we do know is:

- Approximately 1 in 13 personal customers and small businesses and 1 in 16 rural customers change their main bank each year, and that this pattern has been present for a number of years;
- Two new retail banks have established in New Zealand in the last three years – Kiwibank and Superbank.
  - Kiwibank is backed by New Zealand Post, a State-Owned Enterprise and has used NZ Post's branches and franchise outlets as its base. It started operations in February 2002 and claims it had reached 250,000 customers and $960 million in deposits in June 2004.[30]
  - Superbank is a phone and internet bank operated by a joint venture between St George, an Australian retail bank, and Foodstuffs, a New Zealand based supermarket organisation. It started operations in February 2003.
- Two banks – ASB Bank and Trust Bank - were both able to go from having no commercial customers to having significant shares of the small

[28] Merrill Lynch, p.3.

[29]http://www.electricitycommission.govt.nz/operations/registry-statistics/switching-activity-oct04.pdf

[30] http://www.kiwibank.co.nz/news/show-news.asp?story=59

and medium business market in a relatively few years in the late 1980s and early 1990s. Other factors peculiar to the time may have helped them achieve these transfers, but the fact remains that very considerable numbers of customers did switch.

- It is reasonably standard practice for medium to larger New Zealand businesses to put their banking needs out to competitive tender every few years. It is not uncommon for this to result in a change in bank.

To test the last suggestion we conducted a survey of the Annual Reports sent to the NZIER library. Most of these are sent by members of the Institute and most of the members are significant entities. Not every Annual Report records the organisation's bank or banks, but a number do. We identified all those that recorded their current banks in two adjacent years between 1997 and 2003 and of these we identified those that indicated a change in bankers between adjacent years. Table 7 records the results of this study.

The results suggest that around 20 percent of significant organisations change one or more of their banks each year. At first sight this result appears very high. In a significant number of cases the changes recorded occurred when an organisation had a panel of banks listed and added, deleted or changed one or more members of the panel between years. It might be argued that these changes are not real bank changes, but given that our interest is in the level of contestability of banking services we consider to exclude such data would not be consistent with our purpose. If a bank is dropped from a panel it has lost an opportunity, and if it is added is has gain one.

Table 7 Bank Turnover Rates from Annual Reports in NZIER Library

	Sample Size	No Bank Changes	% Bank Changes
1997-98	36	4	11.1
1998-99	46	8	17.4
1999-00	52	8	14.3
2000-01	60	12	20.0
2001-02	55	11	20.0
2002-03	48	10	20.8

Source: NZIER

These points, taken together, do not suggest major difficulties for customers switching banks in New Zealand. More to the point, they do not suggest that the New Zealand banking sector is an environment in which bankers will believe they can neglect competitive pressures from other banks on their market share because it would be too difficult and costly for their customers to desert them.

4.2.5 Presence of Excess Capacity

Excess capacity in branch networks has been a feature of the banking sector for sometime. The reduction in branch capacity tended to lag the reduction in demand for branch services as transactions became more electronic based. There has also generally been spare capacity in the processing facilities of banks because of the high costs of failing to have enough capacity to meet demand at any time. Systems are built to accommodate the busiest times on the busiest days with a margin to spare. Thus, for products and services that do not utilise scarce resources at peak utilisation times for the bank as a whole, marginal cost has tended to be low and the impact on profitability of losses of market share and volume quite high. In general these are conditions that favour competition.

4.2.6 Barriers to Entry

a) The extent of economies of scale

A very recent review of the literature on competition in banking summarised the empirical results in the following way:

> *Early studies on the ability of banks to realize economies of scale focus on the U.S. banking sector. A common finding of these studies is that medium-sized banks are the most scale-efficient, which they take to imply that there are few economies of scale for large banks. Studies on more recent data, however, do find economies of scale for large banks when changes in the risk-taking behaviour of banks are controlled for.* [31]

Markets for banking services in New Zealand are comparatively small and scale economies might be thought to limit the number of viable competitors in many of these markets. On the other hand, many actual and potential providers of banking services in New Zealand are part of a large financial organisation. The ability of these organisations to achieve efficiencies is not limited by the size of the New Zealand market. By internationally integrating corporate functions, computer systems, back office functions, marketing functions, research and the like economies of scale can still be achieved, even with a relatively small New Zealand banking operation.

The current providers of banking services in New Zealand are not able to safely assume that new entrants will not arrive because of the barriers to entry created by economies of scale. The fact that there has been two new

[31] Northcott (2004), pp.9-10.

entrants to the personal retail banking market in the last three years and one of them has now moved on to enter the small business market[32] should be enough to convince the present players, even if consideration of how internationalising functions will help achieve economies with only a small local presence does not.

b) Limitations on access to resources

Branch network

A common argument is that the need for access to a well-located branch network inhibits competition in the provision of banking services, such as transaction accounts, involving frequent contact between customers and banks. As was shown in section 3.2 the importance of branches as a delivery mechanism for services has diminished significantly in recent years. ATM's, EFTPOS facilities, the spread of direct credits and debits, phone banking, mobile mortgage managers and internet banking have all reduced dependence upon bricks and mortar even for transactional based business.

Moreover, Kiwibank has successful established over 300 outlets within three years by utilising existing New Zealand Post shops and franchised premises and Superbank through its joint venture owner Foodstuffs has access to potentially just under 500 outlets in supermarkets.[33] These examples show that it is not impossible to create a branch platform if the task is approached creatively.

Nor is it plausible that these two new entrants have locked up all the available opportunities. There are other supermarket chains, and chains of petrol stations and other retail stores. There are also over 50 Public Trust Offices. There are several networks of travel agents offices which have been left with spare capacity as a result of the spread of internet bookings. In addition, there are chains of fast food outlets. These usually have high visibility locations near major population concentrations with ample parking that is virtually unused during the times business customers want to visit a bank branch. All these features are very attractive for bank branches.[34]

ATM Network

Another network which it is sometimes alleged gaining access to provides a barrier to entry into the transaction business is an ATM network. In 2003 there were over 1800 ATM arranged in four networks in New Zealand. The largest share, approximately 34 percent, is owned by the newly merged ANZ/National Bank. Westpac has 27 percent, BNZ 21 percent and ASB

[32] http://www.kiwibank.co.nz/news/show-news.asp?story=59

[33] http://www.comcom.govt.nz/publications/GetFile.CFM?Doc_ID=429&Filename=507.pdf, p.44.

[34] For just these reasons co-location adjacent to McDonald's franchises was used by Trust Bank Canterbury in the late 1980s when it started to recruit small business customers.

Bank 17 percent.[35] Kiwibank has recently announced it is rolling out a network of 300 ATMs. These will be in place by April 2005.[36] This will give Kiwibank a 15 percent share of the 2100 ATMs in the country after its roll-out.

At present a number of bilateral agreements among ATM owners and between ATM owners and non-ATM owners govern access to the various machines. Fees are generally received on a per transaction basis. There is no reason to believe that access to ATM networks is likely to be a barrier for any potential entrant. Anyway, rolling out a new network like Kiwibank has decided to do is an option. Moreover, EFTPOS terminals can provide a substitute for some services provided by ATMs, such as cash dispensing.

Debit Card Processing Network

Another network a new entrant into the transactional aspects of banking would require access to is the debit card payment processing system. There are currently two switches in New Zealand, one – EFTPOS New Zealand - owned by ANZ, and the other - ETSL - owned jointly by several major banks. The establishment of a third switch is probably uneconomic and any rate a new entrant that chose this route would probably have to pay a relatively high interchange fee to the operators of the current switches to cover their past investments in the current arrangements.[37]

Kiwibank has gained access to the system and it is likely other banks that wanted to do so could through one or other of the switches. A decision by either or both to block entry on a reasonable basis would be open to challenge under the Commerce Act.

Intellectual Property

Access to information is critical to effective participation in banking service markets irrespective of whether those markets relate to transactions, borrowing and lending or the provision of interest rate and currency risk management products.

In many instances this information can be bought either through hiring the staff with the skills and knowledge or from third parties, such as rating agencies, credit agencies, information service vendors, software providers and the like. Access to intellectual property and information does not constitute a significant barrier to entry in New Zealand's banking markets.

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[35] http://www.comcom.govt.nz/publications/GetFile.CFM?Doc_ID=429&Filename=507.pdf, p.46.

[36] http://www.kiwibank.co.nz/news/show-news.asp?story=61

[37] http://www.comcom.govt.nz/publications/GetFile.CFM?Doc_ID=429&Filename=507.pdf, p.48-9.

c) The Importance of Reputation

Reputation is important for entry into the banking sector, or at least it is important for the taking of deposits and participation in settlement arrangements with other institutions. However, in the low entry requirements to become a bank operated by New Zealand there are many entities among overseas financial service organisations with the reputational standing to be credible entrants. In this regard, it is noteworthy that while Superbank is not using the St George brand it has adopted its colour palette and stylised dragon character and makes no secret of its connection with St George and Foodstuffs. Likewise, Kiwibank has widely publicised its connections with New Zealand Post and through it to the Government. The importance of reputation does not constitute a material barrier to entry into the New Zealand banking markets.

d) Regulatory restrictions on entry and compliance costs

A new entrant wanting to be a registered bank in New Zealand must meet the Reserve Bank's minimum capital requirements. These are not particularly onerous:

- Minimum capital of $15 million;
- Minimum capital of 8 percent of risk weighted assets; and
- Minimum tier 1 capital of 4 percent of risk weighted assets.

There are some other competency and prudential system requirements imposed by the Reserve Bank. Even when taken together, however, there is no material regulatory restriction on entry into the banking market.

Moreover, compliance costs in New Zealand are not major. There are regular disclosure reporting requirements for registered banks, but these impose little, if any, additional costs to the reporting requirements a prudent bank board would require any rate.

Compliance requirements could increase under the Reserve Bank's new outsourcing policy for systemically important banks[38]. How significant any increase might be will depend on the details of the requirements, and the circumstances of individual banks and their options for meeting the requirements. Even with the new policy, it is very unlikely that compliance costs will constitute a barrier to entry to New Zealand's banking markets.

e) Empirical Evidence

Appendix C records the entries and exits among registered banks in New Zealand since 1986. The table shows that there have been considerable movement into and out of the ranks of registered banks. If there have been

[38] http://www.rbnz.govt.nz/banking/regulation/0160250.pdf

barriers to entry in banking markets they have not been uniform across markets or have not been particularly high.

4.2.7 Collusion

a) Ingredients for Collusion

The three ingredients for successful collusion – opportunity, detection and retaliation - can all be identified in the New Zealand banking sector in relation to the services provided to smaller customers. This does not mean that explicit or implicit collusion is actually occurring, but it does mean that the issue needs to be investigated for evidence.

b) Opportunities

Significant subsets of the registered banks in New Zealand have forums at which they meet regularly, and which could potentially provide a vehicle for collusive activity:

- Membership of the New Zealand Bankers' Association[39] is open to any bank registered under the Reserve Bank Act 1989. The Association currently has eight members – mainly the full-service banks. Its Council consists of the Chief Executives of the member banks. The Association's functions include:
  - Development of the self regulatory Code of Banking Practice;
  - Development of inter-bank procedures and standards for retail payment methods such as direct debits and automatic payments;
  - Development of collective priority documents for securities over assets;
  - Provision of payment statistics supplied by members; and
  - Collective submissions to Government, the Reserve Bank and other bodies on public policy and regulatory matters affecting banks.
- Interchange & Settlement Limited[40] (ISL)
  - ISL operates the major retail payment processing system in New Zealand. The system is used to interchange cheques, direct debits, direct credits, automatic payments, ATM transactions, telephone banking transactions and off-site electronic banking transactions;
  - ISL is owned collectively by 9 registered banks – the full service banks, apart from Kiwibank plus Deutsche Bank and Citibank;

[39] http://www.nzba.org.nz/about.htm

[40] Commerce Commission (2003), pp. 12-3.

  - The owners of ISL set the rules governing the operation of the clearing house, including transaction pricing. However, access to the system is not restricted to shareholders; and
  - Non-shareholder banks and non-banks can obtain access through having an agency arrangement with a participant or can have a user licence agreement with ISL. A licence gives the holder the right to settle payments via the ISL system in return for a payment. Kiwibank is the only party accessing through the licence arrangement at present.

- Electronic Transaction Services Limited[41] (ETSL)
  - ETSL operates one of the two switches for the interchange and clearance of EFTPOS and credit card transactions. The other – EFTPOS New Zealand Ltd – is wholly owned by the ANZ.
  - There are currently four equal shareholders of ETSL – ASB, ANZ/National, Westpac and BNZ.
  - ETSL's constitution provides that each shareholder has the same rights and privileges and is subject to the same restrictions.
- Visa New Zealand Limited[42] (VNZL)
  - VNZL was incorporated in 2002 as a joint venture vehicle to provide its shareholders with access to the Visa International system. It replaced the need for the entities to be members of Visa International directly.
  - VNZL's Board has discretion to issue shares to any applicant that agrees to accept the obligations of being a shareholder and would otherwise be eligible for direct membership of Visa International. The shares may be issued in various classes, but the main shares are the principal shares which give full rights to holders to issue cards, extend credit and sign up merchants.
  - The current principal shareholders of VNZL are ANZ/National, BNZ, Westpac, and ASB. HSBC has a "plus" share and TSB an "associate" share.
- MasterCard International[43]
  - All the major banks are also members of MasterCard International but this does not have a New Zealand domiciled entity which could potentially act as a focus for collusion.

[41] Commerce Commission (2003), pp.13-4.

[42] Commerce Commission(2003), pp. 14-5.

[43] Commerce Commission, p.15.

c) Detection of Breaches of Collusive Arrangements

The prices and charges for transaction processing, general account fees and other bank charges for small customers are very easily detectable. They are published in bank branches and newspapers and on the webpages of the banks. Our research reported on in Appendix B shows that New Zealand banks that deal with retail clients have extensive websites containing this kind of information.

What are not easily detectable are the lending margins, deposit rates, fees and forex shadings offered in arrangements tailored to a specific customer. The potential sources for this information are the bank itself, which has no incentive to reveal the information to another bank or outsider, and the customer, which has incentives to reveal information that suggests its arrangements are more favourable than is the case. Usually only larger customers have access to tailored deals and usually larger customers have such deals.

d) Retaliation

The Commerce Commission when considering the potential for the exercise of co-ordinated market power in transaction accounts in the context of the ANZ - National Bank merger decision concluded:

> *… it is not clear whether the banks would have a credible punishment strategy. For instance, over the past few years, ASB has been growing successfully and was considered by one market participant as a maverick player.*[44]

The importance, however, of the inter-bank money market for the management of liquidity and the inter-bank foreign exchange market for the management of currency risks provides a potentially potent vehicle for retaliation in the event of a bank breaching a collusive arrangement. Other banks could reduce their dealing limits on the maverick player and this would quickly bring pressure to bear on them without any need for the retaliating parties to explicitly reveal what they had done, or why they had done it. Action against the maverick would not even need to be carefully co-ordinated or monitored.

e) Evidence of Collusion

Having identified that the ingredients for collusive behaviour are present in relation to the services provided to smaller customers does not establish that collusion is actually happening. Evidence of the activity is often difficult to detect. In section 4.2.1 we reported the results of Bikker and Haaf's analysis of the New Zealand banking sector using the Panzar-Rosse methodology. This suggested that the New Zealand banking sector was competitive. The

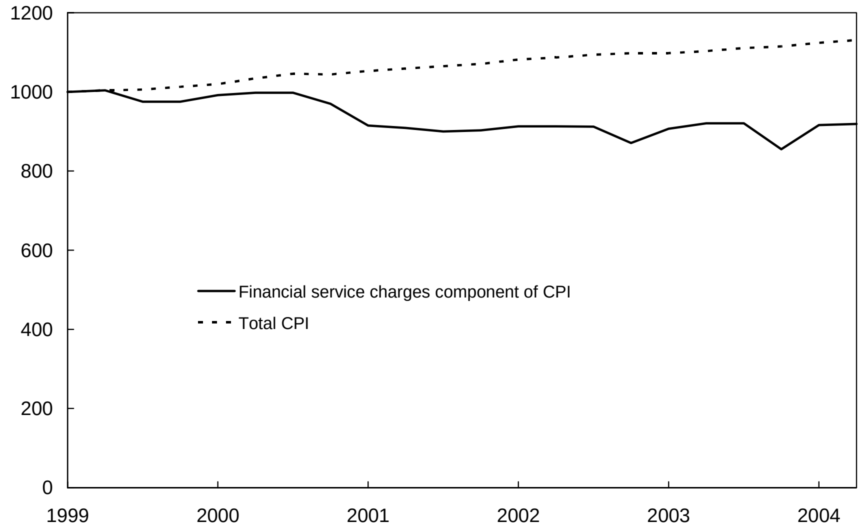
[44] Commerce Commission (2003), p.54.

methodology used means that the analysis was restricted to interest margins of the banks on their core borrowing and lending activities, however, so this result, even if fully accepted, and there are grounds to doubt doing so, does not rule out collusive behaviour in relation to other banking markets.

It is widely perceived by customers that banks have been increasing their fees and charges and that there is a collusive element to this. The financial services charges component of the Consumers Price Index has been published since 1999. This covers bank fees, loan application fees and government bank fees and credit and store card fees. Prior to 1999 interest costs were included with bank charges and so the index is not informative for our purposes. As Figure 16 shows, the popular perception that consumers have been facing steadily increasing charges is not consistent with this index. In fact, on an index basis charges are now lower than they were in 1998; they have not only declined in real terms, they have declined in nominal terms. The most likely explanation for this divergence between popular perception and measured reality is that while the transaction fees charged by banks to consumers have risen as the level of cross-subsidy on these activities was reduced; the charges associated with loan applications have fallen. For many borrowers loan application fees no longer apply.

Figure 16 CPI - Financial service charges and total CPI

CPIQ SE9J2A and CPIQ SE9A, June 1999 = 1000

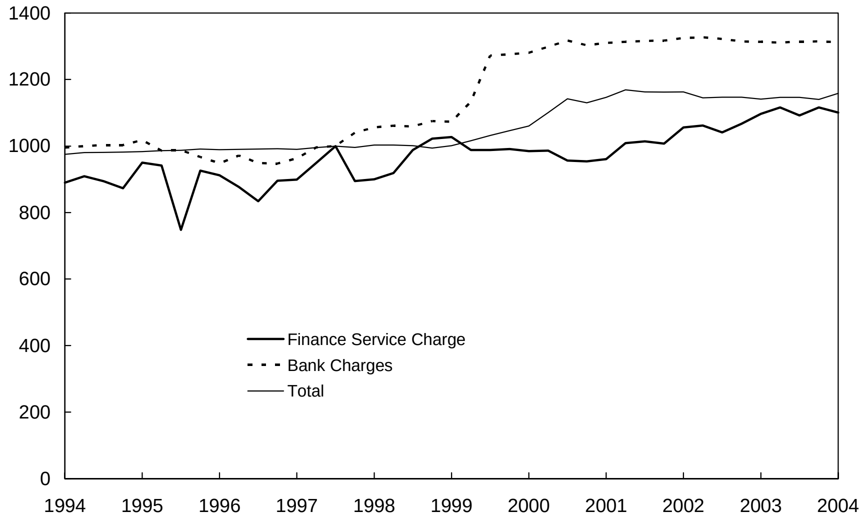


Source: Statistics New Zealand

The Producers' Price Index – Inputs series has included a bank charge component and a financial services charge component since 1994. The data measure the increase in bank charges to businesses as opposed to the consumers covered by the Consumer Price Index data. As Figure 17 shows these series indicate the rise in bank changes for firms over this period at a faster rate than input prices in general with much of the increase occurring in the three years 1998-2000. However, the rate of increase has not been high and when the fact the general rise in the New Zealand dollar in recent years has suppressed the PPI – Inputs index is recognised, whereas bank charges are largely driven by local costs, the increase is not exceptional. Thus, the movements in price indices do not support the view that banks have been aggressively and continually pushing up their charges on individuals or businesses in recent years; never mind that they have been colluding to do this. If banks were colluding why have they not colluded to hold up loan application fees on consumers? If the movement in bank charges for businesses around 1999 were the result of effective collusion, why did the banks not continue to raise charges?

Figure 17 PPI inputs – Financial service charges, bank charges and total PPI inputs

PPIQ SC20, PPIQ SC21, PPIQ SN9, December 1997 = 1000



Source: Statistics New Zealand

The review of bank websites we conducted revealed that banks have a wide variety of fees and charges for basic activities. To more systematically test this we chose seven standard activities undertaken by banks for both personal and business customers and identified the charges for these services at the ANZ, ASB Bank, BNZ, HSBC, Kiwibank, National Bank and Westpac.

The results are shown in Table 8 and they reveal considerable variation in even these basic charges between the various banks in New Zealand. It would be hard to argue this pricing reflects collusion between banks. In short, the movement over time and inter-bank variance of bank fees do not support suggestions of bank collusion in their non-intermediation activities.

On the other hand, the pricing strategies of banks suggest that they are keen to make it difficult for customers to easily compare their prices. Moreover, the variation in fees for relatively standard services does not suggest the market for these services conforms to perfect competition with one price.

Table 8 Variation in Selected NZ Bank Fees

	Mean	S.D./Mean	Maximum	Minimum
Bank Cheque	$5.50	0.17	$7.50	$5.00
Dishonour	$30.00	0.32	$50.00	$25.00
AP Estab. Fee	$4.54	0.18	$5.00	$3.00
Stop payment	$20.00	0.20	$25.00	$15.00
Special Answer	$25.29	0.22	$30.00	$15.00
Other Bank ATM	$0..97	1.38	$4.00	$0.30
Replace Cr Card	$10.00	0.29	$15.00	$5.00

Source: NZIER

4.3 Performance

4.3.1 Issues with Accountancy

Non-professional commentators on banking performance often look at one or more accounting measures of bank profitability and draw conclusions about monopoly behaviour from what they observe. There are a number of difficulties with what looks such an obvious and simple approach. These stem from issues with accounting for banks. Some of the issues only have a short or medium term impact and are unlikely to affect the trends in reported statistics over a number of years:

- Banks now prepare their accounts incorporating revaluations of their assets and most of their liabilities to current market values.[45] A major factor that impacts on the values is movements in interest rates; as interest rates rise, fixed rate assets decrease in value and fixed rate liabilities increase in value, and vice versa for rate falls. Because not all liabilities are revalued - at call deposits and equity are generally not – and the interest rate reset terms of the assets and liabilities do not usually match, the reported profitability of banks can be affected by movements in interest rates. In the medium term, however, the distortions tend to average out;
- Movements in provisions for bad and doubtful debts, which inevitably involve a degree of subjectivity, can also have an impact on reported bank profitability. Again the impact tends to "average" out over a few years;

[45] FRS-33 Disclosure of Information by Financial Institutions. The corresponding Australian and International Standards are AAS-32 and IAS-30. The three standards are generally very similar.

Other accounting issues can have a more material effect and can impact the reported accounts over time and make it difficult to compare banking with other industries or between countries:

- Three of the important categories of "assets" of a bank are: its reputation and brand image; its systems including its various contracts; and the expertise and industry knowledge of its staff. These "assets" generally require considerable expenditure to create or acquire and maintain, but they do not figure in the accounting assets of a bank, and hence do not get reflected in the equity recorded in the accounts. For this reason the accounting equity of a bank generally considerably understates its "economic" equity – what the bank is worth in terms of its ability to generate income – even if the bank were in a competitive market;[46]
- Most major banks in New Zealand are international entities and they look to maximise their profits and shareholders wealth on a global basis. Governments adopt tax rules aimed at preventing banks operating in their economy from shifting profits to lower tax environments. However, these rules also set the limits on what banks can legally do and inevitably they attempt to arrange their affairs so that they minimise their global tax subject to the constraints imposed by the tax rules of each country in which they operate. This can make interpreting bank accounts of subsidiary operations difficult.
- International banks also try to allocate their scarce capital so as to maximise their global profits subject to the constraints on capital adequacy imposed by the bank regulators in the various countries in which they operate. The decisions made for this purpose can lead to distortions in figures such as the accounting returns on capital and assets in individual countries.

4.3.2 The Evidence on Bank Performance

a) Return on Equity

In terms of return on equity as reported in statutory accounts, New Zealand banks have:

- Experienced a relatively high rate when compared with many businesses at between 20 and 25 percent per year for most of the last decade; and
- Performed relatively strongly even compared with the banks of the other countries and regions for which data are shown in Figure 18.

The high rate of return on equity relative to other businesses undoubtedly owes a lot to the three accounting factors with enduring impact identified in

[46] This is a significant factor in why bank takeovers usually occur at well above the targets net tangible asset value. In the recent case of the ANZ purchasing National Bank the purchase price was $5.71 billion 2.8 times the most recently reported Net Tangible Asset figure of $2.03 billion. The anticipated savings from the merger were put at only $129 million per year after three years and these would not justify this level of premium. The other conceptually possible explanation is the purchaser gained the opportunity to earn monopoly profits.

the previous section. More specifically, since reputation and systems and detailed industry knowledge are generally more important in banking than most other businesses, relatively high reported returns in the sector should not be a surprise because the understatement of "economic" equity is generally greater in banking.

If only 10 percent of the operating expenditure of New Zealand banks has gone into creating the various forms of unaccounted for bank "assets" we have identified, and even if such capital has an economic life of only 10 years on average, then in 2003 the "economic" equity of the New Zealand banking system was $16.00 billion, or 23.4 percent, more than the accounting figure of $12.97 billion,[47] and the accounting return on equity was similarly overstated compared with the "economic" return on equity. The multiples to net tangible assets typically paid for banks of well over two suggest that the above assumptions about the extent accounting equity understates "economic" equity are very conservative. On the basis of NTA multiples it is not implausible that "economic" equity is twice or more times accounting equity, and if this is the case the reported relatively high returns in banking are largely, or entirely, a statistical mirage.

Moreover, the opportunities for utilising capital globally and exploiting opportunities to reduce taxation through using international connections are probably also greater in banking than other sectors generally. On the latter factor it has been recently alleged that New Zealand banks have been "under-paying" New Zealand tax by $360 million per year through the use of legal avoidance arrangements. This figure represents approximately 17.2 percent of the reported after tax profit of New Zealand banks in 2003.

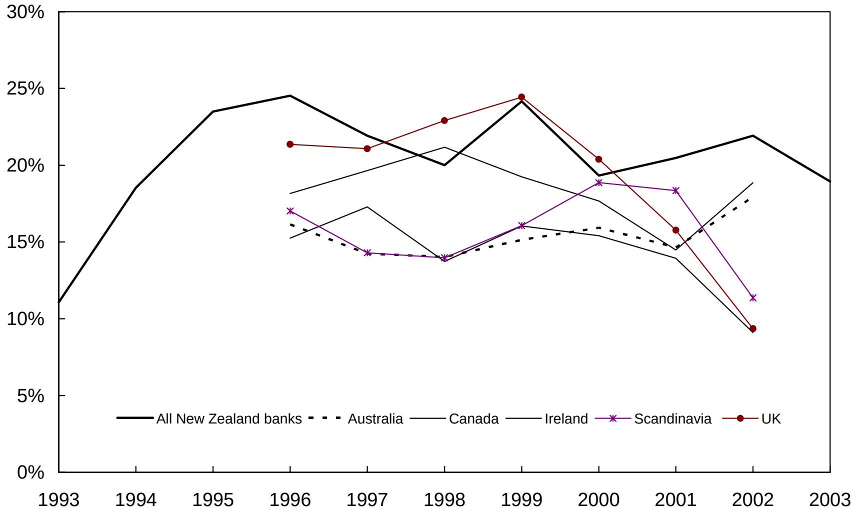
New Zealand banks have tended to have relatively low reported capital ratios (see Figure 19 and Figure 20) and this numerically explains a part of why the recorded return on equity here has been relatively high compared with return in other countries. The low capital ratios do not necessarily mean that New Zealand banks are more risky or less prudently operated. New Zealand banks are in the main subsidiaries or branches of off–shore banks and so will have access to capital through their parents in addition to what they have on their own balance sheets. Moreover, countries vary considerably in the stringency with which the implement the capital adequacy rules so drawing other than numerical conclusions from international comparisons is difficult.

In this context, however, it is noteworthy that the capital ratios of Australian banks tend to be below those of New Zealand banks and they are not generally controlled by offshore banks. In fact, Australian banks control most of the New Zealand banking sector as measured by funds under management (FUM) for example.

[47] Calculated from the KPMG banking statistics for 1994-2003.

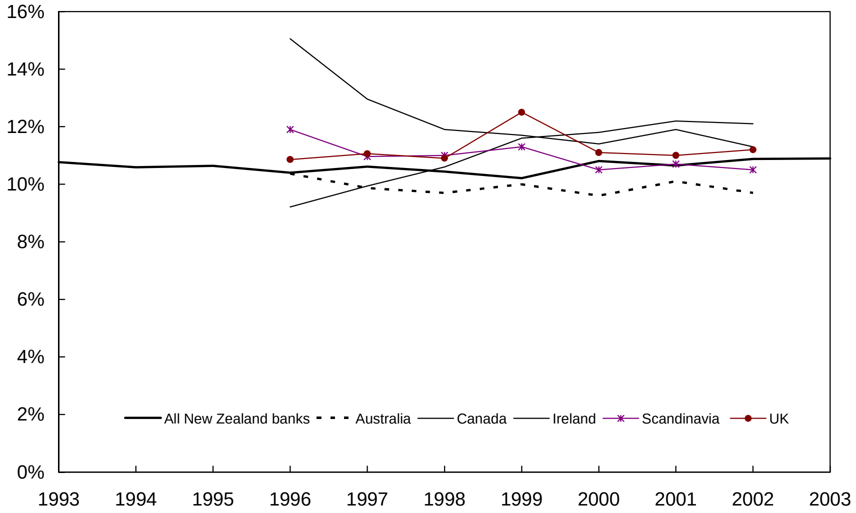
Figure 18 Return on equity

Percent



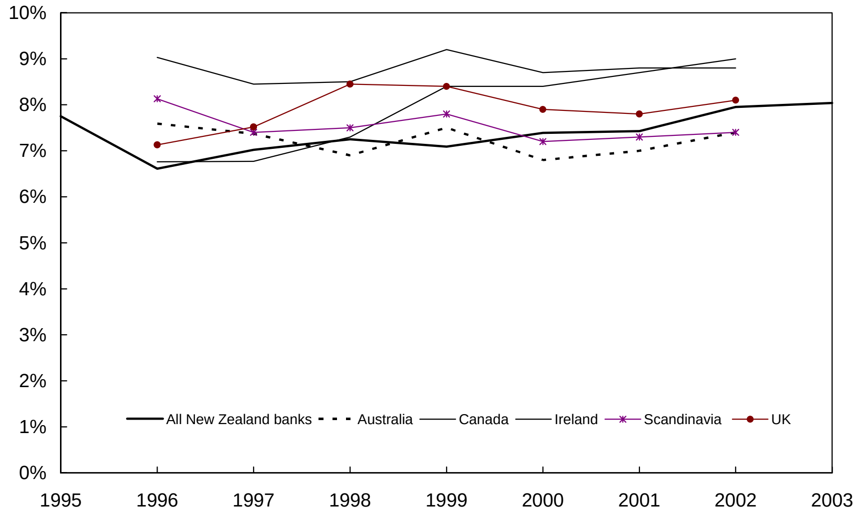
Source: KPMG and RBNZ

Figure 19 Total capital ratio



Source: KPMG and RBNZ

Figure 20 Total tier 1 capital ratio



Source: KPMG and RBNZ

b) Net Interest margin

Figure 21 compares the difference between the borrowing and lending rates, or net interest margin, for New Zealand banks with those of other countries. While the New Zealand margin is somewhat higher than in most other countries it is below Australia and also shares the downward trend, at least until the last couple of years, of all countries.

Figure 21 Net interest margin

Percent

Source: KPMG and RBNZ

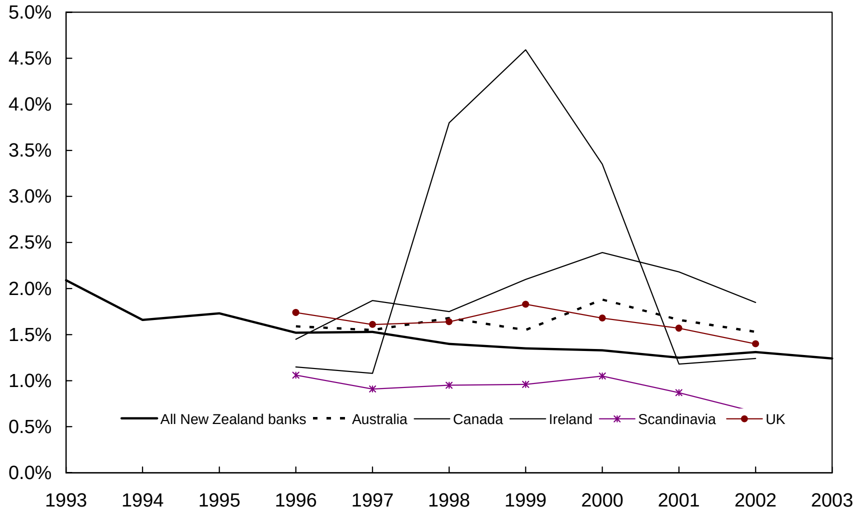
c) Other Operating Revenue

The other major component of bank revenue, apart from the interest margin, is bank fees and charges. These form part of other operating revenue. Figure

22 shows that New Zealand banks are about average in terms of the ratio of other operating revenue to average assets.

Figure 22 Other operating revenue / average assets

Percent, other operating revenue = non-interest revenue



Source: KPMG and RBNZ

d) Cost to Income

A broad measure of bank productive efficiency is the cost to income ratio. Figure 23 shows that this has been trending down for New Zealand banks since the early 1990s and the ratio in New Zealand in 2002 was well below the ratio in the other countries covered, including Australia. This strong downward trend has been quite remarkable and has probably contributed to New Zealand banks maintaining their relatively high accounting returns on equity over the last decade. Why New Zealand banks have been able to achieve such efficiencies relative to banks elsewhere is not easy to explain, but anecdotal evidence suggests that among several New Zealand banks this ratio was seen as important for competitive reasons from the late 1980s onwards and has been particularly targeted by managements.

Figure 23 Cost to income ratio

Total operating expenses/total operating income

Source: KPMG and RBNZ

4.3.3 Conclusions on Bank Performance

We have already warned of the difficulties in drawing conclusions about bank competitiveness from bank performance statistics. Even with this warning firmly in mind, it appears to us that several points emerge from the data reviewed in the previous section:

- New Zealand banks are particularly profitable in terms of accounting return on equity compared with other businesses and banks in other countries;
- Accounting return on equity overstates the "economic" return on equity of banks because several key "assets" of banks – reputation and brand image, systems and knowledge - are missing from their balance sheets. The level of overstatement could be considerable;
- The relatively high recorded profitability of New Zealand banks numerically owes a little to the lower reported capitalisation they tend to have, but New Zealand banks are not reported to be capitalised at lower levels than Australian banks. The parents of most New Zealand banks are Australian;
- The high reported profitability does not seem to be due to New Zealand banks having either unusually high interest margins or other operating revenue;
- New Zealand banks have significantly improved their operating efficiency over the 1990s as measured by their cost to income ratio. This has fallen from over 70 percent to around 50 percent.
- New Zealand banks have gone from the highest cost to income ratio of the 5 countries covered in 1996 to the lowest in 2002.

- On a cost to income basis New Zealand banks are now significantly more efficient than their Australian, Scandinavian, Canadian, Irish and United Kingdom counterparts.

4.4 Competition: Summary and Policy Implications

- New Zealand has a relatively concentrated banking sector when compared with other major economies, including Australia. Recent literature does not support a positive relationship between concentration and competition in banking, however;
- A test of bank competitiveness in the provision of intermediation using the Panzar-Rosse methodology suggests that despite the high concentration the New Zealand market is particularly competitive, and more competitive than Australia. Issues with this test mean its results should be treated cautiously, however;
- The broad similarity of product offerings, easy availability of market information, and general presence of excess capacity identified in the New Zealand banking sector are consistent with it being generally competitive;
- The complexity of pricing structures, minor variations in the terms attached to broadly similar product offerings and degree of price variation for similar services are consistent with the banking sector not being perfectly competitive;
- Data on switching by personal, small business and rural customers is hard to interpret but there have been no clear trends in the rates of switching;
- Other evidence on switching suggests that bankers in New Zealand are not in a position to assume that customers will not move banks if dissatisfied with prices or services.
- The rate of switching among major organisations uncovered in a simple investigation of a sample of Annual Reports was surprisingly high, but not inconsistent with governance practices now widely adopted by New Zealand directors.
- No significant barriers to entry into the banking markets were identified;
- The ingredients for collusion – forums to meet, ease of detection of breaches of collusive arrangements and the capacity to punish breaches – are all able to be detected in the New Zealand banking markets for personal and small business customers. The second ingredient – ease of detection – is not present in the market for banking services to larger customers;
- We found no evidence of collusion actually occurring;
- The trend in bank charges to consumers since 1999 has actually been down in nominal terms, and sharply down in real terms. It appears that the decline in loan approval fees has more than offset the rise in

transaction charges. Bank charges to businesses rose sharply around 1999 but otherwise have been relatively static;

- There is considerable variation among banks in the charges they levy for very similar services suggesting they are not actively colluding on these charges and also that the market for these services is not the classic perfectly competitive market with one price;
- New Zealand banks are particularly profitable in terms of accounting return on equity compared with other businesses and banks in other countries;
- Accounting return on equity overstates the “economic” return on equity of banks because several key “assets” of banks – reputation and brand value, systems and knowledge - are missing from their balance sheets. The level of overstatement could be considerable;
- The relatively high recorded profitability of New Zealand banks numerically owes a little to the lower reported capitalisation they tend to have, but New Zealand banks are not reported to be capitalised at lower levels than Australian banks. The parents of most New Zealand banks are Australian;
- The high recorded profitability does not seem to be due to New Zealand banks having either unusually high interest margins or other operating revenue;
- New Zealand banks have significantly improved their operating efficiency over the 1990s as measured by their cost to income ratio. This has fallen from over 70 percent to around 50 percent.
- New Zealand banks have gone from the highest cost to income ratio of the 5 countries covered in 1996 to the lowest in 2002.
- On a cost to income basis New Zealand banks are now significantly more efficient than their Australian, Scandinavian, Canadian, Irish and United Kingdom counterparts

As with innovation, there are no major grounds for concern about the relative competitiveness of the New Zealand banking sector. The ingredients for collusive behaviour are present for some segments of the market, but no evidence of actual collusion was found.

The banking markets are not characterised by perfect competition but in the key areas of intermediation, transaction processing and currency and interest rate risk management the evidence suggests a reasonable degree of competition between the banks and/or contestability from non-bank entities and potential new entrants.

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Appendix B A Goldstein Web Survey of Bank Services in New Zealand, Australia, Canada and the United Kingdom

Electronic files attached

Appendix C New Zealand Registered Bank Entries and Exits

Electronic files attached

Appendix D KPMG's New Zealand Banking Data

Electronic files attached