Capital Market Development – New Zealand Case Study

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Prepared by Artemisia Kousis and Brian McCulloch
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Contact Details:

Dr Brian McCulloch
Director, International
New Zealand Treasury
PO Box 3724
Wellington
NEW ZEALAND

brian.mcculloch@treasury.govt.nz

Introduction

A strong, well-functioning capital market is essential to the economic prospects of a small country like New Zealand. While New Zealand has a strong sovereign rating, high levels of private sector borrowing have produced a large net foreign indebtedness position. This places even greater importance on the resilience of its financial markets. This paper sets out the structure and function of New Zealand financial markets, describes the experience of reforms to date, and the priorities for ongoing reform. Independent assessments of New Zealand's capital markets that have been carried out recently are also summarised.

Structure and Functions of New Zealand Capital Markets

Financial Institutions

Table 1: Financial Institutions in New Zealand

Category	Total Assets	Total NZD and Foreign Currency Liabilities
Registered Banks	$205 bn	$180 bn
Finance Companies	$9.2 bn	$7.7 bn
Building Societies and PSIS	$2.9 bn	$2.6 bn
Credit Unions and Friendly Societies	$0.8 bn	$0.5 bn
Unit Trusts and Other Managed Funds	$25 bn	
Superannuation Schemes	$20 bn	
Life Insurance Companies	$10.7 bn	
General Insurance Companies	$3.5 bn	

Source: Mortlock (2003). Data are generally December 2002 or March 2003.

Table One provides an overview of the categories of financial institutions operating in New Zealand. Registered banks are the main type of financial institution, dominating deposit-taking, provision of credit and financial risk management products, and the money market and payment system. Most are foreign-owned. The five largest banks are all Australian-owned and account for more than 85% of total banking system assets.

Banks are subject to a licensing and supervision framework administered by the Reserve Bank of New Zealand. Legislation requires the Reserve Bank to conduct these functions for the purposes of:

- Promoting the maintenance of a sound and efficient financial system; and
- Avoiding significant damage to the financial system which could result from the failure of a registered bank.

The Reserve Bank's focus is therefore systemic stability and, unlike some other jurisdictions, not primarily depositor protection.[1]

Finance companies and building societies have a small but growing share of deposit-taking and lending markets. The larger finance companies are subsidiaries of banks, or of firms in the retail and distribution sectors.

Managed funds and superannuation schemes are significant vehicles for personal saving. The number of superannuation schemes has steadily declined over time. This is partly a result of private sector employer sponsored schemes consolidating from standalone to multi-employer arrangements. However, the number of scheme members has also declined, from 23% of the 1990 labour force being an active member of an occupational scheme, down to 14% in 2003. This trend is expected to reverse with the introduction of KiwiSaver in July 2007, although the consolidation into multi-employer arrangements is expected to continue.

Financial Markets

The main financial markets in New Zealand relate to debt instruments, foreign exchange, equities, managed funds, and non-foreign exchange derivatives.

Debt security markets operate at both wholesale and retail levels. They vary widely by type of instrument, issuer, buyer, maturity, and level of risk. Some are listed on the stock exchange. Government stock is issued in the primary market through regular tenders and there is a relatively liquid secondary market.[2]

The foreign exchange market facilitates international trade, capital transactions, foreign investment, and risk management. Most of the transactions are undertaken by the banks. They are generally conducted on a bilateral basis.

Equities in most large New Zealand companies are traded on the New Zealand Exchange Limited (NZX) stock exchange, which is a registered securities exchange

[1] For a discussion of banking supervision and other financial stability functions of the Reserve Bank, see Mortlock (2003). See also Hunter, Orr and White (2006) on the framework for promoting financial stability in New Zealand.

[2] Uridashi and Eurokiwi bonds are issued by foreign entities, to non-resident investors, denominated in New Zealand Dollars. Although they may have implications for New Zealand markets, especially foreign exchange, they are not usually considered to be a part of the local New Zealand debt market.

under the Securities Markets Act 1988. As well as providing an efficient market mechanism, NZX regulations cover disclosure, corporate governance and business ethics. The Securities Commission has oversight of the securities markets, including over NZX. Several New Zealand companies are listed on foreign stock markets, mainly the Australian Stock Exchange. NZX also hosts an Alternative Market "for fast-growing, developing companies and companies with non-traditional structures",[3] and there also is an unregistered securities trading facility called Unlisted.[4] These both have less rigorous disclosure and other requirements than the main stock exchange.

Securities issued by managed funds (e.g. unit trusts) are also traded on financial markets. In some cases, the fund manager operates a secondary market or acts as a broker.

Futures and options are traded on the New Zealand Futures and Options Exchange of the Sydney Futures Exchange in Australia, as well as off-market bilaterally (usually through the banks).

The range of traditional insurance markets operate in New Zealand. No-fault personal injury insurance is provided by the government-owned Accident Compensation Corporation, funded by compulsory levies. Cover for natural disasters on residential property is provided by the Earthquake Commission. Otherwise, insurance is provided through private markets. The main market with limited development is the annuities market.

Legal Framework

New Zealand has an extensive legal framework covering the ongoing operations of financial markets. This includes contract and property law, prudential law, company law, securities law, insolvency law, consumer protection law, financial reporting and auditing law, and a judicial system to resolve disputes and enforce rights and obligations.

The Securities Commission is New Zealand's main regulator of investments. Its purpose is to help build confidence in New Zealand's securities markets. This involves:[5]

Enforcement, monitoring and market oversight: overseeing securities markets activity, inquiring into suspected breaches of securities law, and intervening in the interests of investors.

Law reform: reviewing securities law and practice and recommending reform of the law where appropriate.

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[3] http://www.nzx.com/nzxmarket/nzax

[4] http://www.unlisted.co.nz

[5] See also the Securities Commission website www.sec-com.govt.nz .

Exemptions: considering applications for exemption from securities law, and granting exemptions from the law where appropriate.

Authorisations: considering and deciding on applications for authorisation as trustees and statutory supervisors and futures exchanges and futures dealers.

International co-operation: promoting New Zealand as a well-regulated country, keeping abreast of developments in global standard-setting and contributing the Commission's views to this process, and maintaining good relationships with other regulators.

Public understanding: promoting public understanding of the law and practice of securities.

Experience from the Reforms to Date

The New Zealand experience over the past twenty years can be characterised as a shift from a relatively high level of regulation to a light-handed approach that is now swinging back toward some more formal control. The experience has been variable across markets – some are highly developed and efficient; others are relatively undeveloped and shallow.

In the decade before 1984 the New Zealand economy was burdened with the slowest average rates of real economic growth in the OECD region, serious and persistent balance of payments current account deficits (financed primarily by substantial overseas debt), a large rise in unemployment and a relatively high (albeit variable) rate of inflation (Reserve Bank of New Zealand, 1986). Further, New Zealand was experiencing an extended freeze on wages, dividends, rents, prices, interest rates and the exchange rate.

At that time, New Zealand's approach to regulating financial markets was largely protective and its extensive regulatory regime included: different regulations for different financial institutions; restrictions on entry, especially into banking, and limits on foreign ownership; and direct controls affecting many aspects of financial-market activity (ceilings on deposit and lending rates, restrictions on assets/liabilities, controls on various kinds of lending, and limits on external capital flows) (Suppanz, 1998). Furthermore the macroeconomic environment also faced some challenges. It was criticised that the macroeconomic environment was governed by multiple and often conflicting monetary policy objectives, implementation of monetary policy strongly relied on wide-ranging regulatory controls (e.g. reserve ratio requirements for financial institutions and interest-rate controls), which was coupled with a regime of managed exchange rates (Suppanz, 1998).

This situation prompted the need for significant reforms and this became more a priority with a change in Government in July 1984. Over the following years a process of decontrol which included a programme of deregulation in the financial sector aimed at enhancing competition and transforming the potential effectiveness of monetary policy, transformed New Zealand.

Key financial sector reforms included:

- Abolition of interest rate controls
- Floating of the New Zealand Dollar
- Removing restrictions on balance-sheet structures (restrictions on assets and liabilities, lending controls, etc)
- Relaxation of entry restrictions to the financial sector
- Removal of limits to foreign ownership of New Zealand companies
- Privatisation of state-owned financial institutions
- Removal of restrictions on borrowing foreign currency

It appears that most of New Zealand's reforms delivered on their objectives and the financial system became more efficient (i.e. for banks costs and margins fell; the quality of bank balance-sheets improved; borrowing, lending and the range of financial instruments available grew; service and consumer choice improved). Taxpayers also began to carry far fewer risks and monetary policy became focused on, and achieved, low inflation.

The reforms were generally successful but there are some lessons we can take, such as the length of time that reforms take to undertake, economic cycles can interfere with the achievement of outcomes, etc. Despite the sound operation of New Zealand's financial markets, there are still some enhancements that could be made and indeed the Government is undergoing a number of reviews that will further enhance financial markets (discussed below).

Priorities for Ongoing Reform

Over the past ten years, New Zealand has embarked on a significant program of financial sector reform to promote confidence and participation in its financial markets. This work included and focused on:

- Reforms to ensure confidence in, and promote the efficiency of, New Zealand's capital markets by increasing the effectiveness of securities, securities trading and takeover laws. This included introduction of a takeovers code, establishing a co-regulatory framework for regulating securities markets, reviewing insider trading law, introducing new market manipulation laws, improving investment advisers' and brokers' disclosure and substantial security holders' disclosure regimes.
- Reviewing the Financial Reporting Act, to take into account an IFRS environment

- Reviewing insolvency law to improve the effectiveness of current laws and modernise them.
- Trans-Tasman co-ordination of financial sector regulation.
- Reducing the effects of pockets of illiquidity in the government bond market, and failure-to-settle arrangements for retail payment systems.

The Treasury has also undertaken some investigation in the theories and evidence underpinning the link between the development of financial markets and that economic growth.

A number of further improvements are currently being undertaken in relation to the regulatory regime, which are targeted at improving participation in financial markets (by improving confidence in the system and the flow of information), including:

- *The Review of Financial Products and Providers* - aims to develop an effective and consistent framework for the regulation of non-bank financial institutions (e.g. collective investment schemes, insurance companies, finance companies). This includes updating the current regulation to align with international practice, as well as providing greater consistency and clarity across the different financial instruments and institutional arrangements. It also aims to reduce compliance costs and enhance investor information through improvements to the securities disclosure regime.
- *The Review of Auditors* – will consider the need for changing from a self regulatory system, as well as other reporting issues and institutional arrangements.
- *The Review of Financial Intermediaries* - aims to ensure that consumers can rely on intermediaries providing them with the information they need to make good decisions.
- *International Anti Money Laundering Recommendations* – compliance.

Issues that the Reserve Bank of New Zealand is specifically looking at:

- Preparation for the supervision of non-bank financial institutions and insurers under the review of Financial Products and Providers.
- A number of banking supervision issues are also being progressed, including outsourcing by registered banks, and the implementation of the Basel II capital adequacy framework.
- Ongoing operational cooperation to support previous regulatory harmonisation with the Australian Prudential Regulation Authority (APRA), to ensure the maximum effectiveness of ‘home-host’ supervision of the banks in New Zealand, and continued financial soundness and stability.

Assessments of New Zealand Capital Markets

Several assessments have been made of various aspects of New Zealand capital markets in recent years. This section provides a summary of the studies.

Financial Stability Report – Reserve Bank of New Zealand (2006)

The Reserve Bank of New Zealand publishes its *Financial Stability Report* every six months (in May and November). The *Financial Stability Report* assesses and reports on the soundness and efficiency of the New Zealand financial system. The report covers developments in financial institutions, foreign exchange and debt markets, and payments systems. It also comments on recent financial policy developments.

Overall, the assessment was positive. However, some risks were highlighted: banks competing aggressively in the housing markets which may increase the strain on their balance sheets; the dependence of housing on foreign savings; and the speculative nature of investments in the foreign exchange market that is vulnerable to interest rate movements in New Zealand and overseas. The report concluded that:

- Banks continue to be well capitalised and continue to return strong profits. However, they are competing in an aggressive manner, accepting lower margin and higher risks loans. Increased strain to service these debts (e.g. reduced incomes, higher interest rates, unexpected decline in house prices) would impact negatively on the quality of banks' balance sheets.
- New Zealand households continue to be heavy users of foreign savings to largely finance housing which leaves New Zealand vulnerable to any change in global perceptions of New Zealand's creditworthiness.
- The foreign exchange market is experiencing a high level of foreign investor attention as global investors make use of New Zealand's interest rate differential. Given the inherently cyclical nature of such flows, a shift in expected interest rates globally could lead to an outflow of speculator funds and volatility in the New Zealand dollar exchange rate.

Regulation of Financial Systems and Economic Growth – OECD (2006)

This paper examines whether regulation that is more conducive to competitive and efficient financial system has a significant positive impact on sectoral output ad productivity growth in a sample of 25 OECD countries, including New Zealand. The regulatory indicators used in this paper were assembled from surveys conducted by the World Bank on regulations in banking and securities markets. The OECD found substantial variation in the stance of regulation across countries, in particular with respect to the broad rules underpinning securities market transactions. The empirical analysis indicates that financial system regulation matters for output growth both in a statistical and economic sense.

According to the data provided in the paper in regards to New Zealand:

- Competition in financial markets and development: The cost structure of New Zealand banks is comparably low (i.e. relatively low overheads), but so are the net interest margins:
    - In terms of "banking activities" New Zealand had the third lowest overhead costs relevant to bank activities (average 1996-2003); and tenth lowest net interest margins (average 1996-2003).
    - In terms of "international competition in banking" New Zealand had the fifth lowest share of cross-border loans in total domestic borrowing (average 2000-03); and fourth highest in foreign banks penetration of domestic loan market (measured through local claims in local currency only).
- Barriers to competition in financial markets: Foreign competition in New Zealand banking is high (New Zealand has high foreign bank penetration and low cross border loans), there are low barriers to competition, and New Zealand has significantly more demanding securities market regulation which is favourable to the development of the securities market:
    - In terms of "banking regulation indices" New Zealand performs strongly with the lowest in regulatory barriers to competition (2003) and the second lowest in regulation aimed at stability (2003)
    - In terms of "barriers to competition in banking" New Zealand seems to perform strongly. It ranked third lowest in domestic entry, seventh lowest in foreign entry; lowest equal in activity; and lowest equal in government ownership
    - In terms of "securities markets regulation indices" New Zealand performed strongly with the third highest in contract enforcement; fourth highest in access to credit; highest in investor protection; and twelfth highest in bankruptcy procedures

It is particularly noted that:

- In retail banking services, where a physical presence is usually required, either in the form of branches or subsidiaries, foreign-owned banks play a major role in domestic lending to the private sector in a few countries including New Zealand.
- Regulations affecting competition were particularly permissive in New Zealand.

Financial System Stability Assessment - International Monetary Fund (2004)

The International Monetary Fund was invited to undertake an assessment of the stability of New Zealand's financial system in 2004. Its main findings at the time included that:

- New Zealand has a profitable and well functioning financial system, operating in a framework of well developed financial markets. Short-term risks to stability appear low, given the favorable macroeconomic outlook, and sound and transparent financial policies. Stress tests for systemically important banks show resilience consistent with the sector's relatively high levels of capital and profits. Dynamic stress tests involving shocks to agriculture and to external funding show more persistent effects on bank profits, but do not raise systemic concerns.
- New Zealand's approach to banking regulation is based on disclosure and market discipline, and employs limited prudential requirements. The sole supervisory objective is to ensure systemic stability. Given the high share of foreign ownership, home-country supervision may also act as an additional discipline on bank behaviour. At the time it was noted by the IMF that, notwithstanding the clear strength of the present framework, the Reserve bank of New Zealand would benefit from increased real-time knowledge of potential stress in the banking system.
- The absence of a depositor-protection mandate, along with the foreign ownership of all systemically important banks, would pose unique challenges to the Reserve Bank of New Zealand if a financial crisis were to occur. The high level of Australian bank ownership suggests that the successful management of systemic challenges will also require close cooperation with the Australian authorities. At the time the Reserve Bank of New Zealand was reviewing possible crisis management options and has intensified trans-Tasman cooperation in banking regulation and failure management.
- Recent reforms in securities regulation and the restructuring of the New Zealand Stock Exchange (NZX) have strengthened the securities regulatory framework. At the time it was noted by the IFM that to fully implement the IOSCO Principles would require: (i) a stronger regime for prevention and detection of market abuse; (ii) a more robust supervisory regime for market intermediaries and collective investment schemes; (iii) improvements to the disclosure regime for issuers; and (iv) stronger public oversight of private sector monitors. The objectives of the Review of Financial Products and Providers (referred to above) generally cover these points.

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