Regulation in New Zealand Banking and Financial Services

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Abstract

This paper reviews banking regulation in New Zealand from the deregulation of the 1980s through to the present day. It focuses on the effects of light-handed regulation that was introduced as part of the deregulatory process and asks whether this has been effective for protecting depositors and at preventing the looting of New Zealand banks by their foreign owners.

The paper also considers Reserve Bank (of New Zealand) plans for a system of open bank resolution, and rejects these as unrealistic in the current state of the world.

Introduction

Historically, from the 1930s through to the 1980s, the New Zealand financial sector (including the banking sector) was subject to a significant degree of regulation.[1] This originally reflected a preference for managing the economy in an attempt to achieve broader objectives around economic growth and development, and a perception that finance should be the servant of this process. Regulation also lead to a segmentation of the financial sector, with different classes of financial institutions specialising in different types of loans and other products. This regulatory framework began to be eased a little in the 1970s, with changes such as banks being given greater freedom to set their own interest rates on lending, and permission being given for new products to be offered. These were often in response to changes in the global economic environment which meant, for example, that there was a demand for foreign-exchange hedging, which had not been necessary while all exchange rates globally were fixed relative to each other.

Also in response to this environment, new institutions and new classes of institutions were established to offer new products and services which existing institutions might have been barred from offering. Regulatory frameworks often struggled to keep up these new institutions, and when some of these institutions got into difficulty, some social disruption was experienced as these institutions were dealt with under standard insolvency legislation. An eventual response to this was the Securities Act 1978, with accompanying regulations, which set out the process for issuance of the prospectuses required for solicitation of funds by entities other than banks, savings banks, building societies and credit unions.

In an attempt to gain control of inflation, the Muldoon government that was re-elected in 1981 imposed wide-ranging wage and price controls. It moved in 1982 to extend these to the financial sector, so as to ensure some sharing of the burden of restrictions in the battle against inflation. These were primarily effected through the setting of maximum interest rates on various classes of loans, although there were also restrictions on bank lending growth, with regulatory powers being continually extended as financial institutions found ways to circumvent them. By the time the Muldoon government lost office in July 1984, the mesh of regulation had become extensive, and the financial sector found itself quite constrained in how it could provide financial services. One aspect of this was that, in the regulated environment, access to borrowing from banks was something of a privilege, with the less privileged having to utilise the services of other classes of institutions.

[1] See Quigley (1992) for a review of financial regulation in earlier periods.

The election of the fourth Labour Government in 1984 provided the opportunity for much of the previous regulatory structure to be unwound. Over the following few months interest rate restrictions, foreign exchange controls, the fixed exchange rates, mandatory liquid assets holdings (through the reserve asset ratio system) were abolished, as were restrictions on private foreign borrowing.[2] Later in 1985, proposals were advanced for opening up banking by allowing new banks to enter the market; this and a number of other changes were codified in a 1986 amendment to the Reserve Bank Act, and then extended further in the Reserve Bank of New Zealand Act 1989 (Dawe, 1990). Major changes were also made in respect of monetary policy analysis and implementation, but consideration of those is outside the scope of this paper.

One of the consequences of the deregulation was that the banking sector was no longer disadvantaged in the way it had been in offering financial services, and in competing with other financial institutions. Some previous classes of institutions, such as official short-term money market dealers,[3] disappeared, while there was a move by many other non-bank financial institutions to convert to bank status. This meant that the numbers within some classes of financial institutions, such as building societies and finance companies, were considerably reduced, while the savings banks all converted to bank status and consequently looked to broaden the scope of the activities which they undertook.

The overarching principle that might be applied to the regulation of the banking sector was set out in an article in the May 1987 Reserve Bank of New Zealand Bulletin (Staff, 1987).[4] This proposed that the Reserve Bank should not be concerned about the failure of individual institutions, but only about the failure of multiple institutions through a systemic financial crisis, where the undermining of financial intermediation capacity would have negative effects on the economy as a whole. Another perspective was that the object of policy should be failure management, designed to limit the disruption caused by failures, rather than failure prevention, with occasional failures being perceived as desirable as a way of spreading the message about market discipline (Doughty, 1986). The scope of regulation was to be prudential: in other respects, the market was seen as being the most appropriate source of regulation for the New Zealand financial system (Grimes, 1998), although this could be supplemented by the broader legislative framework such as the Companies

[2] See Hodgetts (1992) for a more detailed chronology of some of the relevant events. Evans et al (1996) suggest that the financial sector was one where deregulation proceeded most rapidly.
[3] See Nicholl & King (1985) for a more extensive discussion of the role of official short-term money market dealers.
[4] Although, as we are reminded by Grimes (1998), there had previously been no system for the prudential supervision of New Zealand banks.

Act and Financial Reporting Standards. The concern for the financial system was subsequently affirmed by White (1990, 1991), who stressed the importance of protecting the payments system.

This view of regulation has generally regarded deposit insurance schemes, which would be a standard response to individual bank failures and which protect the interest of small depositors, as something that should be avoided. The Reserve Bank (of New Zealand) has seen deposit insurance as undermining depositors' incentives to monitor banks, leaving banks to take greater risks than they might otherwise – a phenomenon described as moral hazard (White, 1990). In such a situation, it is possible that bank losses could be aggravated at the expense of taxpayers, who would be likely to be the ultimate underwriters of a deposit insurance scheme.

During the period following initial deregulation, we saw an economic boom, reflected particularly in a booming stock market and property development activity, followed by a bust, a key element in which was the 1987 share market crash. The bust in property development impacted severely on the banks that had supported it, and this lead in due course to the failure of the (formerly government-owned) Development Finance Corporation (DFC) in 1989, and to two bail-outs of the formerly government-owned Bank of New Zealand. This lead the Reserve Bank of New Zealand to give further consideration to issues around the prudential supervision of banks, a topic they had been able to overlook in former times when banks were much more restricted in the activities they undertook, and when competition between the banks was much more limited. The other consequence of this was that the banks collectively became much more cautious about property development financing, to the extent that they more or less ceased this line of business. We discuss this further in a later section of the paper that focuses on the finance company sector.

During the late 1980s and 1990s we also saw a substantial increase in the proportion of foreign ownership of the New Zealand banking sector, in some cases reflecting a lack of financial strength on the part of the New Zealand owners, but also in response to the deregulated market. We saw previously New Zealand-owned entities such as the Post Office Savings Bank, the Bank of New Zealand and most of the trustee savings banks become part of international (predominantly Australian) banking groups. This made it easier for international banks to participate in the New Zealand market, while it also became more important for them to do so as New Zealand became part of the global financial system. In some cases we also saw firms coming to New Zealand because it was easier to gain access than to some other markets internationally. The extent of foreign ownership is also regarded as having facilitated the inflow of non-resident funding into New Zealand banks (which had previously, in any case, been constrained by regulation). It was also within such a context that the Reserve Bank deemed it appropriate to conform to the Basel Committee's guidelines on bank capital adequacy.

A further development in the approach adopted to prudential supervision of banks was the introduction of a bank specific disclosure regime, which came into effect at the beginning of 1996.[5] This requires banks, every quarter, to publish a balance sheet and year–to-date income statement, along with a range of other financial and non-financial information[6]: on the basis of this, depositors are supposed to be able to assess the soundness of the bank with which they are placing their funds, and to be able to exercise market discipline by withdrawing their funds if they decide that the risk profile of the bank has changed adversely so that their deposits might be at risk. A further principle enunciated was that the Reserve Bank would get the same information as was made available to the general public. They would therefore be not be privy to any better information than the general public: if a bank failed, they could not then be said to be in a position to have acted to prevent that failure, and they could not then be responsible for any losses incurred by depositors (Brash, 1997a).

There was also a view that the need for banks to report publicly every quarter would make them more cautious about the risks to which they exposed themselves (Brash, 1997b; 1998). In this respect, the role of a bank's board of directors was seen as particularly important, in terms of their responsibilities to individually sign off on the disclosure statements, which would make them liable to a range of penalties if there was anything misleading or untrue in the disclosure statements.[7] It was also envisaged that the disclosure statements would be reviewed and commented on by journalists and banking experts, who would highlight problems, for the public benefit.

Foreign ownership of the New Zealand banking system was also relevant, with the argument being advanced in some circles that New Zealand did not need to regulate its banks as they were almost all subject to the oversight of foreign regulators.[8]

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[5] Banks had been required to issue Securities Act-type prospectuses if they wished to accept retail deposits following the passage of the 1986 amendment to the Reserve Bank Act, but the disclosure requirements under the new regime were more specifically directed at the risks banks faced, and were required to be produced quarterly (rather than 6-monthly, as previously) by all banks (and not just those which sought retail deposits).
[6] More information on the data required to be disclosed under the disclosure regime, and the principles that underpinned it, are provided in Mortlock (1996a). There have been a number of changes to the detail of what is required to be disclosed since the scheme was introduced, but the principles remain the same.
[7] This is discussed at greater depth by Mortlock (1996b, 2002)
[8] Brash (1997a) specifically argued against this proposition.

The protection provided to the public under the disclosure regime provided a justification for the Reserve Bank to remove some of the quantitative restrictions previously applied, with the exposure limits replaced by requirements to report large exposures and open positions. A similar approach was applied to the reporting of market risk exposures, as per Harrison (1996).

Reliance on disclosure was a most unorthodox approach internationally, with most countries around the world preferring to apply specific prudential regulation on exposures, and to have some sort of programme for specific examination of banks.[9] It is also common to adopt deposit insurance schemes of some type to protect unsophisticated retail depositors, who could not be expected to read a set of bank financial statements to assess a bank's soundness. The Reserve Bank has no specific objective to protect bank depositors per se.[10] Despite the disclosure regime having been publicised by the Reserve Bank, such research as has been undertaken has found relatively limited public awareness of how it operates, with many people believing that the government or the Reserve Bank would ultimately protect their deposits.[11] At least in the case of retail deposits, there is no obvious indication that interest rates are sensitive to (agency-provided) credit ratings. Even in 2012, the Reserve Bank continues to identify the disclosure regime as the basis for prudential supervision (Fiennes & O'Connor-Close, 2012), although they now require significant amounts of information to be reported directly to them by the banks, other than via their quarterly disclosures, which means that they can no longer claim to be no better informed than the general public.

The attempts at reregulation

Towards the end of the 1990s, it had started to become apparent that an approach of light-handed regulation of banks, with limited objectives, as outlined in our introduction, might not provide the best outcomes for New Zealand and bank depositors, particularly with the extent of foreign ownership of the banks that were operating in New Zealand. The Reserve Bank started to take some initiatives to allow it to take greater control over what banks were doing, although these were by no means easy to implement. Among a series of changes made were the promulgation of some revised

[9] By contrast, Reserve Bank monitoring is focused on making sure that banks comply with the disclosure rules.
[10] See Bollard (2003) for further discussion of these issues.
[11] See, for example, McIntyre et al (2009). Wilson et al (2012) could not find evidence for the effect of market discipline, although they did find evidence for banks exercising self-discipline in response to the disclosure regime.

rules on corporate governance, to provide for more genuinely independent directors, including New Zealand resident directors.[12]

Obtaining and reporting of ratings from a credit rating agency approved by the Reserve Bank was also made mandatory. For foreign-owned banks, the rating has generally been the same as for the parent bank, and the desire to maintain credit ratings and keep funding costs down accordingly is likely to have caused banks to act in a more conservative fashion.

Rules were also adopted to control banks' outsourcing activities, with the objective being that the Reserve Bank (or statutory managers) should be able to have access to banks' computer systems,[13] in New Zealand, if parent banks got into difficulty, while the Reserve Bank also got the power to regulate payment systems (which had previously been wholly under the control of the banks themselves).

We also saw steps being taken to try and get Westpac, in particular, to establish a New Zealand incorporated subsidiary, which was seen as being of particular importance because, as a branch, there was a concern that Australian depositors might be given priority in terms of the repayment of New Zealand deposits (reflecting the priority given under the Australian Banking Act).[14] This was regarded as part of a local incorporation policy, designed to ensure that larger and systemically significant banks had local boards of directors, which should be more responsive to New Zealand needs than the directors of a foreign bank operating a New Zealand branch (Chetwin, 2006). It was also argued that having a New Zealand-incorporated entity made matters clearer for creditors (the most important category of which is depositors), particularly in cases where statutory managers might be appointed to a failing bank.[15]

In response to concerns about the risk structure of New Zealand bank funding, which were exacerbated during the depths of the global financial crisis in September and October 2008, we have also see the reintroduction of specific rules on bank liquidity. The mismatch and core funding ratios

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[12] See, for example Bollard (2004). A further set of rules following a review were announced in December 2010.

[13] See Ng (2007) for more detail on this.

[14] The other major banks already conducted the majority of their New Zealand business through New Zealand incorporated subsidiaries. The Reserve Bank had been going through a process of setting conditions under which banks would not be allowed to operate as branches, but only as subsidiaries (see Mortlock, 2003). These conditions implied change only for Westpac (although they may have discouraged other banks from taking retail deposits). The policy would also have been likely to have impacted on Australian-owned AMP Banking, but they chose to sell their business and withdraw from the New Zealand market.

[15] See Evans & Quigley (2002) for a more extensive discussion of the relevant issues.

apply to short and long term liquidity and funding risks respectively, and came into effect on 1 April 2010 (Hoskin et al, 2009). This approach is broadly consistent with one that has since been mandated internationally as part of the Basel III process, and it is also consistent with what the banks appeared to be doing anyway as they sought to reduce the riskiness of their funding portfolios (Tripe & Shi, 2012).

A more problematic area of reregulation has been in developing a process for dealing with banks in financial distress. The current proposal, which has been under discussion at the Reserve Bank since at least the beginning of the present century, is for a system of open bank resolution, which would see bank deposits having a haircut applied to them, to provide funds to recapitalise a failing bank. Following the haircuts, funds remaining in the accounts at the failing bank would then be guaranteed (Hoskin & Woolford, 2011). This regulatory change has been presented by the Reserve Bank as having been approved, and preparations are therefore under way at the banks to provide for its implementation. No regard has been had for the effects of such a policy on the general public, or on the taxpayer who would be expected to bear the cost of the associated guarantee. The assumption is made that the public should be protected because the disclosure regime gives depositors the means to identify potentially failing banks, from which they should withdraw their funds for lodgement in another bank! One positive aspect of the open bank resolution proposals is that it aims to reduce the social costs of financial institution failure by getting a bank re-opened promptly after the hair-cut has been applied, so that the payment system can resume operations.

Non-bank Deposit Takers

The other outcome of the crash at the end of the 1980s was much greater aversion to risk by the banks when it came to property development financing, to the extent where they almost ceased financing development projects at all. In this case, however, the would-be property developers found a solution to the impasse by developing activities in a relatively lightly regulated class of financial institutions, the finance company sector. Regulation in the finance company sector was based on the Securities Act 1978, which had an emphasis on form, rather than substance: as long as the finance company had a trust deed with one of the small number of corporate trustees (generally with relatively limited powers), and as long as prospectuses (intended to provide market disclosure) were issued at requisite six-monthly intervals, finance companies could raise funds from the public, with potentially only relatively limited constraints on how these could be lent or otherwise allocated.

In a significant number of cases we thus found people associated with the property investments and development businesses getting involved in owning and managing finance companies, with funds being lent to associates (although not necessarily defined as such), and a number of other practices which might be perceived as “looting” (in the sense of Akerlof & Romer, 1993). In many cases, there was nothing illegal about the transactions that were entered into: it is arguable that the regulatory structures applying around such activities did not provide sufficient constraints to prevent the owners and managers of finance companies applying the funds invested with them towards their own enrichment.

The ineffectiveness of the regulatory environment for non-bank deposit takers, finance companies in particular, was highlighted by the wave of failures that began in 2006. For some of the earlier failures, problems appeared to be in weaknesses in management, and losses to depositors were not particularly severe, but as the plague of failures persisted, it became evident that there were significant gaps in the regulatory architecture which appeared to have exacerbated losses for investors. In a small number of cases, directors of failed finance companies have faced prosecutions for fraud or breaches of the Securities Act, but there has been a general acknowledgement that regulatory weakness was a major contributor to losses.

In response to this we have seen reregulation in the non-bank sector as well, with non-bank deposit takers having now become subject to prudential oversight by the Reserve Bank of New Zealand Barker & Javier, 2010). As of 2012, however, the non-bank deposit taking sector is much smaller than it was in 2006, with there having been particular shrinkage in the finance company sector, and with two large mutual institutions (in the building society/credit union area) having converted to bank status. It is probable that losses in the non-bank deposit taking sector will be relatively much less in the future than they were in the 2006-2009 period, but this may be as much a consequence of the sector’s shrinkage rather than of the new regulatory framework.

There is a view that losses for retail investors were further compounded by financial advisors encouraging their clients into finance company investors because of higher levels of commission paid to advisors (with these commissions not necessarily being effectively disclosed to investors). This area of potential regulatory deficiency has also been subsequently addressed through new legislation governing financial advice.

The effect of regulation

A key rationale for regulation in the financial services sector is the corporate governance problem, as set out by Shleifer & Vishny (1997):

> *"How do suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects?"* (p 737).

This is even more of a challenge in financial services than in other areas where assets are invested, in that electronic money is hard to trace, while it can also be diverted to a wide range of other uses.

In this context, a key function of regulation has to be to ensure that financial institutions are run consistent with their supposed purposes, and that the funds are not looted (again, in the sense of Akerlof & Romer, 1993). Other reasons for regulation reflect the sorts of roles that financial institutions play in a modern society, and the privileged position that they hold in terms of the means of payment that society uses. In the New Zealand environment, the focus of regulation has otherwise been to try and reduce the likelihood of a systemic banking crisis that might otherwise damage the operation of the economy.

What then are the constraints that apply to the management and owners of financial institutions to discourage them from looting the resources, in terms of deposits, with which they have been entrusted? As the Reserve Bank of New Zealand and others have noted, this is more complex in the New Zealand environment because the banks are predominantly foreign-owned: if the owners seek to appropriate resources to other uses, it is difficult to recover them. We have seen how complicated this has been for the finance company sector in New Zealand since 2006: to take action, the authorities needed to establish that there is some sort of criminal culpability, and then try to find any money that may still be available to repay the depositors who entrusted it to the institutions in the first place. It is presumed that, with the non-bank deposit taking sector, the transfer of regulation to the Reserve Bank of New Zealand will reduce the scope for misappropriation or even just mere carelessness with depositors' funds.

In the banking environment, the sums involved are relatively much larger than for the non-bank sector, reflecting the much greater significance of banks in New Zealand financial intermediation. The issue of concern from a regulatory perspective would be that resources at the New Zealand banks might be transferred to a foreign parent and that the New Zealand bank might act in the interest of the foreign parent rather than in the interests of the bank's business in the New Zealand market.

Much of the regulatory effort that has been applied since the late 1990s has been directed at this issue. There was a view that, with Westpac incorporating a subsidiary in New Zealand, the New Zealand system was somehow protected, in that any transfer of funds from a New Zealand bank that rendered the New Zealand bank insolvent would mean that the directors, particularly those that were New Zealand resident, could be prosecuted.

It is doubtful that this would really afford much protection to New Zealand if the Australian parent bank was in difficulty. Would the managers on secondment (from Australia) and Australian-based directors and owners really care that much about the New Zealand directors? Moreover, one needs to be mindful of the typical structure of the New Zealand subsidiary balance sheets, which usually have significant ordinary borrowings from parent banks. If one was looking for resources that could be repatriated, the most obvious resources to seize on would be to repay those borrowings (which would be quire legal), but which might well have the effect of depriving the New Zealand bank of the liquidity needed to maintain operations.[16]

The question then arises that, if the looting of the New Zealand bank is simple, why it has not been done already. Why have the Australian banks not already ripped out the resources from their New Zealand business and supplied these to their Australian parents? There are two main reasons why this has not happened, and one might note that essentially the same issues apply in respect of the finance companies. The first factor is the governance regime applying at parent company level: this is clearly much more robust for the major Australian banks, reflecting the influences of APRA and the ASX, than it was for New Zealand finance companies.

The second and more important factor is a desire to preserve a profitable business to receive an ongoing stream of returns into the future. In that context, owners would only be incentivised to loot a bank if they regarded its future prospects as poor. Moreover, we know from the goodwill that is paid for acquisitions that then market value of New Zealand banks is generally substantially in excess of book values (of equity): any looting of banks would cause that surplus market value to be rapidly dissipated.

[16] Kaufman (2004) questions whether it makes any difference if a local bank operates as a branch or as a subsidiary of a holding company.

Related to this is the general reluctance by banks to abandon their foreign subsidiaries, because of the effect it would be likely to have on their perceived creditworthiness, and thus their agency credit ratings. The desire to maintain credit ratings is a factor which is likely to have contributed to more conservative bank behaviour, such as banks holding capital in excess of regulatory minima.

Concluding thoughts

We have, then, reached an interesting endpoint. New Zealand financial markets have, since the deregulation of the 1980s, been relatively lightly regulated, consistent with an approach that has required regulation to be justified, rather than the alternative view that might have required the argument to be presented to remove regulation. In such an environment, the more domestically focused parts of the New Zealand financial system have not fared particularly well, an effect which can be seen with the New Zealand Stock Exchange, which has a much smaller capitalisation relative to GDP than for example, Australia (although this difference cannot be attributed solely to regulatory effects).

The part of the financial system that seems to function best is the banking system, which is largely foreign-owned, and which is thus significantly governed by foreign regulators. Even here, however, the ability of the Reserve Bank to prevent the looting of New Zealand banks by foreign owners is not especially strong. That this has not happened is, in the author's view, more a matter of good luck and the constraints applied in banks' home countries than anything else. Would we be drawing too long a straw to ask if the New Zealand approach to financial system regulation was not especially effective? We should not rely solely on Australian regulators because, as Kane (2006) notes, they are responsible to Australian rather than New Zealand taxpayers.

The disclosure regime is becoming less effective as a vehicle for protecting depositors' interests. A key reason for this is that bank financial statements have become increasingly complex, reflecting both the increasing complexity of banks' business and the adoption of the International Financial Reporting Standards (IFRS). Development of a consistent view on how banks are performing has not always been helped by changes to required disclosures, made in response to changes in regulation and to assist the banks by reducing the burden (and hence cost) of disclosure. Very little effort is now being directed at trying to comment on what is reported in banks' disclosures.

At the same time, the process of bank liquidation has become more complex, with the value of the banks as per the financial statements showing an increasing difference with what might be available to repay depositors. As Bertram & Tripe (2012) have noted, categories of assets that might disappear could include cash borrowed from a parent bank, assets that were subject to repurchase agreements (potentially including residential mortgage backed securities), loans in covered bond pools, intangibles and deferred tax. It would be easy to see 40% of a bank's assets disappearing by the time a statutory manager got to intervene!

Looking at matters from a longer term perspective, the 1980s were characterised by a rush to remove previous regulation, and a regulatory structure was developed which was directed at the not especially globalised world of the 1980s. Since that time globalisation and new financial products have made financial markets and financial institutions a lot more complex, and the simple approaches to the resolution of failing institutions that might have worked in the 1980s would be likely to be overwhelmed by the much more complex financial institutions that exist in the 2010s. The proposals for open bank resolution are a reflection of a 1980s view, rather than something that can work in the 2010s. Against this background we would seem to need a review of banking regulation, with serious consideration needing to be given as to how to manage the failure of one or more banks.

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