Light-handed Regulation in New Zealand Banking and Financial Services: Has it worked?

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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 examines its effectiveness for protecting depositors and at preventing the (potential) looting of New Zealand banks by their foreign owners. It notes the extent of reregulation now being undertaken.

Keywords: Banking regulation, New Zealand, bank failure management

1. Introduction

This paper provides an overview of some recent history of banking and financial services regulation in New Zealand. This is of interest because, particularly during the latter part of the 1980s, the New Zealand banking and financial system was deregulated very swiftly, according to a different set of regulatory principles, to become one of the most lightly regulated financial systems in the world. Barth et al (2001) included New Zealand among a small group of countries that permitted the widest latitude in terms of the activities banks might undertake. This light-handed regulation persisted through the 1990s and subsequently, although since around 2000 steps have been taken to put more power into regulators' hands.

The regulatory structure that existed from the 1930s to the 1980s for the New Zealand banking and financial sector was particularly pervasive.[1] Developed following the great depression of the 1930s, it generally reflected a preference for managing the economy to achieve broader objectives around economic growth and development: finance should be the servant of this process. Markets were not seen as important, with a feeling in some circles that it was markets that had engendered the great depression, and that markets should be prevented from repeating this process. With no particular role for markets, 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.

In a broader context, Spong (2000) identifies four main strands to justify the regulation of financial services firms: protection of depositors, monetary and financial stability, an efficient and competitive financial system and consumer protection. Depositor protection (often addressed by deposit insurance) addresses depositors' inability to look after themselves. Monetary and financial stability is concerned with protection of the payments system and the avoidance of systemic banking crises, and costs that such disruptions or crises would impose on society more broadly. An efficient and competitive financial system will be able to support more financial intermediation at lower prices, and be able to respond better to changing economic conditions and technological advances. It also reduces the costs of trading goods and services. Consumer protection is concerned with preventing abusive practices and ensuring fair access to financial services for all. Spong also argues that banking regulation should not be directed at preventing bank failures, at providing for governments to override bankers' decision-making, or favouring certain groups over others. Prior to 1984, regulation in New Zealand was not generally consistent with Spong's principles.

Prior research also identifies negative consequences from banking regulation. Deposit insurance can give rise to moral hazard, as depositors no longer have to ascertain whether the bank they deal with acts prudently so that it can repay deposits as required. Another version of moral hazard arises when large banks get to be classed as too big to fail: incentives for prudent behaviour are undermined. Another potential problem is looting, which we discuss further below: managers may seek to enrich themselves at the expense of small shareholders and depositors.

The rest of this paper proceeds as follows. We next look at the process of deregulation that occurred in New Zealand, and then at the reregulation that occurred after around 2000. After that we come back to look at governance issues and their interaction with regulation. We conclude by asking whether New Zealand regulation has, in the end, been very effective.

2. The Process of Deregulation

New Zealand's 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 to offer new products. 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, not previously 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, from which existing institutions might have been barred. Regulatory frameworks often struggled to keep up with these new institutions, and when some of them got into difficulty, some social disruption occurred as these institutions were dealt with under standard insolvency legislation. A response to this was the Securities Act 1978 and 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. This was intended to ensure that investors received standard format information on what they were investing in.

In an attempt to control inflation, the re-elected Muldoon government in 1981 imposed wide-ranging wage and price controls. It moved in 1982 to extend these to the financial sector, on the basis that the financial sector should be seen as sharing the burden of restrictions in the battle against inflation. These were primarily effected through setting maximum interest rates on various classes of loans, although there were also restrictions on bank lending growth, with regulatory powers 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 was quite constrained in providing financial services. In this regulated environment, access to borrowing from banks was something of a privilege, with the less privileged having to utilise the services of other institutions

The election of the fourth Labour Government in 1984 provided the opportunity for much of the previous regulatory structure to be dismantled. Over a short period, 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 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. Opening up the market to new banks necessitated developing a set of rules for registration of banks, replacing a previous system which had required individual acts of parliament. The only quantitative requirement for registration was a minimum capital level of $15 million. This was all intended to promote a more efficient and competitive banking market. Requirements were codified further in the Reserve Bank of New Zealand Act 1989 (Dawe, 1990). Throughout the process, major changes were also made in respect of monetary policy and its implementation, including the adoption of inflation targeting.

A consequence of deregulation was that the banking sector was no longer as disadvantaged in offering financial services and competing with other financial institutions. Some previous classes of institutions, such as official short-term money market dealers,[3] disappeared, while other non-bank financial institutions converted to bank status. This meant that the numbers of participants 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 looked to broaden the scope of activities they undertook.

The overarching principle to be applied to regulating 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 with the failure of multiple institutions through a systemic financial crisis. Moreover 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 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 regarded deposit insurance schemes, a standard international response to individual bank failures, as something to be avoided. Deposit insurance is seen 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. The Reserve Bank has continued to uphold this argument.

Immediately following initial deregulation, there was an economic boom, seen 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, leading 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 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 more limited.

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 of the New Zealand owners, but also in response to the deregulated market. 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. Deregulation 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 more integrated into the global financial system.

Within such a context the Reserve Bank deemed it appropriate to adopt the Basel Committee's guidelines on bank capital adequacy. There was a view that this was driven primarily by a desire to conform to international norms (and to avoid the costs of not doing so), but stated views have generally been to the effect that more capital was better for promoting bank safety and soundness (and under the 1988 Basel I rules, New Zealand and Australia both imposed a capital requirement for holdings of government securities).

A further development in the 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 other financial and non-financial information[6]: on the basis of this, depositors are supposed to be able to assess the soundness of banks with which they place their funds, and to exercise market discipline by withdrawing their funds if they decide that the risk profile of the bank has changed adversely, putting their deposits at risk. A further principle was that the Reserve Bank would get the same information as was made available to the general public. If they had no better information than the general public, they could not then be said to be in a position to have acted to prevent a bank failure, and could not then be responsible for 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 their risk exposures (Brash, 1997b; 1998). In this respect, the bank's board of directors was seen as particularly important, with their responsibilities to individually sign off on the disclosure statements making them liable to 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 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]

The protection provided to the public under the disclosure regime provided a justification for the Reserve Bank to remove some previously applied quantitative restrictions, with exposure limits replaced by requirements to report large exposures to individual counterparties and open foreign exchange positions. A similar approach was applied to reporting market risk exposures, as per Harrison (1996), although the Reserve Bank chose not to follow the Basel Committee's guidelines, and did not require capital against market risk.[9]

Reliance on disclosure was most unorthodox internationally, with most countries preferring to apply specific prudential regulation on exposures, and to have programmes for specific examination of banks.[10] Consistent with Spong's principles, it is common to adopt deposit insurance schemes to protect unsophisticated retail depositors, whereas the Reserve Bank of New Zealand has no specific objective to protect bank depositors per se.[11]

Despite the disclosure regime having been publicised by the Reserve Bank, research 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.[12] At least for retail deposits, there is no obvious indication that interest rates are sensitive to (agency) credit ratings. 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, meaning that they can no longer claim to be no better informed than the general public.

Another distinctive feature of the New Zealand approach to banking regulation is the absence of any process for on-site visits to banks by the monetary or supervisory authorities, such as commonly occurs in other jurisdictions. The Reserve Bank will from time to time meet with a bank's management, but verification of a bank's condition is otherwise undertaken only by external auditors.

3. The Attempts at Reregulation

Towards the end of the 1990s, it was becoming apparent that light-handed regulation of banks might not provide the best outcomes for New Zealand or bank depositors, particularly with the extent of foreign bank ownership. The Reserve Bank took some initiatives to allow it to take greater control over what banks were doing, although these were not always easy to implement. Among a series of changes made were some revised rules on corporate governance, to provide for more genuinely independent directors, including New Zealand resident directors.[13] Obtaining and reporting of ratings from a credit rating agency approved by the Reserve Bank was made mandatory. 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 that the Reserve Bank (or statutory managers) should have access to banks' computer systems,[14] 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 taken to get the Australian-owned Westpac Banking Corporation (Westpac), in particular, to establish a New Zealand incorporated subsidiary. This was seen as of particular importance because of a concern that Australian depositors in the branch might be given priority in repayment of New Zealand deposits (reflecting the priority under the Australian Banking Act).[15] This was 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 (depositors in particular), when statutory managers were appointed to a failing bank.[16]

In response to concerns about the risk profile of New Zealand bank funding, which were exacerbated during the depths of the global financial crisis in September and October 2008, we have also seen the reintroduction of specific rules on bank liquidity. The mismatch and core funding ratios 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 what has since been mandated internationally as part of Basel III, and 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. One proposal is for a system of open bank resolution (OBR), 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). A key outcome of the OBR is 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 (not necessarily possible under standard insolvency practices).

Although the banks have been required to establish computer systems to allow OBR to be implemented, debate over whether this is the most sensible approach to resolving failing banks has been limited. OBR relies on an assumption that depositors should have been able to protect themselves through the knowledge that deposits were not guaranteed, and that they could review disclosure statements to identify banks at risk.

We now see approaches internationally where, if banks are failing, bond-holders and other wholesale depositors may be bailed in and required to contribute to losses. There are some suggestions that the OBR is similar to this, but there are differences. The OBR proposals treat all creditors equally (although there may be scope to exempt some small depositors) rather than imposing the costs of failure on those counterparties who might be better positioned to bear them. Moreover, other countries provide some form of deposit insurance or guarantee for retail depositors, a protection which is absent in New Zealand.

OBR might have been reasonable in a simpler environment such as existed in the 1980s, and is certainly consistent with the philosophy of light-handed regulation. There is an expectation that depositors should bear some of the cost of a failure because of their own failure to monitor the bank with which they do business. It is, however, less clear as to how effective OBR can be in the more complex banking environment that now exists.

4. The Effect of Regulation

An additional key rationale for regulation 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, in that electronic money is hard to trace, and can be diverted to a wide range of other uses. Where financial services firms are managed by owners, such as with foreign-owned banks or closely held finance companies (and it has been argued that this was a particular problem in the New Zealand finance company sector, where depositors/investors incurred substantial losses), this can be even more of a challenge, as scope for independent oversight may be limited to periodic external audits. Against this background, regulation, which should be part of broader corporate regulation, has to ensure that financial institutions are run consistent with their supposed purposes, and that the funds are not looted (in the sense of Akerlof & Romer, 1993). In the financial sector, regulation is particularly important because of the roles that financial institutions play in a modern society, and their privileged position in terms of the means of payment that society uses.

What are the constraints that apply to the management and owners of financial institutions to discourage them from looting the resources, deposits, with which they have been entrusted? As the Reserve Bank and others have noted, this is more complex in New Zealand because the banks are predominantly foreign-owned: if the owners seek to appropriate resources to other uses, it is difficult to recover them. We saw how complicated this was for the finance company sector in New Zealand since 2006: to take action, the authorities needed to establish that there was some sort of criminal culpability, and then try to find money that might still be available to repay the depositors who entrusted it to the institutions in the first place.

In banking, the sums involved are relatively much larger than for non-banks, 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 New Zealand banks might be transferred to a foreign parent and that the New Zealand bank might act in the foreign parent's interests, rather than those of the bank's business in the New Zealand market.

Much regulatory effort 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 made the New Zealand bank insolvent would mean that the directors, particularly New Zealand resident directors, could be prosecuted. This also justified a stronger role for independent directors.

It is doubtful that this would really afford much protection to New Zealand if the Australian parent bank was in difficulty. Would managers on secondment (from Australia) and Australian-based directors and owners really care that much about New Zealand directors? Moreover, one needs to be mindful of the typical structure of New Zealand subsidiary balance sheets, which usually have significant borrowings from parent banks. If a foreign owner was looking for resources that could be repatriated, the most obvious source would be to repay those borrowings (which would be quite legal), but which might well deprive the New Zealand bank of the liquidity needed to maintain operations.[17]

The question then arises that, if the looting of a New Zealand bank is simple, why it has not been done already. Why have the Australian banks not already removed the resources from their New Zealand business and supplied these to their Australian parents? There are two main reasons why this has not happened. 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, more important factor is a desire to preserve a profitable business to receive an ongoing stream of returns into the future. Owners would be incentivised to loot a bank only if they regarded its future prospects as poor. Moreover, we know from the goodwill paid for acquisitions that the market value of New Zealand banks is generally substantially in excess of book values (of equity): any looting of banks would rapidly dissipate that surplus market value. Related to this is the general reluctance by banks to abandon their foreign subsidiaries, because of the potential effect 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.

5. Concluding Thoughts

We have reached an interesting position. 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 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 largely foreign-owned banking system, which is significantly governed by foreign regulators. Even here, however, the ability of the Reserve Bank to prevent foreign owners looting New Zealand banks 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. 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 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). The process 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. Relatively 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 assets as per banks' financial statements increasingly differing from 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 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 intervened!

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 New Zealand experience is of international relevance as well, particularly with the greater frequency of significant foreign ownership of banking systems. Foreign ownership poses challenges for host country regulators, and in some environments, such as the European Union, regulators' roles in overseeing the local operations of foreign-owned banks can be quite limited. Gaining control of a banking system to encourage it to operate consistent with a national interest, but also within the confines of the invisible hand, can be a challenging process.

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Notes

1. See Quigley (1992) for a review of financial regulation in earlier periods.
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 an area 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.
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 changes to the detail of what is required to be disclosed since the scheme's introduction, but the principles remain the same.
7. This is discussed at greater depth by Mortlock (1996b, 2002)
8. See, for example, Heffernan (2005), p 178 (footnote 7) and Turner (2000), although Brash (1997a) specifically argued against this proposition.
9. This changed with the adoption of Basel II in 2008, following which banks are now required to hold capital against market risk.
10. Reserve Bank monitoring is generally focused on making sure that banks comply with the disclosure rules.
11. See Bollard (2003) for further discussion of these issues.
12. 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.
13. See, for example Bollard (2004). A further set of rules following a review were announced in December 2010.
14. See Ng (2007) for more detail on this.
15. 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.
16. See Evans & Quigley (2002) for a more extensive discussion of the relevant issues.
17. Kaufman (2004) questions whether it makes any difference if a local bank operates as a branch or as a subsidiary of a holding company.

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