

ABOLITION OF COMPULSORY RATIO REQUIREMENTS

INTRODUCTION

On 11 February 1985, all compulsory investment requirements imposed on the major groups of financial institutions were abolished. This move revoked a wide range of compulsory requirements to hold specified levels of public sector securities and other financial assets ('ratios') imposed on trading banks, trustee and private savings banks, building societies, private superannuation funds, life insurance companies and finance companies. Probably the best known of these is the trading banks' 'reserve asset ratio' system which was introduced in 1973, but which had been preceded by a cash ratio system that dated back to the 1930s. Most of the other ratios were introduced in the 1960s or the first half of the 1970s, although the trustee banks' government security ratio dates back to the late 1940s. The table accompanying this article gives details of the ratios which were abolished.

With the removal of interest rate controls in July 1984 and the adoption of a more conventional form of monetary policy involving greater emphasis on sales of government debt at market interest rates, a detailed review of the role of the network of ratio controls became possible. This article summarises that analysis under four headings: ratios as a tool of monetary policy, financial sector efficiency aspects, prudential considerations, and ratios as a means of sectoral assistance.

RATIO REQUIREMENTS AS A TOOL OF MONETARY POLICY

In New Zealand there have usually been two justifications cited for having ratio requirements as a monetary policy tool. Firstly, ratios have been used to assist a public debt sales programme by providing a captive market for government securities in the belief

that monetary control could be achieved without incurring the usual interest rate effects. Secondly, mandatory ratio requirements, especially the trading bank reserve asset ratio system, have been used as an instrument for attempting to constrain credit growth; by diverting funds from the private sector to the Government, and by imposing a profit penalty on financial institutions for inappropriate lending behaviour (since government stock has usually been issued in the past at uncompetitive interest rates).

Overseas, the justification that is commonly cited for the use of ratios as a monetary policy tool is that they increase the effectiveness of public debt policy and help stabilise monetary aggregate growth by limiting the short run variability of the reserves to deposits relationship and hence the short run variability of credit expansion. However, this argument did not apply to government securities ratios in this country because the securities that met the ratio obligations were also the securities in which public debt operations were conducted. As a result ratioed institutions could obtain securities from the secondary market as an alternative to the new issue market.

The major problem with the use of government security ratios as a monetary policy tool is the process of 'disintermediation' — financial flows tend to be diverted to markets or institutions to which ratios are not or cannot be applied. The more severe the ratio the more rapid this market adjustment process tends to be. Because of this, high public sector security ratios tend to be ineffective in the long run in terms of the comprehensive monetary policy objectives they may have been designed to achieve. This weakening of the impact of ratios has increased over the last twenty years with the growing diversity of the financial system. Ratios do not therefore any longer allow the authorities to avoid the fundamental requirements that competitive rates of interest be paid on government debt and that interest rates in general must be high enough to deter excessive borrowing if firm monetary control is to be achieved and maintained.

Although it is sometimes argued that the problem of disintermediation can be avoided by applying ratio controls more broadly and more equitably, this would not be practicable. There would always be the possibility of new financial instruments or markets developing which were not covered by the controls and which would necessitate further recourse to regulation. To be all-encompassing, the ratio system would have to apply to direct financing transactions between individual borrowers and lenders.

Another complication with ratios is that their effects across institutions and markets may result in significant distortions, depending on where the ratios are applied and the gap, if any, between the interest rate paid on the captive securities and market rates of interest. The pressures on lending interest rates, for example, are almost entirely upwards. Institutions subject to ratios are forced to raise the margin between deposit and lending rates to restore profitability, and/or turn potential private sector borrowers away. As borrowers are forced to compete for funds in other markets, interest rates in those markets are driven up. If these interest rate effects are constrained by interest rate controls, then disintermediation and/or evasion will occur quite rapidly.

Use of ratios to assist a public debt sales programme may result in muted or less obvious interest rate effects at first. This is because the diversion of funds to uncontrolled areas may take some time to occur, and the greater costs incurred by borrowers in trying to locate other sources of funds may force some of them to forego borrowing. However, these effects rely on disruption and impairment in the ability of the financial system to channel funds from depositors to borrowers at minimum cost. This suggests that reliance on ratios as an instrument of monetary policy has several major disadvantages as an alternative to an active debt sales programme.

Some additional monetary policy problems arise in the case of the trading banks' 'reserve asset ratio' (RAR) system which operated in a manner different from the ratios applying to other financial institutions. (See, for example, the articles in the October and November 1981 *Bulletins* for a detailed commentary on the RAR system.) These additional problems can be largely summarised by the comment that the RAR system was an imprecise and uncertain method for modifying trading bank behaviour. This was partly because of the forecasting uncertainties inherent in the system, partly because of the variety of ways in which the banks were able to fund a reserve asset shortfall, and partly because the system relied on potential profit penalties and interest rate effects which had a variable effect on bank credit expansion.

The essence of the matter from a monetary policy point of view is that adequate monetary control can be obtained only in an environment of flexible interest rates, including competitive rates on government securities. Conventional debt selling techniques are much more broadly based and less discriminatory than ratio requirements, and do not involve the distortions and inefficiencies associated with ratios, as discussed in the next section of the article. In any event, ratio requirements will be effective as a means of monetary control only if they have interest rate effects which in turn have an impact on the community's willingness to hold and/or borrow money. If these interest rate effects are seriously inhibited, then monetary policy will be ineffective. If the interest rate effects are allowed to

work their way through the system, then it would be preferable to utilise conventional debt sales techniques rather than compulsory ratio requirements.

The New Zealand experience would appear to confirm these views. Even in periods where ratios have been used relatively vigorously, private sector credit has at times still grown rapidly. Disintermediation seems to occur readily in the New Zealand financial system, as a result of considerable practice in operating in an environment of controls. Even relatively severe penalties at best appear to slow only the growth of particular groups of institutions. The ratio system became progressively less satisfactory as an instrument of monetary control in the face of changes in the structure of the financial system and with the development of new financial instruments, new transactions, and new approaches in the way in which financial institutions operate.

RATIOS AND EFFICIENCY CONSIDERATIONS

A major source of concern over the operation of ratio requirements has been their impact on the efficiency of the New Zealand financial system. Since ratios have compelled institutions to invest in government securities with below market yields, these institutions have been subject to an implicit 'tax' which has varied according to the severity of the ratio involved. (The accompanying table illustrates the wide variation in ratio levels across different institutions, and that variation has been further complicated by differing administrative arrangements.) The tax has ultimately been incurred by the institutions' customers, however, through lower deposit and/or higher lending rates than would have otherwise occurred. Viewed in this light, the ratio network can be seen to have been uneven and discriminatory in its impact on groups of institutions and their customers. As already noted, applying ratio controls more broadly and more equitably would not in the end be a practical proposition for avoiding such difficulties as the problem of disintermediation would still persist.

The ratio system that operated in New Zealand eroded the competitive position of high ratioed institutions relative to low ratioed ones, and of ratioed institutions generally relative to fringe financial markets. The result has been the 'disintermediation' process already referred to, whereby financial flows have tended to be re-routed through less controlled markets, which are often more costly channels. Examples of this can be seen in the housing finance market, where savings banks, which have specialised in that market, have been inhibited in their growth because of the high ratios to which they were subject. In comparison, the relatively low ratios on finance companies have assisted their historically rapid rates of growth, while the absence of ratio requirements on the non-institutional finance market (e.g. the solicitors' mortgage market) has undoubtedly contributed to its proliferation.

Ratios have thus imposed unnecessary costs on borrowers and savers. The impact has probably fallen heavily on 'small' savers and borrowers — i.e. generally the lower income groups. Small savers have received a lower return on their savings since their funds tend to be less mobile and they have fewer opportunities for diversifying their portfolios away from ratioed

institutions compared with the larger savers. The higher costs of credit imposed by ratio requirements has also penalised the small borrower, compared with the larger more affluent borrowers who are the best credit risks and therefore have tended to receive preference when seeking finance. Consequently, small borrowers have been moved towards the back of loan queues and have been more likely to be forced to seek credit in higher cost markets, such as the non-institutional one.

The inherent inflexibility of compulsory ratio requirements is another important aspect of ratios in terms of efficiency considerations. By their very nature, ratios prevent institutions from fully adapting their balance sheets and operations to changes in market conditions, meaning that they are less able to meet the changing demands of their customers in the most effective way. The more severe a ratio system is and the longer it is in place, the more likely it is that the allocation of financial resources will differ from the most desirable allocation from an overall economic or social point of view. This will in turn be reflected in an inefficient allocation of economic resources in general.

PRUDENTIAL ISSUES

It has sometimes been argued that ratios involving compulsory holdings of high quality financial assets play a useful role in underpinning the soundness of financial institutions. Financial institutions need to hold a diversified range of financial instruments so as to ensure they have adequate liquidity to meet the range of contingencies their businesses face. Liquid asset or prime asset ratios are used in a number of countries. However, the compulsory holding of a substantial proportion of their portfolios in government securities in the manner of the New Zealand ratios is not an appropriate means of encouraging sound prudential management for a number of reasons.

First, if a ratioed institution gets into difficulties, it may not be able to liquify its stock holdings without a special exemption from its ratio requirements. Such an exemption might serve only to advertise its difficulties and thus possibly compound them. Secondly, with government stock issued in the past at below market rates, the sale of stock holdings could involve the realisation of capital losses, causing further problems if the institution is already in difficulty. Thirdly, the compulsory holding of low yielding assets reduces an institution's ability to adapt to changing market conditions and impairs its ability to compete for funds. The implicit tax reduces an institution's ability to realise reasonable profits and accumulate sufficient reserves to sustain it against future difficulties.

Rather than performing a useful prudential role, it therefore seems more likely that the ratio system was counter-productive in this area. A preferable response to concerns about the soundness of the financial system is that now being developed by the Reserve Bank. This emphasises the improved monitoring of financial institutions but does not attempt to distort balance sheets or dilute normal market disciplines on management.

RATIOS AS A MEANS OF SECTORAL ASSISTANCE

In addition to diverting funds from the private sector to the Government, ratios have sometimes been used to try to influence the flow of funds to particular areas of the economy, such as local authorities and the housing and farming sectors. The use of ratios as a means of sectoral assistance has often resulted from addressing the symptoms rather than the causes of particular problems in the marketplace. These have usually been either a reluctance to pay competitive interest rates, such as in the case of local authorities, or an effort to mitigate the effects of earlier controls. For example, the housing/farming ratios arose because of a concern about the lack of funds available for those purposes, which in turn could at least partly be attributed to the interest rate controls and ratio requirements imposed on the institutions which would normally meet the needs of those particular sectors.

The direct regulation of institutions' portfolios may ensure the availability of a certain level of funds for particular sectors from particular sources (although even this may be rather doubtful over the longer term due to the effects of disintermediation), but it cannot ensure that the overall level of funds for those sectors is appropriate. Nor can it ensure that resources are applied within the sectors in the most beneficial way, economically or socially. Indeed, any assistance that such measures may provide is likely to be poorly targeted. For example, if the housing/farming ratios have resulted in extra housing finance, it may be that it has been for medium to higher-cost housing, because of the greater security and higher return likely to be obtained, whereas the Government may have preferred the finance to be directed to the lower income groups.

More generally, sectoral investment requirements have the same sort of efficiency problems as government security ratios. They restrict the ability of institutions to invest in areas where they see the greatest benefit and reduce their flexibility to respond to short term fluctuations in market conditions, or to longer term trends.

The needs of particular sectors can be met most satisfactorily by ensuring that the normal market mechanisms work efficiently. This is not to deny that some sections of the community may need special assistance. What is important is that the market should be allowed to work for the bulk of savers and borrowers, so that the need for any special assistance can be accurately identified and targeted. Assistance is most effectively extended to target groups directly through fiscal measures, rather than resorting to financial regulations such as ratios which create new distortions in the process of trying to correct existing problems.

CONCLUSION

To summarise, the analysis of the role of compulsory ratio requirements presented above indicates that the network of ratios had become an inefficient and in many ways damaging means of attempting to achieve the objectives of influencing monetary conditions and

directing finance to preferred sectors. In particular, ratios:

1. Imposed penalties on the major institutions which forced them to raise margins between deposit and lending interest rates and resort to additional non-price rationing measures. This encouraged funds to move to less controlled areas which tended to be higher cost/lower quality sources of finance.
2. Affected smaller savers and borrowers adversely.
3. Were not an effective means of achieving overall monetary control because of the diversion of funds to uncontrolled areas.
4. Were not helpful and were probably counter-productive in terms of underpinning the soundness of financial institutions; and
5. Were not effective in directing funds to particular sectors of the economy.

In recognition of these points the Government lifted all forms of ratio requirements on 11 February 1985. This action also formed part of the Government's programme of removing regulatory controls which affect the operating efficiency of the financial system in a way which does not contribute to the ultimate objectives of the Government's overall economic policy.

The new interest rate environment provided a particularly suitable opportunity for ratio abolition. With the removal of ratios, some institutions may attempt to shed stock holdings that were previously locked in. This could lower the price of government securities on the secondary market, and increase yields (with similar effects on new issue yields in the government stock tenders). At the aggregate level however, it is not expected, at least in the short run, that existing portfolio structures of institutions will alter substantially in terms of the levels of government securities held. Government stock yields are already attractive, increasing the likelihood that there will be willing buyers for any stock that is put on the market, and decreasing the likelihood of large scale portfolio adjustments in the short term.

In the longer-term the removal of ratios should not in itself result in an increased level of total private sector credit, given the need for a continuing firm monetary policy. However, it should result in a more efficient financial sector, and an improvement in the quality of the overall level private sector credit. This will occur as the more efficient financial institutions gain market share at the expense of institutions and markets which previously benefited from an artificial competitive advantage. These changes to the financial sector will contribute to the Government's aim of improving the allocation of economic resources in general.

RATIO REQUIREMENTS ABOLISHED AS OF 11 FEBRUARY 1985

Institutional Group	Type of Ratio(s)	Ratio Base
Private Savings Bank	— Government securities (GS)	Deposits, less statutory cash and low start mortgages
	— Statutory cash ratio (SC), requiring 5% of the first \$20m. in deposits and 2.5% of additional deposits to be held in the form of certain liquid assets.	Deposits
Trustee Savings Banks	— GS ratio of 38% (with special 15% ratio on outstanding housing bonds)	Deposits, less statutory cash, low start mortgages and housing bonds.
	— SC ratio, as for private savings banks	Deposits
Life Insurance Offices	Public sector (PS) securities ratio of 31%, of which minimum GS of 20%, and 11% optional GS or local authority securities (LA) Minimum housing/farming investments ratio (HF) of 20%	Total assets, less bank overdraft
Private Superannuation Funds	Overall ratio of 41%, of which minimum GS of 20%, optional GS or LA ratio of 11%, and optional GS or HF ratio of 10%	Total 'residual' assets
Finance Companies	GS ratio of 30%	'Investments'
Building Societies	PS ratio of 19%, of which minimum GS of 14%. Also, special GS ratios of 30% for holdings of 'savings bank' deposits, and 50% for home/farm ownership account deposits.	Total assets (less some exclusions)
Trading Banks	Reserve asset ratio of 27% set at beginning of February 1985 (virtually all held in GS)	Average reserve asset holdings for month as proportion of average total deposits through previous month