NEW BANKS AND FINANCIAL STRUCTURE REFORM

This article sets out the proposed framework for the prudential supervision of financial institutions and the establishment of new banks in New Zealand.

Introduction

On 11 November 1985, the Government announced its intention to introduce a revised framework for the prudential supervision of financial institutions and to accept applications for the establishment of new banks in New Zealand. These moves build upon the series of financial sector reforms already undertaken by the Government.

The freeing-up of entry into banking is a further reflection of the Government's desire to encourage a more efficient financial sector by promoting an environment which is both competitively neutral among different institutional groups and which allows for more direct competition among participants. The review of the supervisory arrangements for banks and other financial institutions complements this approach in that it recognises the need for provisions allowing both free entry and orderly exit from the financial system. The purpose of this article is to outline the Bank's view of the underlying philosophy for these moves and their place in the overall framework of financial structure reform.

Background

The supervision and banking policies currently being implemented represent two further aspects of an overall programme of financial structure reform. A number of significant elements of this programme have already been put in place.

One of the first steps was taken in September 1983 with the introduction of a number of non-bank dealers to the foreign exchange market. Additional new entrants were admitted throughout 1984 and further moves to strengthen the market were taken in October of that year, followed by the floating of the New Zealand dollar in March 1985. The abolition of exchange controls in December 1984 represented a fundamental policy change as restrictions of varying intensity had been in force in this area since 1938.

Important progress in reducing restrictions on financial institutions and removing barriers to competition among institutional groups had already been made with the removal of all controls on interest rates and the withdrawal of credit guidelines and other directives during July and August 1984. These measures were reinforced in February 1985 with the abolition of all compulsory public sector security (or 'ratio') requirements on financial institutions.

The current proposals to reduce entry barriers to the banking sector and to review the Reserve Bank's role in the prudential supervision of institutions are natural extensions of the moves made to date to remove many of the arbitrary institutional and regulatory distinctions imposed on the financial sector in the past.

Financial Sector Reform: The Conceptual Framework

The basis for the programme of financial sector reform now almost completed lies in a new approach to economic and monetary management by the present Government. The approach acknowledges that in the medium-term improved economic and social equity can be promoted most satisfactorily against a background of improved economic efficiency — a prerequisite for sustainable economic growth. This general philosophy has led to a recognition of the need to review the nature and extent of government interventions in the economy. This has been necessary in order to focus on the most appropriate set of interventions to meet the policy objectives of the Government.

The economic efficiency aspects of government-imposed regulations and restrictions are properly considered within the context of the microeconomics of market structures. Recent microeconomic literature emphasises the degree of 'contestability' or *potential* competition in a market, rather than the degree of *actual* competition, as being a significant determinant of industry performance and efficiency. In order to discuss the underlying rationale for the programme of financial sector reform it is necessary to outline briefly some of the essential features of contestability theory.

The contestable market approach rejects the notion that there is a necessary relationship between the number of competing firms in an industry and the extent to which production is efficient or welfare

maximised. If a market is contestable — loosely, if there is relatively free entry into and exit from the market —it can be expected that neither larger than normal profits nor production inefficiencies or unnecessary costs will characterise that market in the long-term. This is because the existence of either large profits or inefficient suppliers constitutes an incentive for new firms to enter the market and undercut existing producers by lowering either prices or costs or both. In short, the only way in which incumbents can avert the threat of entry is to behave in a competitively optimal fashion.

Even this simplistic presentation of contestability theory has reasonably clear implications for regulatory policy. The most obvious of these is that the emphasis of policy should be on removing or reducing artificial obstacles to entry into (or exit from) markets, rather than on simply increasing the number of actual participants in a market (which is not necessarily the same thing). Once imposed barriers have been removed, and if 'natural' barriers are not unduly significant, the threat of potential competition plays an important role in ensuring a competitively efficient outcome regardless of the number of actual market competitors. Conversely, if a market is perceived to be relatively contestable, any policy initiatives should be weighted against regulation or intervention, irrespective of the number of incumbents and the history of actual entry.

In applying this approach to banking and financial markets the likely (and, indeed, familiar) behaviour of profit-seeking financial institutions in the face of discriminatory regulations is relevant. In general, institutions which are discriminated against will often attempt to circumvent legislative disadvantages or other market-generated barriers, up to the point where the cost of them doing so offsets their expected benefit. Regulatory experience both in New Zealand and overseas provides ample evidence illustrating the relative ease with which this can be done in the financial sector. Clearly, this outcome will not be optimal as substantial resources are allocated to the relatively unproductive and costly process of circumventing barriers; resources which could be more productively employed elsewhere if the restrictions did not exist.

The implications for a government objective of promoting an efficient and stable financial sector are self-evident. A policy approach based on government intervention and regulation of an arbitrary and detailed nature has proved to be not only costly and inefficient but also largely ineffective and inconsistent with what it aimed to achieve. By imposing an inflexible, ad hoc structure on the financial system the ability of both entire sectors, and individual institutions, to adapt in a changing financial climate was diminished as, consequently, was their prudential soundness.

Clearly a more appropriate framework for financial sector policy was required. An approach more in accord with general economic efficiency arguments as well as prudential and institutional considerations has thus been adopted. The essence of this approach can be broadly summarised by the three major principles on which it rests:

1. The most fundamental premise is the general desirability of a 'competitively neutral' policy environment, or one which does not alter the underlying structure of market incentives and hence, ultimately, the overall allocation of financial and real resources. Achieving this involves the reduction or elimination of forms of arbitrary discrimination between different classes of institution, whether imposed by legislation, regulation or administrative practice. Government intervention, where required, should desirably be as uniform as possible in its effect on different institutional groups amongst which competitive and legal conditions should be as neutral as possible.

   To a large extent developments in this area have been the result of a market-led blurring of the historical and largely artificial distinctions between different classes of financial institution.

2. Closely related to the principle of competitive neutrality is the importance of improving the contestability of particular markets or industries for the reasons already explained. Removing artificial barriers to entry into (or exit from) markets enables both those involved in the market and those outside it to respond appropriately to market signals. Minimum detailed intervention in financial markets on the part of government should allow markets to develop competitively and efficiently with a minimum of externally imposed distortions or rigidities.

3. In general the existence of competitive and efficient financial markets is also the most effective way of promoting a stable environment for the financial system. However, to the extent that there are factors such as uncertainty and costly information which may give rise to social costs from the failure of institutions (especially where these lead to system-wide effects) and to the extent that markets cannot be expected to deal with these appropriately, then there may be grounds for an explicit prudential supervision policy. But, it is important that any such policy framework be as consistent as possible with the efficiency considerations already outlined.

The application of this general framework to the banking sector and the resulting 'new banks' policy package is covered in the next section. This is followed by a discussion of the design and place of the prudential supervision arrangements in the overall financial sector framework.

Financial Sector Reform and the Banking Industry

Entry into the banking industry in New Zealand has been under review by the authorities for several years now, in line with the general programme of financial sector reform. At present, statutory law restricts 'bank' status to the four trading banks, the private savings banks, the trustee banks, the Post Office Savings Bank and the Reserve Bank, with each of these groups carefully delineated under their respective sets of legislation. Various legal restrictions mean that a new bank may only be incorporated by an Act of Parliament. This situation of legislatively restricted access to an artifically constrained banking sector is undesirable and somewhat unrealistic in the current environment of growing financial market sophistication and development.

A significant motivation for the banking policies now being introduced has been the substantial blurring that has been occurring for a number of years now, both in New Zealand and overseas, in the differences between banks and non-bank financial institutions. It has become obvious that the largely historically determined and rather contrived distinctions between different

types of financial organisation are being gradually eroded. Major finance houses and building societies have become more bank-like over the past decade, and likewise banks have made some inroads into the more traditional preserves of non-bank financial institutions. Those institutions which do not technically qualify as banks in the legal sense nevertheless operate very like 'banks' in a functional sense. Customers can obtain most bank-type services from these organisations, (e.g. short-term credit, foreign exchange, electronic funds transfer etc.). At the same time banks now provide mortgage-type lending, corporate advice, underwriting etc, services formerly regarded as predominantly non-bank areas of business.

Thus, even in the face of both market-imposed and legislatively conferred entry restrictions, the banking sector has continued to become increasingly contestable and contested, albeit via the indirect route of developments which provide close substitutes for bank services. These changes are desirable because they provide more opportunities for inter-institutional competition in an area that has otherwise been dominated by a small group of legally franchised banks. It is in the public interest that as few impediments as possible to direct competition exist, as these impediments reduce the benefits that would otherwise accrue from a potentially wider range of choice and from more favourable pricing of services. Indeed, it would be very difficult to prevent some of these developments given the advent of payments' mechanisms such as electronic funds transfer at point of sale (EFTPOS), and other cheque-like instruments such as negotiable orders of withdrawal. In many ways the new policies are simply formal recognition of changes already taking place.

Given that most banking activities are now undertaken by other 'non-bank' institutions and that such institutions are likely to be just as sound as the traditionally recognised 'banks', an important aim of the new banks policies is to alter gradually the current rather limited perception of the word 'bank' in order to reflect these changes. However, the adjustment process associated with moving to completely free entry into banking in the short run needs to be considered. For example, existing perceptions of what constitutes a bank, both domestically and in the international community, will need to change. This process will take some time. On balance therefore, the retention of an explicit authorisation system for banks has been favoured by the authorities at this stage. Nevertheless, the importance of an authorisation procedure which is consistent with the objectives of encouraging a competitive, efficient and contestable banking sector has been recognised.

For these reasons a qualitative rather than quantitative approach to the introduction of new banks will be taken. In particular, it is seen as especially desirable from a long run viewpoint that as great a degree of market contestability as possible is retained as an incentive to competitive behaviour. To this end the Government has decided to adopt an 'open-ended' system for authorising institutions which wish to become banks. There will be no fixed limit on the number of new entrants or on the time-frame associated with entry i.e. the ability to apply to the Reserve Bank for bank status will not be a one-off measure — access (as well as exit) is intended to remain open. Concerns about indiscriminate entry or low quality applicants will be met by qualitative authorisation criteria rather than by numerical limitations. Public knowledge of a liberal, ongoing licensing system, together with the removal of many of the advantages that previously applied to being a bank, will of course influence the number of new applicants. In this respect, the fact that there will be more institutions entitled to call themselves banks (and that some of these institutions may have formerly been well-known to the public by other names), is likely to act to dilute inappropriate perceptions of banks being in some way special.

In addition, non-bank institutions will not be discouraged from offering cheque account facilities and taking part in the payments system or otherwise becoming involved in the clearing/settlement of debts. Competitive efficiency and equity arguments suggest that the existing restrictions in this area are undesirable and should be removed. No official criteria will be laid down regarding participation in the clearing system as it is envisaged that any necessary prudential standards or controls will be developed by participants themselves. In any event there now exist such a large range of more or less close substitutes for cheque services that non-banks can legally offer (e.g. orders of withdrawal, credit cards, ATMs, direct crediting and debiting, electronic funds transfer etc), that any restrictions in this area would probably become increasingly ineffective as institutions continued to find ways of circumventing them.

Apart from the requirement that deposit-taking and lending functions form a substantial part of an institution's business there will be no official limitations or requirements on the range of banking activities that might be undertaken. It would be counter-productive to require the compulsory duplication of existing facilities or to unduly stifle the development of specialised banking institutions. Hence, requiring banks to have a particular branch network or to provide a whole range of banking functions is considered undesirable. Moreover, a bank need not issue cheques or join the clearing system should it not wish to get involved in this area of business. However, authorisation as a bank will not carry with it automatic authority to deal in foreign exchange. This will remain subject to a separate, although similar, approval process.

The criteria institutions will be required to satisfy before they are permitted to use the word 'bank' in their names include:

1. Issued capital of at least NZ$30 million, with a minimum of $15 million fully paid up. This minimum size guideline is designed to provide evidence of financial substance and commitment, and to deter frivolous applications. At the same time, it is not so large as to stifle the development of specialist banking operations and will thus leave the contestability of the market intact over a wide range of sizes. In addition, it can of course be expected that large existing institutions may need to provide more than $30 million capital to ensure they are adequately capitalised when they commence operations as 'banks'.

2. Demonstrable expertise in the conduct of banking business and the willingness and capacity to make a positive contribution to the development of the New Zealand financial sector. 'Banking business' will clearly be interpreted in a relatively wide sense, given the aim of the new banks policy.

3. Evidence of good standing in the financial community.

4. Willingness to co-operate with the Reserve Bank in

all of its functions under the Reserve Bank of New Zealand Act 1964. Clearly this will include the functions associated with prudential supervision.

In keeping with the general approach of encouraging competition in the financial sector, there will be no restrictions on whether successful applicants for bank authorisation are domestic or foreign entities. There is no justification on economic or prudential grounds for any such restriction; on the contrary, there is already extensive overseas participation in the financial sector and the degree of openness currently proposed is similarly seen as having further major benefits for the New Zealand financial system.

The new banks and other financial sector policies have been based on the belief that, in general, the most beneficial outcome for the community as a whole is that which market participants will arrive at in a competitively neutral policy environment. However, there may be specific areas or circumstances where the market outcome can be shown to be not socially desirable. In these cases any policy response should be carefully designed so as to minimise unforeseen and undesirable side-effects. The need to establish a clear framework for any such intervention has led to a closer examination of the role of both government and the Reserve Bank in financial markets. The resulting approach to policy in this area is outlined in the following section.

Prudential Policy

An important justification for the extensive deregulation of the financial sector has been the wish to remove special privileges and restrictions which relate to the activities of different groups of financial institutions in order to enhance the flexibility and adaptability of their operations. Apart from contributing to a potentially improved monetary policy and a generally more efficient financial sector (which in turn will lead to a more appropriate allocation of real resources), the policy changes will also have beneficial longer run effects on the structure and stability of both individual financial institutions and the financial system as a whole.

Seen in this light, deregulation is itself an integral part of improving prudential management. Overseas experience demonstrates not only that prudential problems are no more severe under a deregulated environment than under a regulated one, but also that many of the prudential problems which emerge in a deregulated situation can be seen to have their root causes embedded in the earlier regulatory environment. This is because of the severe distortions in balance sheet structures and profit margins which may be induced under widespread regulations. The suggestion that deregulation is likely to lead to instability within the financial sector has often been presented, but there is little evidence to suggest that, in the longer term, a higher rate of business failure or bankruptcy is generally associated with a less regulated commercial environment.

On the other hand, it must be acknowledged that the process of change from a regulated to a deregulated environment may lead to transitional difficulties for some individual institutions. For this and other reasons, it is likely that some degree of restructuring and rationalisation will be seen within the New Zealand financial sector over the next few years. Some current participants and new entrants will gain market share while other institutions will experience a loss of market and in some cases choose to merge or wind up their operations. Such a process over this period, and indeed beyond, should be regarded as a useful and necessary one. In view of the many changes taking place in the financial sector and in the domestic policy environment in general, a review of the supervisory framework for financial institutions was considered appropriate.

The fundamental objective of prudential policy is to create an economic and legal environment conducive to stability and efficiency for the financial system as a whole and for individual institutions. A consistent and coherent approach to economic policy provides the best environment for proper prudential management by allowing institutions to respond to the correct market signals. Deregulation has already removed some of the major restrictions on sound management, for example the compulsory investment ratios, and further changes under the new banks policies will extend that approach.

Conceptually, the question arises as to the justification for special supervisory arrangements and powers which do not apply to the non-financial corporate sector. The need for these lies in the speed with which problems can develop in the financial system and the possibly widespread impact of the collapse of a major financial institution on other financial market participants and on the commercial sector generally. In particular, the phenomenon known as 'contagion' in financial markets may specifically give rise to the need for intervention in some circumstances. The contagion effect occurs when one financial institution experiencing difficulties leads to a generalised loss of confidence in the financial system which sets off 'runs' on other financial institutions which have nothing to do with the original problem. This in turn has the potential to bring about a multiple contraction in the money supply, with resulting adverse effects on real economic activity. It is this possibility of major disruption to the real economy which the authorities wish to avoid.

The more lengthy and uncertain the process of bank failure is, the more likely it will be that a widespread loss of confidence will follow from an individual (large) institution getting into difficulty. Thus, one important aspect of the Government's upgraded prudential policy is its emphasis on failure *management* rather than failure *prevention*. The failure of an individual institution need not in itself be the central issue; indeed, the potential for institutions to fail may be seen as a necessary and appropriate exercise of a market discipline upon participants in this industry as in others. However, the speedy isolation and exit (by for example, winding up, merging or selling) of an institution in trouble — in circumstances where authorities judge confidence in the overall system might otherwise be impaired — may be an appropriate policy response in terms of minimising the potential social costs associated with any such loss of confidence. Hence, the revised supervisory arrangements include the provision of a suitable legal framework to deal with such situations.

A related issue is that of the coverage of supervisory arrangements for financial institutions. Research has shown that there is a positive relationship between size and 'systemic' risk (i.e. the likelihood that failure of an institution will damage confidence in the whole financial system). Given that the foremost objective of the Government's prudential policies is to preserve that confidence, and that the failure of large non-banks could impose social costs broadly similar to those

arising from the failure of a bank, the upgraded prudential supervision framework treats banks and large non-banks in the same way. Thus, the emphasis is on size rather than on what label an institution is known by.

The prudential policies complement the new banks' policies in that the latter free-up entry into one part of the financial sector, while the former ensure provisions exist for a smooth and orderly exit process from the financial system should it be necessary. Both policies should help improve the contestability and therefore the efficiency of financial sector operations. While it is intended to supplement and reinforce the normal commercial disciplines and also to provide for last resort powers to minimise the impact of serious failures on other well managed institutions, prudential supervision is not intended to replace the normal marketplace influences on the conduct of financial institutions.

It is important to note that neither a form of deposit insurance nor any explicit or implicit deposit guarantees are being proposed. The onus of responsibility for sound prudential management rests with the shareholders, directors and management of individual institutions. Moreover, any prudential losses which may be incurred should not be borne by either the Reserve Bank or the taxpayer, but instead should be borne by the shareholders, depositors and creditors of the institution which gets into difficulties. The authorities will not be providing a safety net for institutions which may develop problems as a result of inefficiency or unresponsive management practices. It is essential that strong incentives remain with management to ensure good performance and high prudential standards, and that the Government should not in any way impair these incentives by offering or implying to offer any financial underpinning for particular institutions.

The overall approach may be viewed as a framework for reinforcing, first, the normal commercial incentives and procedures (board supervision, analysis by sharemarket professionals, audit, etc) for monitoring the condition of financial institutions and, secondly, the normal commercial procedures which are adopted by owners or management to deal with enterprises which become uncompetitive or experience financial difficulties. The two principal elements of the package relate to information collecting and monitoring of the financial condition of institutions, and to last resort powers of intervention. The actual role of the Reserve Bank will be largely a monitoring one, based on comprehensive powers to collect statistics from institutions. These powers will be provided by amendment to the Reserve Bank Act as will authority for the exchange of information with foreign supervisory authorities and provision for possible regulations to govern the published financial statements of institutions. In addition, the amendments contain wider powers of inspection than the present Act and a new provision for special audit.

The supervision framework will not be based on preventative regulation such as the imposition of legal minimum capital ratios or liquidity requirements. Overseas experience indicates that reliance on this approach has limited success and may involve unduly high costs, especially in terms of reduced operational flexibility for supervised institutions. Instead, the approach is intended to be essentially low key, focusing on better information flows to the public and the Reserve Bank by moving to more comprehensive and uniform reporting and disclosure requirements across comparable institutions. Regular consultations with financial institutions will be aimed at encouraging them to adopt appropriate prudential standards. The approach rejects the notion of the Government or the Reserve Bank accepting primary responsibility for the safety of depositors' funds or for the solvency of particular institutions. No guarantees can be given that problems with the financial condition of a supervised institution will be detected at an early stage.

This process will effectively represent a periodic 'check-up' on the health of supervised institutions. Where problems are suspected which are apparently not being adequately addressed by the institution or its Board, these can be investigated further and discussed with management, and remedial action could normally be expected to follow. In the event of irremediable difficulties developing, resort to normal commercial processes of merger, sale or any other option for reconstruction or orderly exit will be encouraged. A catalyst for this process would be the ability of the Bank to serve formal notice on an institution in danger of becoming insolvent that it is considered to be a company at risk. In the extreme case where an orderly process of exit does not appear likely to occur the Bank may seek to exercise its powers to facilitate exit. Intervention of this type, which could abrogate or attenuate the rights of owners and creditors, would be examined with great care before being proceeded with. These emergency powers will only be used to facilitate an orderly exit of a large institution where a collapse might carry risks for system-wide stability. In such a situation, the normal processes of liquidation of a major financial institution could lead to significant disruption and uncertainty in the system. However, other than in these exceptional circumstances, the proposed provisions are not designed to supplant the normal legal arrangements, such as those contained in the Companies Act.

The smooth functioning of the financial system (and hence of the economy in general) is critically dependent on the retention of confidence in that system by its customers. Minimising special privileges and particular institutional restrictions should contribute importantly to the ability of financial institutions to manage their assets and liabilities in a sound manner and enable them to respond rapidly and efficiently to changes in competitive pressures. Many changes along these lines, such as the removal of compulsory ratios and the new banks policies, have already been made and further changes are planned with respect to a number of areas. The following section briefly outlines some of the more important complementary and related issues that still remain to be addressed.

Remaining Institutional Issues

In the area of special legislative privileges and particular institutional restrictions there remain a series of questions to be resolved over time. One of these is the role of the government guarantee for trustee savings banks. The Government has made it clear that the phase out of this guarantee will not be contemplated until appropriate alternative arrangements have been made. Representatives of the trustee banks and the Reserve Bank are currently investigating a number of options regarding the future structure and role of these institutions.

Another issue relates to building societies which are seeking some legislative amendments to their Act. The

Government has indicated a willingness to consider liberalisations which would eventually place building societies on a footing more similar to that of other financial institutions.

A review of the Trustee Act is currently underway in order to determine whether the present 'legal list' should be replaced by the 'prudent man' principle, or some appropriately more liberal arrangements. Another matter under study is the question of how to eliminate special preferences for banks in terms of access to certain classes of deposits as provided for under a wide range of legislation. It could take some time to resolve this issue given the legal and administrative complexities involved.

Government owned financial entities (the Post Office Savings Bank, Rural Bank, Housing Corporation, Bank of New Zealand and the Development Finance Corporation) are currently being reviewed under the State Owned Enterprises framework with a view to enhancing the efficiency of their operations and to making them more comparable with their private sector counterparts. In particular, the objective is that these institutions be placed on a basis such that they neither enjoy special advantages nor suffer any special disadvantages by reason only of their government ownership.

Most of these remaining institutional developments could be expected to take a period of time to be resolved as the majority of them involve both extensive discussions with a number of public and private sector organisations and also, in many cases, changes to existing legislation.

Summary

From a background of rigid constraints and controls on the structure and operation of the New Zealand financial sector, the Government has taken a series of steps designed to promote competition and efficiency in the financial community. The banking and prudential policies discussed in this article represent two further elements of this programme of financial sector reform.

The underlying rationale for the new approach is based on the desirability of both a competitively neutral policy environment and a generally more contestable financial sector, as both will lead to greater competition and efficiency in the financial system. The Government's objective of promoting a stable financial sector environment will also be most effectively achieved by this outcome.

It can be expected that the implementation of the new banks policies will eventually lead to a significantly larger number of banks and to the development, in time, of a wider and more convenient range of financial services. These will have benefits both for domestic markets and for New Zealander's external transactions. Pricing of these services should benefit by competition from other non-bank intermediaries and by the continuing possibility for entry into banking by potential competitors.

The Government's upgraded prudential framework focuses on preserving stability in the financial system, while avoiding any weakening of incentives for institutions to manage their own affairs in a prudentially sound manner. In circumstances where the market outcome may be socially undesirable and government involvement is required, that involvement should be uniform in its effect and consistent with the underlying efficiency criteria, rather than of an ad hoc or arbitrary nature. This is based on the view that, in general, the most beneficial outcome for the community as a whole is likely to be that which market participants will arrive at in a policy environment which is non-discriminatory and involves a minimum of direct or detailed government intervention.