Reserve Bank Bulletin

ADDRESS BY THE GOVERNOR

This article is taken from an address by the Governor, Mr Spencer Russell to the Building Societies' Association Conference on 21 November 1984.

"Since the Government assumed office it has implemented a number of initiatives which, as I perceive them, are designed to make structural changes in the economy. It is the stated objective of these measures to make the New Zealand economy more adaptive, and more able to react to a changing environment.

Some of the most significant policy initiatives that have been taken so far are the moves to de-regulate the financial sector. These include the removal of the Interest on Deposit Regulations 1984 and the abolition of the Economic Stabilisation and Financial Institutions (Interest Rate) Regulations and the one per cent credit growth guidelines.

These policies are designed to remove impediments to the flexible operation of the money market. The intention is not only to improve the efficiency of the financial sector per se, but also to have a positive impact on all other sectors, by channelling resources to those areas which can make the most economic use of them. This is seen as a necessary prerequisite to placing the economy on a path to stronger and more sustainable growth.

Complementing these initiatives, the Budget made a range of adjustments to other sectors. These appear to have two main aims: to improve the allocation of resources by freeing up relative price signals, and to reduce the size of the budget deficit. These measures include progressive removal of a wide range of subsidies, especially in the agricultural sector and the realignment of Government charges on the basis of a partial or full recovery of costs.

Although these moves will reduce the budget deficit only slightly in the current fiscal year — to $2,761 million — they are expected to have a much heavier impact over the following two years. Indeed, the Government estimate in the budget is that its initiatives, together with those previously announced, will result in a net saving of $1.1 billion in the 1985/86 year, followed by a saving of $1.8 billion in the next year. The Reserve Bank's econometric model is forecasting a deficit of about $1.7 billion for the year to March 1986, equivalent to about 3.9 per cent of forecast gross domestic product, compared with just over 9 per cent in the fiscal year just ended. A reduction of this size should clearly have an impact in a number of ways, particularly in the monetary sector. A reduction in fiscal injections will help reduce pressure on monetary aggregates and this, in turn, should take some of the pressure off monetary policy.

However, although the beneficial effects of a reduced deficit should become apparent over the next two or three years, the short-term consequences may not be so positive. Increased Government charges, the effects of devaluation and the removal of most controls on wages and prices should all have some effect on prices. As a result, it seems a reasonable forecast that the rate of inflation will rise in the short-term. The Bank's model predicts a rate of inflation of about 12.5 per cent over the year to March 1985, rising to a peak of about 14 per cent in the June 1985 year. If the country can avoid an excessive wage round, and the Government adheres to a firm monetary policy, there should then be a gradual decline in the inflation rate. As an indication, the Bank predicts an easing beyond the middle of 1985, with an expected inflation rate of about 10 per cent in the March 1986 year.

This type of movement in monetary aggregates and inflation rates must have implications for interest rates. In the short-term, the Government's obvious determination to maintain a firm monetary policy should continue to place pressures on the level of

nominal interest rates. This is likely to be reinforced by the private sector's expectation of a short-term build-up in inflation. However, beyond the short-term, the reduced fiscal injections should allow the Government to reduce the size of its stock tenders. This will ease a lot of the pressure on interest rates. Once the market adjusts to this and to what, by then should be an expectation of a lower inflation rate, it is my belief that the level of nominal interest rates should begin to fall. Indeed, if the market accepts that there will be reduced fiscal deficits and lower inflation in future, we should see the beginning of a reduction in nominal interest rates even earlier, and before these events actually occur.

If I were to outline the broad philosophical thrust that I see as guiding the substantial reforms that have occurred, I would emphasise that there was now a clear commitment to the removal of barriers to competition across the entire financial sector. In practical terms, this commitment means ensuring that an institution's profitability stems from the efficiency with which it carries on its business, rather than from the regulated environment in which it happens to find itself operating. The impact of deregulation on the building societies should be seen in this light.

There is little doubt that the historical prohibition on banks paying interest on deposits for terms of less than 30 days and the limitation of 3 per cent interest on ordinary savings accounts, gave the building societies (and the finance companies) a substantial competitive advantage. That advantage was removed with the abolition of the 30 day rule and the 3 per cent interest rate restriction in August.

However, the rather cautious movement into the short end of the retail deposit market by the banks has afforded the building societies time to adjust to any likely changes. The success with which the societies complete that adjustment process will eventually determine whether as an institutional group, the share of the retail market it presently enjoys will expand, be maintained or eventually be eroded.

Public Sector Security Ratios

As is now widely known, the authorities are reviewing the role and structure of the ratio system. In the consultations with members of the finance sector that have been held there has been a measure of disquiet. Some of the concern is largely misplaced, being based on two popular misconceptions as to the 'role' of ratio policy generally.

The first misconception is that public sector security ratios play a useful prudential function within the financial system. I would be the first to concede that financial institutions need to hold some government stock as part of a diversified range of financial assets within a well managed investment portfolio. However, compulsory holdings of Government paper which amount to a substantial proportion of an institutional's investment portfolio, and which at times may only be able to be liquified at a significant cost, are probably inconsistent with an objective of encouraging the prudent management of financial institutions.

In fact, going back to the days before the tendering of government stock, it is fair to say that many of the interest rates paid on government securities were significantly below comparable market rates. That reality imposed an implicit tax on those institutions which were forced to hold such assets, and, quite obviously, will have depressed their overall profitability. One of the Reserve Bank's concerns is that reduced profitability of a financial institution impairs the ability of that institution to set aside adequate capital reserves. Also of concern is that such ratios seriously impair the ability of the affected institutions to compete for funds, and this can only aggravate, rather than ameliorate, stability problems should they arise in the financial system.

The second popular misconception concerning ratio policy has two separate components. The first is that such a policy assists an active debt sales programme by providing a captive market for the sale of Government paper. The argument runs that monetary control can therefore be achieved through that market while avoiding the upward pressure on wholesale interest rates that can be associated with an active debt sales policy.

The other part about which there is a misconception is that ratio policy is an effective means of enforcing credit growth guidelines. It is argued that funds can be effectively diverted from the private to the public sector and, that in addition, ratios can be used as a means of fining financial institutions which pursue 'inappropriate' lending policies.

A major problem encountered in most forms of finance sector regulation, and with ratio policy in particular, is that extensive 'disintermediation' occurs quite rapidly. That is, financial flows tend to be redirected as a result of regulation through alternative channels which are not or cannot be ratioed. This 'disintermediation' imposes real economic costs on all participants in the financial sector, but those investors with small savings balances tend to be the hardest hit, since they have fewer investment opportunities available to them. Similarly if the use of such ratios is, in fact, effective in curbing the flow of loan moneys to the private sector, the large borrowers generally obtain funds at the expense of the 'smaller' savers, who again tend to be relegated to the end of the queue.

Turning to the interest rate effects of ratio policy it is now clear that, in the medium to long term, disintermediation will erode any downward interest rate effects that might have occurred in the short-term as a result of ratio policy. Even short-term interest rate gains are not certain.

The overall conclusion is that ratio policy does not necessarily enhance prudent management nor is it a particularly effective or efficient instrument for attaining monetary control when used as a substitute for public debt policy.

Role of the Reserve Bank in the Field of Prudential Supervision

Those opposed to finance sector deregulation point to the associated risks of increased finance sector instability, and advocate extensive prudential supervision of financial institutions. Rather than being seen necessarily as the quid pro quo for finance sector deregulation, the Reserve Bank's view of prudential supervision is as a means of formalising the ground rules within which a fair game can be played. The reality is that there are risks even if there is no deregulation. If there are barriers to competition there is risk of a deteriorating finance industry which lacks flexibility to respond to the changing market place. If, as the Government has done, the industry is allowed to

become more efficient through competition, financial institutions themselves may choose the type of risk they assume. The exercise of this choice is an essential element in the development and operation of an efficient financial system.

Partly as a means of setting those ground rules and also recognising the Reserve Bank's on-going international obligations to other central banks that we ensure that our major financial institutions are adequately 'supervised', the Bank has mentioned publicly on a number of occasions recently its intention to upgrade its system of prudential supervision. Work in that area has been taking place over the last few months and we are now close to being able to initiate extensive discussions with the major groups of financial institutions. This we see as a first and necessary step toward ensuring their on-going co-operation in our supervisory endeavours.

The institutional coverage of the upgraded system of prudential supervision will necessarily be limited by the physical resources the Bank has available. It will, in the first instance, be applied to all major financial institutions operating in New Zealand. The Reserve Bank envisages the system would be based on:

1. The continuous monitoring of upgraded statistical returns.
2. Development of standards of adequacy covering a number of dimensions of financial soundness.
3. Consultations with institutions on their own position and on developments in the market place affecting all institutions.
4. The capacity to intervene in the event of failure of an institution to preserve confidence in the system.

We are currently examining the breadth of the Bank's Act to ensure the requisite powers implied in that list are provided.

At this stage, the Bank envisages a relatively low cost system; low direct costs in terms of the Bank's personnel commitment, and low compliance costs for the various institutions which fall within the scheme's coverage. The Bank also sees the system as being complemented by the development of self-regulation within institutional groupings. It would be augmented by a system of voluntary public financial disclosure on the part of financial institutions, which would parallel the types of disclosure made under the securities act with respect to prospectus, trustee, and trust deed requirements.

In the main, the Bank's system will focus on the five primary prudential dimensions known by the acronym 'Camel'. 'Camel' comprises:

C — Capital Adequacy
A — Asset Quality
M — Managerial Performance
E — Earnings Performance, and
L — Liquidity

There are a few simple rules. It is really a question of judgement having regard for all the factors. One can't look at capital, asset quality, liquidity and so on in isolation — a judgement of the adequacy of each factor depends to some extent on the condition of one or more of the other factors.

The assessment usually begins with capital, that is reserves and shareholders' funds in the companies act sense which means funds available unconditionally to support the whole balance sheet. Capital is the fundamental risk cushion and is usually assessed with particular regard to the level and quality of assets.

The assessment of liquidity covers most aspects of the balance sheet and other factors as well. It usually begins with an assessment of the liquidity of liabilities — the proportion at call or which can be withdrawn at short notice. This leads to a measurement of the liquidity of assets, both quality and level, including cash flow from loans, which is assessed together with actual and potential external support — irrevocable stand-bys or overdraft facilities. Some consideration may be given to the likelihood of support from parents and other associates.

Asset quality is a critical element in the evaluation of most banks but perhaps less so for building societies. Mortgages over residential property are usually low risk assets but we must also look at such factors as term and frequency of interest rate review.

Revaluations aside, profits are the only source of capital for non-proprietary institutions such as the majority of building societies. A good level of profit is important for this reason and is also a good indicator of financial condition. Operating cost ratios are an indicator of operating efficiency and of staying power in the more competitive financial system. The quality of management is, of course, a big factor. In this regard we would be particularly interested in the quality and effectiveness of internal control systems. Size by itself may be of no value in an assessment but can be a factor influencing 'standing' as can loyalty of the customer base which develops over time and can be particularly important for an institution in the 'retail' market catering largely for individuals rather than large businesses. Finally, although the Bank recognises that there may be important special factors in the assessment of each institution which may need to be taken into account, the above framework must be applied more or less to all institutions.

Of course, these various dimensions are heavily inter-dependent and the degree of that inter-dependence will vary between institutions. For this reason it is certainly the Bank's intention that each supervised institution be assessed in relation to the nature of its own area of business. However, I would also imagine that the assessment of particular institutions would include an analysis of the position of 'peer groups' of institutions and would clearly have regard for the influence of parents and subsidiaries on the institution's financial position.

Needless to say, the Bank will be examining the guidelines adopted in other countries when it comes to devising standards and guidelines for application in New Zealand. But, this process will be inevitably gradual, and one which will require a great deal of consultation with the institutions concerned. While the Bank will be increasing its prudential supervision this will not absolve any institution from following good prudential policies and practices and no one should assume that the Reserve Bank will provide a safety net for those that do not. There will continue to be a responsibility on institutions to conduct their business in a manner that justifies the confidence of their customers".