Liberalisation of financial markets in New Zealand

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This article is an edited version of a paper commissioned by the Reserve Bank for presentation to the EMEAP (Executives' Meeting of East Asia and Pacific Central Banks) Working Group on financial market development, at its October 1998 meeting in Wellington.[1] Its author, Dr Arthur Grimes, was formerly Chief Manager of the Economics and Financial Markets Departments of the Reserve Bank, Chief Economist of The National Bank of New Zealand Limited, and Chief Executive of Southpac Investment Management Limited. The views expressed in this article are those of Dr Grimes, and do not necessarily reflect those of the Reserve Bank.

1 Introduction

Since mid-1984, New Zealand's financial system has undergone something of a revolution. The raft of regulations placed on financial institutions promulgated prior to 1984 has been largely removed. Entry to the banking system has been greatly opened up, with the number of "banks" increasing from 4 to 19 over this period.[2] Liquidity ratios on banks and other financial institutions have been removed, foreign exchange dealing restrictions removed and interest rates, which were almost wholly regulated prior to 1984, are now wholly market-determined. Banking functions can now be carried out fully by non-bank institutions (provided those institutions do not call themselves a "bank").

This paper examines these and other changes. It is argued that the unifying theme to this liberalising process is one of a strengthening of competition. Yet in some (limited) aspects the financial system in New Zealand is more regulated now than it was prior to 1984. A system of prudential supervision has arisen that was absent in the early 1980s, imposing new requirements on banks. However, the paper's analysis suggests that these additional requirements can also be seen as moves to promote competition. In many markets, the process of enhancing competition is largely one of removing state-imposed regulations that had previously inhibited new entry to the market. In financial markets, however, the reputation and soundness of the system is regarded by most policy-makers as a *sine qua non* of appropriate policy-making. Is this approach anti-competitive? The literature in this regard is examined and it is concluded that some limited level of prudential regulation can promote competitive forces. With this as a background, we compare competition within the New Zealand financial system in 1998 with its competitive state 15 years earlier prior to the 1984 election.

2 Liberalisation & competition principles

I take the central focus of the liberalisation process to be the implementation (or, more frequently, the removal) of policies with the intention of acquiring an economic environment more closely resembling that envisaged by the classical economic liberals.[3] This definition implies that liberalising moves are those which enable the greater working of market mechanisms unfettered by government regulations. However, in rare cases some government intervention may be required to achieve welfare-enhancing outcomes. As a result, this paper treats liberalisation as a policy process designed to enhance competition between and within markets. One statement of an over-arching theme for competition policy is:

> *The openness of markets to contest from all sources of supply.*[4]

Within this over-arching theme are a number of sub-themes including: generally reducing, and where possible eliminating, government barriers to market entry; ensuring that the

1 For some background on EMEAP, see "Regional Control Bank Relations" in the December quarter 1996 Reserve Bank Bulletin.

2 These figures refer to the number of "trading banks" in 1984 and the number of "registered banks" in 1998.

3 See, for instance, the discussion in Hayek (1961).

4 This theme and the following sub-themes are taken from *the Fifth Draft [31 August 1998] of the Competition Principles Project*, Pacific Economic Co-operation Council (Trade Policy Forum).

erection of private anti-competitive barriers do not work against other measures to achieve more open markets; adopting an integrated approach to policy for the purposes of promoting welfare; ensuring competitive neutrality (whether domestic or foreign, government or private, large or small); and maintenance of transparency in the application of competition regulations.

This approach does not preclude industry-specific regulation if authorities judge this to be appropriate to address an industry-specific competition issue. However, where other policies are required to implement particular objectives, the aim should be to minimise the regulatory distortion to the competitive process consistent with achieving the particular policy objective.

3 Financial sector considerations

Financial markets differ in two important respects from many other markets:

(i) crucial information (eg on credit-worthiness of borrowers and of banks themselves) is often asymmetrically distributed and is costly to obtain; and

(ii) failure of major financial institutions may impose considerable external costs on other agents.

Banks (and other financial institutions) are susceptible to "runs" by debt-holders (depositors) because a large proportion of their liabilities are in the form of demand deposits. Depositors who find information about the solvency of a bank difficult to process are individually best advised to withdraw their deposits from a bank which has any solvency doubts rather than acquire or process the relevant information. This may lead to a run on a particular bank, which may force the bank to liquidate assets quickly at prices less than those which would be obtainable if more orderly disposal were allowed. In turn, this may lead to an otherwise solvent bank becoming insolvent.[5]

The failure of a bank in these circumstances causes problems for other borrowers and depositors (as well as for shareholders). The failure of a bank may lead to runs on other banks as the failure of an institution sows the seed of doubt regarding the solvency of other, especially alike, institutions. The result is that existing and potential borrowers, even those who are credit-worthy in normal times, face difficulty in obtaining loans. This can have both micro-economic distortionary effects, and macro-economic effects resulting in recession or depression.[6] Recognition of this problem leads to other potential distortions. Governments may introduce deposit insurance to prevent depositors from "running" and/or depositors may expect the government to "bail out" any financial institution (especially an institution regarded as "too large to fail") that faces difficulties. Both these alternatives can lead to excessive risk-taking by institutions and lack of monitoring by depositors or their agents.

A comprehensive examination of the reasons for regulatory intervention in the banking system has recently been provided by Dewatripont and Tirole (1994). They note that financial intermediation is an industry where (theoretically at least) there are increasing returns to scale both within an individual bank (through standard principles of diversification)[7] and with regard to payments networks. However these issues do not require specific interventions. They can be covered by non-industry-specific legislation that includes prevention of market dominance and access of competing parties to networks.

More importantly from the current perspective, the opening up of competition through a lowering of barriers to entry without any prudential restrictions, may in some circumstances lead to a worsening in welfare. This comes about through an increase in risk-taking by financial institutions faced with greater competition in light of some of the information issues discussed above.

This has policy implications relating to the need to prevent banks from competing unfairly by posing as a higher-quality (sounder) institution than they actually are. Because it is a problem of information, the most appropriate action is to ensure that appropriate information is made available to

[5] For a more detailed discussion of this phenomenon, see Diamond and Dybvig (1983).

[6] See Bernanke (1983) for a description of this process with reference to the United States in the Great Depression of the 1930s, and Grimes (1998) for an application to the current Asian financial crisis.

[7] See Diamond (1984) and Yanelle (1989).

actual and potential clients. In theory, individual clients could contract with banks to obtain this information but transactions cost considerations suggest that a single contract between an agent acting for the clients (eg a banking "regulator") and each institution may be a more efficient solution. The imposition of certain minimum standards on banks may also be justified by similar arguments. A counter-argument is that once a bank's positions are truly and fully disclosed, customers should be able to choose a bank that meets whatever criteria a customer may desire. A counter-counter-argument is that in the presence of institutions that may be considered "too big to fail" customers will not choose an institution according to an institution's actual soundness, but according to the likelihood that it may receive government assistance in case of difficulties.

We return to this "too big to fail" issue below. Firstly, however, the information issues imply the following interventions:

(i) Mandatory disclosure of all relevant information at the level of the individual bank that is required to assess the soundness of a bank; and

(ii) Mandated accounting treatments for all types of disclosed information.

These provisions attempt to correct the key information problems in the financial services industry which enable unfair competition to emerge. However they do not necessarily fix the contagion (or "runs") problem that can lead to the insolvency of an otherwise sound institution. At the least, this factor implies that an additional restriction is required which gives authorities the power of "suspension of convertibility" (ie prevention of withdrawal of deposits in a crisis) and the ability to direct the affairs of a bank subject to a run. This prevents a "fire-sale" disposal of assets, thus aiding a stricken institution and preventing a collapse in asset values for other institutions consequent on forced liquidation of assets.[8]

Some minimum prudential standards (particularly capital standards) may also be placed on banks if a "too big to fail" approach (implicit deposit insurance) is anticipated by customers. Another rationale for such standards is to define a set of institutions which must meet certain criteria without the need for contracting and/or additional monitoring of individual institutions' capital policies by individual customers. This is analogous to the argument for defining a class of institutions which must meet certain disclosure standards. In this respect adoption of the capital standards contained in the Basle Accord may be appropriate domestically because of the "brand name" already attached to them.

It is possible to limit the scope of these interventions by having more than one class of financial institution. Full disclosure and/or other standards would be required for one set of institutions and a different set of standards for another set. This *menu of options* approach is suggested by Dewatripont and Tirole who contend that it may be better to allow institutions to self-select their class (and hence their level of regulation) rather than impose blanket regulations on all institutions. This is on the proviso that depositors know the requirements laid down for each class of institutions.

It is also a key transparency requirement that there be clear accountabilities for enforcement of disclosures and other restrictions. This has two corollaries:

- First, there needs to be a single, clearly-specified agency which monitors (and implements any action relating to) restrictions; any sanctions on banks must be carried out in a systematic manner without greater "forbearance" for some banks relative to others which have breached requirements.[9]

- Secondly, banking legislation must make it clear who, within the bank, is legally accountable for ensuring that the restrictions are met, and the stated individuals must indeed be held legally accountable.

[8] Suspending convertibility for one institution could provoke a run on others. Prior disclosures of a sound position in other institutions may be of assistance in mitigating such problems.

[9] "Regulatory forbearance" by authorities to banks breaching regulations has been a major problem in many jurisdictions. In the United States, the Federal Deposit Insurance Corporation Improvement Act 1991 attempted to minimise the potential for forbearance by prescribing a series of steps to be taken as a bank's capital falls into successive tranches below the required capital ratio.

4 The New Zealand financial system: Pre-1984

Prior to the reforms of the mid-1980s, New Zealand had a financial system in which government regulations and other interventions were pervasive. These interventions had not only macroeconomic efficiency problems, but also microeconomic distortionary effects as a result of treating different sub-sectors in very different ways. Broadly speaking, the financial system could be broken down into three groups: trading banks, savings banks, and other non-bank financial institutions although this latter group could be broken into many smaller sub-sectors. We discuss these categories below. More macroeconomic aspects of the financial system are dealt with in greater length elsewhere, and are summarised only briefly.

Trading Banks

Prior to 1984, New Zealand's financial system included a clear demarcation between "trading" banks and other financial institutions. The Reserve Bank of New Zealand described the characteristics of a (trading) bank as follows:

> *A financial institution is part of the banking system if its main functions include the acceptance of deposits on a demand basis, the operation of the money transfer system based on these deposits (ie the provision of cheque facilities), the authority to deal in foreign exchange and the making of loans.* (RBNZ, 1983, p 29).

It acknowledged that non-bank financial institutions (in which "savings banks" were included) shared some of these characteristics, but not all. It also noted that the differences between banks and non-banks were narrowing.

For most of the post-war period, New Zealand had had five trading banks, although a merger of two Australian-owned banks in 1982 took the number to four. One of the banks (Bank of New Zealand) was owned by the New Zealand government. ANZ Banking Group and Westpac Banking Corporation were each owned by their respective Australian parent, while the National Bank of New Zealand was British owned (a subsidiary of Lloyds Bank). In theory, entry to the trading bank market was permitted through an Act of Parliament, but in practice, the potential for new entry was virtually ruled out and no new entry had occurred since 1951.

In the thirty years following the establishment of the Reserve Bank of New Zealand (RBNZ) in 1934, the trading banks became increasingly bound by controls, implemented principally for monetary control purposes. This led to a reduction in their competitiveness relative to non-bank financial institutions, and as a result they lost significant market share to non-bank institutions. The RBNZ responded to this trend in the 1960s by extending the monetary control instruments to cover non-bank institutions and by gradually easing controls on banks. They concluded, as a result of this levelling up of the regulatory regime, that trading banks had become more competitive (RBNZ, 1983, p 30). This contention is substantiated by the RBNZ's reporting that:

> *Whereas interest-bearing deposits with trading banks declined from 63 per cent of total deposits in 1934 to 22 per cent in 1962, they had recovered to be 67 per cent of total deposits at the end of 1981.* (RBNZ, 1983, p 34).

Regulations applying to trading banks varied over the period 1934-1984. They tended to intensify in the early years of the period, and to diminish beyond the late 1960s, but these were not linear trends. Controls extended to measures which regulated, *inter alia*:

- banks' holdings of government securities (initially imposing an upper limit, and later effectively imposing a lower limit on such holdings);
- the financial instruments which banks were permitted to issue (eg banks had to seek authority from the Reserve Bank in 1971 to issue transferable certificates of deposit and were allowed to enter the commercial bill market only in 1978);
- banks' lending patterns (with directives in place regarding lending to certain sectors favoured by the government of the time); and
- interest rates on deposits and loans (at times setting maximum rates, and at other times setting minimum rates).

While an intensified programme of deregulation began in 1976, this was reversed in the 1981-84 period.[10] During this latter period, strict interest rate controls on deposits and loans were reintroduced and "moral suasion" regarding the total allowable increase in credit extended by banks was exercised. Banks, at this time, were also subject to a ratio system for monetary control purposes which impacted on their holdings of government securities.[11] While banks were subject to these regulations, they also had some competitive advantages. Notably, with one exception, the only "authorised foreign exchange dealers" up to 1983 were the Reserve Bank and the trading banks.[12]

Savings banks

The Government regulated for a different class of deposit-taking institution by authorising the existence of "savings banks."[13] These banks concentrated on accepting deposits from the public and making mortgage and other personal loans, as well as holding local government and (a mandatory level of) central government debt securities. They were severely limited in the nature of business which they undertook (for instance, they were not allowed to make loans to corporates).

The only entities allowed to establish as savings banks were "Trustee Savings Banks" (community-based banks where the trustees were appointed by the Governor-General on the advice of the Minister of Finance[14]); the (government-owned) Post Office Savings Bank; and (since 1964) subsidiaries of the trading banks.

A key distinguishing feature of the savings banks, apart from the restrictions on their activities, was the existence of deposit guarantees. Depositors' and bond-holders' funds held in the Trustee Savings Banks and the Post Office Savings Bank were guaranteed by Government, while trading banks were required to guarantee deposits in their savings bank subsidiaries. Two notable features arose as a result. Firstly, the nature of the government guarantee for the trustee and post office banks was described as follows:

> *If one of these banks has insufficient money to meet claims of depositors, the Minister of Finance can authorise payment to the savings bank out of the Consolidated Account if necessary or, in the case of a trustee bank, can guarantee overdrafts to the savings bank from the Bank of New Zealand.* (RBNZ, 1983, p 58).

The implication here is that the government could be expected to direct the Bank of New Zealand (which was government owned) to lend to the trustee banks if directed by the Minister. Secondly, this regime embodied significant non-neutralities with regard to competition policy:

> *The need to exercise those powers of guarantee has never arisen but it does add to the quality of the security offered to depositors, most of whom are small savers.* (RBNZ, 1983, p 58).

Other non-bank financial institutions[15]

Other non-bank financial institutions prior to 1984 included:

- official short-term money-market dealers;
- merchant banks (unofficial short-term money-market dealers);
- finance companies;
- stock and station agents (for rural financing);
- private mortgage lenders (especially solicitors);
- friendly societies and credit unions;
- trust companies;
- building societies;
- life insurance offices;
- superannuation and provident funds; and

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[10] The reimposition of controls was ostensibly to control inflation. They were imposed at a time when government was running a massive fiscal deficit and did not wish to experience the level of interest rates required to finance it through bond sales to the non-bank sector.

[11] This system was known as the Reserve Assets Ratio system. It is described in chapter 20 of RBNZ, 1983.

[12] The only exception was Thomas Cook and Co (involved in issuance of travellers cheques).

[13] The historical development of these institutions is described in chapter 4 of RBNZ, 1983.

[14] An inspection of trustees appointed by successive governments shows a significant degree of political "cronyism" in appointments as trustees.

[15] The material in this section is derived from chapters 5, 6 and 7 of RBNZ, 1983.

- specialised government lending agencies, including:
    - Housing Corporation of New Zealand,
    - Rural Banking and Finance Corporation of New Zealand, and
    - DevelopmentFinance Corporation.

These institutions existed under a raft of differing Acts of Parliament and regulations, and were subject to very different restrictions and obligations both compared with each other and compared with the trading banks and savings banks. To focus attention on specific competition features we note below relevant details regarding official short-term money-market dealers, finance companies, private mortgage lenders, and the specialised government lending agencies.

Official short-term money-market dealers were (normally four or five) institutions approved and licensed by the Reserve Bank meeting certain minimum capital requirements. They were permitted to act as intermediaries in the short-term money-market, but had very tight controls placed on their assets (having to hold principally government securities). They were eligible to accept only deposits of at least \$20,000 (effectively ruling out deposits from most individuals). The restrictions on their asset holdings (especially in a time when government securities paid below-market interest rates as a result of various government restrictions) made them less competitive than their unofficial counterparts (the merchant banks). The one advantage that official money-market dealers had over their unofficial counter-parts was that they had access to a Reserve Bank lender of last resort facility.[16] This facility was drawn upon by one intermediary when its parent company (Securitibank) collapsed in 1976. The Reserve Bank gave a loan to the company (which was eventually fully repaid) enabling it to repay all its depositors in full. Unofficial money-market dealers did not have access to the Reserve Bank as a lender of last resort.

Finance companies were the dominant form of financial institution dealing in "medium term" funds. In 1981, approximately half of the seventeen largest finance companies (with over \$10 million in assets) had a dominant offshore shareholder; the others were predominantly New Zealand owned, many by banks in order to open business channels where the banks were more regulated. Through the 1960s and 1970s, the finance companies were among the fastest growing financial intermediaries in New Zealand. The reasons for this were outlined by the Reserve Bank below (to which should be added the observation that attractive rates of return offered by these institutions were as a result of the higher interest rates that they were legally allowed to offer depositors compared with banks):

> *This [their fast growth] has been a result of a combination of the effects of controls of the other major financial intermediaries (savings and trading banks) and a willingness to pursue business by offering attractive rates of return to investors* (RBNZ, 1983, p 96).

Like the banks, finance companies were subject to liquidity ratio controls, but these differed from those imposed on trading banks and those imposed on savings banks (which in turn differed from the trading bank ratios). Overall, the differing regulatory treatment of different classes of institutions had the effect of favouring the development of some (less regulated) institutions, especially finance companies, at the expense of the more regulated (and presumably sounder) banks. This differential regulatory approach therefore had competition, efficiency and system stability (soundness) consequences.

Private mortgage lending (via solicitors) was a significant source of housing funds throughout the pre-1984 period. Because of the lending and interest rate restrictions placed on savings banks and other financial institutions, housing credit was normally rationed at the regulated interest rate prior to 1984. This led to the development of what the Reserve Bank described as a "significant" source of medium-term funds. They estimated "that some 25% of all mortgages registered in the year to March 1981 were directly from private sources without the use of any intermediary other than the legal firm involved" (RBNZ, 1983, p 107). This was at a time when interest rate restrictions on financial intermediaries were relatively light; the Reserve Bank expected an increased share for this market as interest rate and lending restrictions intensified over 1981-84. They also noted that interest rates within this informal sector were much more responsive to market demand for funds than in the more regulated sectors.

16 Announced in the government's 1962 Budget (RBNZ, 1983, p 74).

Thus regulations placed on more standard intermediaries did not necessarily alter aggregate lending practices, but shifted lending activity to virtually unpoliced (but legal) channels. From a competitive neutrality viewpoint, this development was undesirable.

The Housing Corporation was almost entirely funded from government sources; its purpose was described as follows:

> *The Corporation generally concentrates on assisting the first home buyer and those with a large family to purchase accommodation. Lending is also undertaken to public servants on transfer. The Corporation also carries out a number of agency functions for the Government including administration of the Home Ownership Savings Scheme and loans for tourist facilities and tourist accommodation.* (RBNZ, 1983, p 125).

Three features of this description bear comment. Firstly, the Corporation existed primarily because of the restrictions placed on home lending by other intermediaries. These restrictions prevented potential purchasers gaining access to funds. Instead of dealing with the distortion, government created an institution (with preferential access to funds via government borrowing) and created administratively cumbersome schemes (such as the Home Ownership Savings Scheme) to help offset the distortionary effects. Secondly, loans were differentially applied to public versus private sector employees on transfer, to the detriment of the private sector. Thirdly, the government used its loans policy to favour at least one industry sector (tourism) at the expense of other sectors.

The Rural Bank, which was also funded almost entirely from government sources (so having preferential access to funds) was established to "provide loan finance for farming, primary industry and related services industries." We reproduce below a description of its operation (in 1983), without the need for further comment as to the distortions involved:

> *The Rural Bank is a government agency and implements policy decisions to provide assistance of various kinds. The Corporation exists for farm settlement, farm development, sharemilker assistance, refinancing of existing debt and seasonal assistance, as well as providing funds under livestock incentive and climatic relief schemes. In addition, the Corporation provides finance to the fishing industry, rural industries and agricultural contractors.* (RBNZ, 1983, pp 126-7).

The Development Finance Corporation vied with the Rural Bank for distortionary effects. It was originally created by the government "to provide finance and advisory services for new and expanding industries…[where] finance was not otherwise available on satisfactory terms and conditions." This reflects problems caused by the rationing of credit as a result of regulation elsewhere in the financial system. It was nationalised in 1973 with the aim (again stated without need for comment as regards to distortionary features):

> *The Corporation's Act requires it 'to evaluate each proposal having regard to the economic worth of the industry concerned, its usefulness to the New Zealand economy, the extent to which it will be owned or effectively controlled by persons domiciled in New Zealand, and the prospects of it becoming profitable within a reasonable time'.* (RBNZ, 1983, p 129).

Prudential supervision and payments systems

Prior to 1984, New Zealand had no formal prudential framework[17] either for the financial system as a whole or for the banking system in particular. The Reserve Bank began formally examining the issues in the early 1980s, resulting in the introduction of a prudential surveillance system with an amendment to the Reserve Bank Act in 1986. The Reserve Bank stated the historical reasons for the lack of a formal approach as follows:

> *We have a small number of banks whose soundness has never been seriously in question.*[18] *The Reserve Bank has always maintained close contact with most aspects of individual trading banks' positions through various statistical reports and by less formal contacts. The degree of regulation, the existence of official guarantees, the resistance to entry of new trading banks and the close links with the Reserve Bank have all contributed to*

[17] Except with regard to supervision of trading banks' foreign currency exposures.

[18] This despite the fact that government had taken over the Bank of New Zealand in 1894 when it was on the verge of collapse. That bank (and others) was to be brought to the verge of collapse again within five years of the Reserve Bank's statement quoted above.

the stability of the banking system" (RBNZ, 1983, p 367).

Within a year of this being written, a sharp rise in interest rates caused the market value of long-term government securities to fall markedly. This left a number of institutions forced to hold substantial quantities of such paper (by liquidity ratio regulations) technically insolvent. Thus, contrary to the claim made by the Reserve Bank, the degree of regulation in some respects caused banks to adopt unsound business practices and so threaten the stability of the banking system.

Macroeconomic features

Our focus is primarily on institutional issues. However some description of "macroeconomic" restrictions in which institutions had to work is useful. These are dealt with briefly here because they are covered at length elsewhere.[19]

Interest rate controls have already been mentioned. Briefly, New Zealand had a history prior to 1984 of imposing restrictions on both deposit and lending rates. These differed across institutional classes, and their intensity varied over time. By 1984, they had become so intense that the interest rate on a loan of any amount of money from virtually any party to another was governed by regulation.

A fixed exchange rate had historically been adopted in New Zealand albeit with several variants. All had the feature that the government set the rate against another currency (or a basket of currencies) and stood ready to buy or sell New Zealand dollars to defend this rate. Like Britain, New Zealand had had a series of mini-foreign exchange rate crises, with periodic devaluations. These culminated in the July 1984 closure of the foreign exchange market for a brief period (immediately after the election) and subsequent 20% devaluation of the New Zealand dollar.

Foreign exchange restrictions were pervasive in New Zealand from 1938 to 1984. Initially these covered both current account and capital account restrictions, but over the two decades to 1984, the former had effectively been removed.[20] For the capital account, repatriation of funds by foreign companies operating in New Zealand and emigrants' transfers were allowed, but virtually all other capital transactions were restricted. In particular, New Zealand residents (and companies) were not entitled to freely invest money abroad. The Reserve Bank (1986, p 159) noted that the regulations prior to 1984 "did not impact on all potential capital flows in a neutral fashion, with the result that some productive activities were favoured relative to others". Further they noted that foreign exchange controls could not be maintained once it was decided to move towards a floating exchange rate regime (in 1985).

The financial sector pre-1984: summary

The foregoing description suggests a number of features of pre-1984 New Zealand financial markets which may serve as reference points against which to compare the current state of competition policy:

- government regulations distinguished between many different categories of financial institutions – but not necessarily for "soundness" reasons;
- regulations prescribed the allowable activities of most classes of financial institutions;
- liquidity ratios were imposed on financial institutions (except fringe intermediaries such as solicitors) with different ratios for different classes of institution;
- new entry to the trading bank market was effectively non-existent;
- entry to the savings bank market was extremely limited;
- entry to the foreign exchange market was extremely limited;
- entry to the official short-term money-market was extremely limited;
- interest rates were controlled, with different rate structures applying to different classes of institution;
- credit was rationed through regulation and/or because of interest rate controls;
- some institutions had government guarantees over de-

[19] See RBNZ (1986), RBNZ (1992), and Evans et al (1996).

[20] The Reserve Bank stated: "Virtually all current payments for imports were freely approved … provided relevant shipping documents were sighted and, although export receipts still had to be returned to New Zealand through the banking system, exporters were given six months to fulfil this requirement" (RBNZ, 1986, p 155).

posits; others had a formal lender of last resort facility; most institutions had neither;

- the government owned the country's largest bank and a number of smaller banks;
- the government appointed directors to trustee banks and to the banks it owned;
- the government owned three specialised lending agencies, where credit was directed according to politically mandated directives;
- two government lending agencies had preferential access to funds;
- the exchange rate was controlled by direct government intervention in the foreign exchange market;
- capital account restrictions were pervasive and non-neutral in their application.

5 The New Zealand financial system: 1998

Macroeconomic developments

Since July 1984, reforms have applied to financial markets, public sector management, general competition policy, labour market legislation and the social welfare system. Some of the earliest and most dramatic reforms were in the field of financial markets. Within the first two years, relevant reforms had included:[21]

- removal of all capital (and current) account restrictions;
- floating of the New Zealand dollar;
- removal of all liquidity ratios on all financial institutions;
- removal of all interest rate controls;
- removal of directed lending criteria.

These reforms, which were predominantly at a 'macroeconomic' level, are still standing today. They paved the way for New Zealand becoming a more open economy especially with regard to international capital markets. One interesting feature is that financial market volatility – which one might expect to be affected by the liberalisation process – has tended to be more influenced by domestic monetary policy operating regimes than by liberalisation *per se* (Grimes, 1996b). Thus the authorities must have regard to the changed nature of the financial system when devising approriate monetary implementation mechanisms during and after liberalisation. However, provided the authorities take cognisance of the new environment when designing their operating systems, there is no presumption from New Zealand's experience that a liberalised financial system is any more volatile than a tightly controlled one.

Institutional developments

Our major concern is with liberalisation and competition policy at the institutional level. Here too there have been major changes. The institutional structure can now be divided into two major categories:

- 'registered' banks; and
- non-bank financial institutions (NBFIs).

The category of registered banks was created (in 1986) as a means of enabling both:

(i) new bank entry; and

(ii) imposition of prudential controls on banks.

Financial institutions (either domestically or foreign owned) can apply to the Reserve Bank to be registered as a bank. To be accepted they must meet certain prudential criteria. Being registered as a bank brings few if any explicit benefits to an institution other than the right to use the word 'bank' in its name. No institution other than a registered bank may use this word (or, any translation of it) in their name when operating in New Zealand.

NBFIs may undertake any banking function undertaken by a registered bank and *vice versa*. Given this lack of distinction between NBFIs and registered banks, and the fact that banks are more heavily regulated, why does any financial institution apply to become a registered bank?

The answer goes to the heart of our earlier analysis regarding information flows. The fact that an institution chooses to become a bank in these circumstances indicates (by revealed preference) that there is some advantage to it in being

[21] See RBNZ (1986) for details of each of these reforms.

seen by potential clients as a 'bank' as opposed to an NBFI. The very fact that an institution has the word 'bank' in its name under this legislative framework is seen to give some degree of quality assurance. New Zealand has no deposit insurance, so there is no advantage in terms of (explicit) government support for depositors arising from this factor.[22]

The explanation instead is that depositors are prepared to place their funds in a 'bank' rather than in an NBFI because, without further information, they can presume that a bank meets standards that an NBFI may or may not meet. Thus registration as a bank saves on contracting costs as discussed earlier, and conveys information (which is virtually costless for the potential client to obtain) regarding important soundness factors. This is not to deny that many NBFIs will be just as sound; but a depositor cannot verify that without more costly information processing on a continuous basis. NBFIs that raise funds from the public do have to disclose information under the Securities Act but given that there are no standards to compare these disclosures with, monitoring and processing of the information content of these disclosures is likely to be higher.

Registered banks

When the new regime began in April 1987, the existing four trading banks (ANZ, BNZ, National Bank of New Zealand (NBNZ), and Westpac) were "deemed" to be registered. There was then a growth in the number of registered banks as other financial institutions applied for and met the requirements of registration. Many of these institutions were already operating as NBFIs (either foreign or domestically owned) in the New Zealand market; but others were established foreign entities seeking to start from scratch in New Zealand. Normally, these latter institutions were already banks in their home country. For much of the past ten years, the number of registered banks has fluctuated at around 20. However the relative stability in the number of banks disguises the degree of entry and exit amongst registered banks over the period.

Appendix 1 lists (in alphabetical order) all institutions which are, or have been, registered as banks from April 1987 - October 1998. (They are listed as related groups where changes in registration have occurred as a result of minor changes in ownership or name.)

In total, 33 groups are, or have been, registered over the past eleven years. All four originally deemed banks are still banks. Of the remaining 29 groups, 15 are currently registered while 14 have registered only subsequently to relinquish their registration; many, but not all, of these have been as a result of acquisition by other banks.

In some cases, registrations have been given to institutions new to the New Zealand market: for example, Kookmin Bank of South Korea in 1997. Others have purchased the assets of a former registered bank: for instance, ABN-AMRO Bank N.V. purchased the New Zealand operation of Barclays Bank (which voluntarily deregistered).[23] Others had operated already as a New Zealand domiciled NBFI and obtained registration; for instance, ASB Bank Limited.

The latter institution, together with Trustbank (now part of WestpacTrust) and Taranaki Savings Bank (TSB), were the registered bank equivalents of the former trustee savings banks. There is now no category of "savings banks" and existing savings banks applied to become registered as "registered banks". Also included as a registered bank were former finance companies, such as BNZ Finance; and former building societies, such as Countrywide Banking Corporation.

However there are still significantly sized finance companies (including bank owned subsidiaries) and one large building society that have chosen not to be governed by the registered bank requirements and so are still NBFIs. Thus the legislative approach appears to give institutions a true "menu of options", while minimising competitive distortions.

Of the banks that have relinquished registration, some (such as Barclays) have done so on commercial grounds (generally citing poor profitability in a crowded banking market in a country with a small population). Others (such as Trustbank) have done so following takeover; and others (such as NZI Bank Limited) have relinquished registration after running

[22] There may be some expectation of implicit government deposit insurance, but the government and the Reserve Bank have frequently stated that insurance does not exist.

[23] RBNZ (1998), p 16.

Bank	Current owner	Parent's domicile
Bank of New Zealand	National Australia Bank	Australia
BNZ Finance	National Australia Bank	Australia
Post Office Bank	ANZ Banking Group	Australia
Rural Bank	National Bank of NZ	United Kingdom
Trustbank	Westpac Banking Corp`	Australia

into difficulties (especially in the aftermath of the 1987 sharemarket crash).

Of the 19 banking groups currently registered, 18 are predominantly foreign-owned.[24] All former government-owned institutions and trustee banks (other than TSB Bank Limited) have since become foreign owned as shown on the table above:

In addition, the loans of the former Housing Corporation were sold; and the Development Finance Corporation was partially privatised before collapsing in 1989.

Prudential supervision and payments systems

The move to register banks was coupled in New Zealand with a move to a formal system of bank supervision. This system has evolved (in a non-linear fashion) over time. Since 1996 there has been a considerable emphasis on disclosure, compared with most jurisdictions, and less emphasis on standards (eg there is mandatory disclosure of, but no limit on, large exposures).

The current system is described in a number of publications and so is not dealt with in detail here.[25] Briefly, the objectives of bank supervision (specified in the Reserve Bank of New Zealand Act) are:

(i) promoting the maintenance of a sound and efficient financial system;

(ii) avoiding significant damage to the financial system which could result from the failure of a registered bank.

The Reserve Bank states that its approach to achieve these objectives is to:

(i) encourage individual banks ... to carry out their business in a prudent manner, and to ensure that bank directors, managers and shareholders remain responsible for maintaining the soundness of their institutions.

(ii) avoid imposing excessive administrative burdens or unnecessarily constrain banks from pursuing commercial objectives.

(iii) minimise the perception that the government underwrites the prudential soundness of individual banks. Should a bank fail, the RBNZ has statutory powers to limit the risk of that failure creating more widespread disruption to the financial system.

In implementing the revised prudential regime, the Reserve Bank stated "the most important mechanism of the new framework is a public disclosure regime ... that requires all banks operating in New Zealand to publish quarterly disclosure statements on a wide range of financial and prudential information." The mandated public quarterly disclosures cover:[26]

- credit rating of the bank (if there is one);
- guarantees (if they exist);
- capital adequacy;
- impaired assets and provisioning;
- exposure concentration;
- exposures to connected persons;
- financial statements and profitability;
- corporate information;
- funds management information;
- sectoral exposure concentration of lending;
- risk management systems;
- conditions of registration;

[24] In November 1997, of the 18 foreign-owned banks, 8 were locally incorporated while 10 operated as branches of overseas parents. Foreign ownership was 100% in all cases other than one bank with 75% foreign ownership (RBNZ, 1997b).

[25] See, for instance, Grimes (1996a) and RBNZ (1997b). The latter is the source of any otherwise unattributed descriptions of the system in this section.

[26] Details are given in RBNZ (1997b).

- market risk exposures.[27]

The Reserve Bank considers that such disclosures:

(i) strengthen the incentives for banks to monitor and prudently manage their banking risks;

(ii) provide a more focused role for bank directors in overseeing, and taking ultimate responsibility for, the management of banking risks;

(iii) provide depositors ... and others with higher quality and more timely information on banks, so as to improve investors' ability to decide where to place their funds.

However, some minimum standards are required covering:

- a minimum level of capital (NZ$15 million);
- minimum tier 1 capital of 4% of risk weighted assets;
- minimum total capital of 8% of risk weighted assets;
- limits on exposures to "connected persons" (for locally incorporated banks).

The Reserve Bank states that such requirements:

- are consistent with international norms (especially the BIS Capital Accord);
- provide a capital buffer against losses;
- provide equity-holders with incentives to manage risk carefully;
- limit decapitalisation by lending to connected persons.

There are no prudential rules (as opposed to disclosures) applying to asset quality, large exposures (except connected lending), country risk, liquidity, or market risk. This places the New Zealand system at one end of a continuum of international regulators in terms of direct controls. However the country is probably at the other extreme in terms of required disclosures. The approach can therefore be characterised neither as more interventionist than most, nor less interventionist: it is the nature of interventions that differ.

Three further aspects of the regime are worthy of mention. Firstly, the Reserve Bank places very clear accountabilities on bank directors for ensuring that regulatory and accounting standards are adhered to and that disclosures are correct. The accounting standards to be followed are prescribed. All disclosures must be attested to by each director. Bank directors can be personally liable for breaches resulting in depositors' losses, and may also face fines and/or imprisonment.

Secondly, the Reserve Bank has powers to place a troubled bank into "Statutory Management" whereby the Bank (or its appointed agent) immediately takes over the running of an institution. The Reserve Bank also has other intervention powers, including to require information to be provided, to inspect, to give directions to a bank where it is failing to maintain the required levels of capital adequacy (and/or is breaching requirements in any other manner), and to deregister a bank.

Thirdly, there is no specific legislation or regulation applying to the payments system in New Zealand (eg ATM or EFTPOS networks).[28] The operation of networks is governed only by the conditions agreed between participants in the context of general commercial law and competition policy. This is in contrast to many other jurisdictions. For instance the Canadian payments system has strict access barriers and has a statutory monopoly power to provide payments services reflecting the traditional view that the industry is a natural monopoly. In comparing the competitive effects of the two approaches, Evans and Quigley (1998, p 39) conclude that relative to the New Zealand approach, the Canadian approach has:

(a) slowed innovation and entry of new players in the provision of payments instruments;

(b) allowed the development of rules which advantage the incumbents over potential new entrants; and

(c) restricted the development of direct competition in the provision of messaging, clearing and settlement services.

The Evans and Quigley analysis demonstrates the dynamic benefits of allowing competition to evolve (as in the New Zealand system). This is the case even where a static view of

27 Including exposures to interest rates, foreign exchange rates and equity prices.

28 See RBNZ (1997a). Our discussion here does not extend to the important system stability feature of real time gross settlement, which has recently been implemented in New Zealand. RBNZ (1998, p.16) discusses this feature further.

efficiency may imply the need for specific competition laws to be enacted.

6 Liberalisation of financial markets: summary

In the past fifteen years, New Zealand has moved from having an extremely regulated, cartelised banking and financial market that contravened sound competition principles, to an extremely open market with few distortions and extremely open entry. Entry and exit of banks is now common-place, whereas prior to 1984 no new entry had occurred in the trading bank market for over 30 years. The authorities have adopted the "menu of options" approach favoured by Dewatripont and Tirole,[29] whereas fifteen years previously, regulations had assigned institutions to particular categories and applied differential standards and restrictions to each category.

Today, the regulation of NBFIs is almost completely left to the Securities Act and to general competition laws. Banks and payments systems are also subject to general competition laws but banks have an additional layer of prudential standards imposed upon them. The regulatory emphasis, which is primarily on mandated disclosures, accounting conventions, capital standards, and accountability of directors plus failure management provisions, are designed to address the specific issues that create a need for intervention. Thus while they represent industry-specific interventions, they are consistent with general competition principles.

Overall, we conclude that great strides have been made in implementing competition principles within the New Zealand financial sector. The key test is whether the style of interventions that have been adopted result not only in competitive outcomes, but also in a sound banking and financial system. At this stage there is no evidence to question the soundness of the system, and the *ex ante* accountability mechanisms engendered by the approach to disclosure and directors' accountability appear to be successful in ensuring that banks adopt prudent practices.

Financial systems, and the risks embodied within them, change over time. The authorities will have to continue monitoring emerging types of risk and ensure that the regulatory system evolves if necessary to contain these risks. In the end, however, it remains desirable for any required measures to be implemented in keeping with the broad approach to competition policy that has been adopted since 1984.

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29 The New Zealand authorities adopted this approach well before it was suggested by Dewatripont and Tirole.

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Appendix 1:

List of the banks that have been registered in New Zealand and the dates of their registration, amendment and relinquishment

(Bold type indicates banks currently registered.)

NAME	DETAILS
ABN AMRO Bank N.V.	Registered 2 March 1998
AMP Bank Limited	Registered 12 October 1998
ANZ Banking Group (New Zealand) Limited	Deemed to be registered on 1 April 1987
ASB Bank Limited	Registered 11 May 1989
(and its subsidiary) Westland Bank Limited	 Registered 27 March 1990 Relinquished 1 July 1994
Bank of New Zealand	Deemed to be registered on 1 April 1987
Bank of Tokyo-Mitsubishi (Australia) Limited	Registered 18 September 1996
Indosuez New Zealand Limited Banque Indosuez New Zealand Limited Banque Indosuez Crédit Agricole Indosuez	Registered 22 July 1987 Amended 3 December 1987 Relinquished 31 August 1991 Registered 28 March 1991 Amended 22 May 1997 Relinquished 20 August 1998
Banque Nationale de Paris	Registered 14 March 1997
Barclays New Zealand Limited Barclays Bank New Zealand Limited	Registered 22 July 1987 Amended 3 December 1987 Relinquished 30 June 1989
Barclays Bank PLC	Registered 7 December 1988 Relinquished 27 March 1998
BT New Zealand (Holdings) Limited	Registered 21 June 1988
Bankers Trust New Zealand Limited	Amended 22 August 1988
BNZ Finance Limited	Registered 23 January 1991
CIBC New Zealand Limited	Registered 22 July 1987 Relinquished 4 July 1989
Citibank NA	Registered 22 July 1987
Deutsche Bank AG	Registered 8 November 1996
Countrywide Banking Corporation Limited	Registered 3 December 1987 Bought by NBNZ
Elders Merchant Finance Limited Elderbank Limited	Registered 8 March 1989 Amended 1 April 1989 Relinquished 31 August 1990
The Hongkong and Shanghai Banking Corporation	Registered 22 July 1987
Kookmin Bank	Registered 14 July 1997
Macquarie Bank Limited	Registered 22 July 1987

	Relinquished 8 January 1991
National Mutual Corporation New Zealand Limited	Registered 2 June 1989
National Mutual Bank New Zealand Limited	Amended 20 July 1989 Relinquished 10 December 1990
NZI Financial Corporation Limited NZI Bank Limited	Registered 22 July 1987 Amended 3 December 1987 Relinquished 17 February 1992
The National Bank of New Zealand Limited	Deemed to be registered on 1 April 1987
Broadbank Corporation Limited National Australia Bank (NZ) Limited	Registered 22 July 1987 Amended 3 December 1987 Relinquished 1 October 1993 Merged with BNZ
Post Office Bank Limited	Registered 11 August 1989 Relinquished 1 December 1994 Merged with ANZ
Primary Industry Bank of Australia Limited	Registered 11 May 1989
Rabobank Nederland	Registered 1 April 1996
Rural Banking and Finance Corporation of New Zealand Limited	Registered 13 August 1990 Merged with NBNZ
The Rural Bank Limited	Amended 24 December 1990 Relinquished 1 July 1994 (merged with NBNZ)
Taranaki Savings Bank Limited **TSB Bank Limited**	Registered 8 June 1989 Amended 29 November 1989
Trust Bank New Zealand Limited	Registered 21 December 1989 Relinquished 18 November 1996 (merged with Westpac)
Trust Bank Auckland Limited*	Registered 21 December 1989
Trust Bank Bay of Plenty Limited*	Registered 21 December 1989
Trust Bank Canterbury Limited*	Registered 21 December 1989
Trust Bank Central Limited*	Registered 21 December 1989
Trust Bank Otago Limited*	Registered 21 December 1989
Trust Bank South Canterbury Limited*	Registered 21 December 1989
Trust Bank Southland Limited*	Registered 21 December 1989
Trust Bank Waikato Limited*	Registered 21 December 1989
Trust Bank Wellington Limited*	Registered 21 December 1989 * Relinquished 1 April 1995 (merged with Trust Bank New Zealand Ltd)
Security Pacific New Zealand Limited Security Pacific Bank New Zealand Limited	Registered 23 December 1987 Sold to SBSA Amended 10 February 1988 Relinquished 13 December 1988
State Bank of South Australia	Registered 7 December 1988 Relinquished 1 July 1994
United Banking Group Limited United Bank Limited	Registered 29 June 1990 Amended 13 December 1990 Relinquished 16 May 1994 Merged with Countrywide
Westpac Banking Corporation	Deemed to be registered on 1 April 1987

Total number of currently registered banks = 19

Source: Banking System Department, Reserve Bank of New Zealand (12 October 1998).