

Banking and Business Environment

Supervision of the Financial Sector

The Reserve Bank of New Zealand

The Reserve Bank of New Zealand was established in 1934 as New Zealand's central bank by Act of Parliament. It is government-owned and holds most of the powers normally associated with a central bank. The Reserve Bank of New Zealand Act 1989 provides the Bank with autonomy to implement monetary policy within the framework of the Act and the Policy Targets Agreement entered into under the Act.

Since 1984, New Zealand's financial sector has undergone a process of comprehensive deregulation. The principal objective of deregulation has been to improve the efficiency of the financial sector by making it more competitive and to promote market discipline in financial markets. Policy initiatives have therefore been directed at reducing impediments to competition. Interest-rate and other controls have been removed and regulatory and legislative distinctions between different institutional groups have been reduced.

Deregulation contributed to rapid growth in money market activity, the development of a sizeable secondary market in government securities, the introduction of a wider range of financial instruments, including forward contracts, options and interest and exchange-rate futures, and the growing use of such devices to hedge interest-rate and exchange-rate risk.

Legislation affecting the financial sector is reviewed as necessary to ensure that it fits with modern banking practices. The Reserve Bank of New Zealand Act has been amended a number of times over the years to facilitate the coordination of home and host banking supervision between New Zealand and Australia, to extend the Reserve Bank's regulatory powers to include non-bank deposit takers and to allow the Reserve Bank to designate payment systems.

Registered Banks

The Reserve Bank, in addition to its role in determining and carrying out monetary policy, is the supervisory authority for New Zealand's registered banks. Entities wishing to use "bank" in their name or title must be authorised under the Reserve Bank Act as a "registered bank" and are subject to prudential supervision by the Reserve Bank.

The objective of supervision is to promote and maintain the overall soundness and efficiency of the financial system and to avoid significant damage to the financial system that could result from the failure of a registered bank. Until October 2008, there were no deposit insurance arrangements operating in New Zealand in respect of registered banks or other financial institutions. In line with many countries, the New Zealand government moved in October 2008 to provide a partial guarantee of retail deposits in registered bank and non-bank deposit takers and an opt-in guarantee scheme for wholesale debt issues by New Zealand financial institutions. In February 2010, in response to improvements in the global credit markets, the Minister of Finance announced that the government was considering ending the guarantee for wholesale debt issuances by New Zealand financial institutions.

New Zealand's major banks are subsidiaries of Australian banks. The Reserve Bank recognises the principles underlying the Basel Concordat that the home country should supervise on a consolidated basis and the host country is responsible for the supervision of the operations in the host country. The Reserve Bank is working with the Australian Prudential Regulation Authority to improve regulatory co-ordination under this home-host model. The government has established a Trans-Tasman Council to progress co-ordination issues.

The Reserve Bank utilises a combination of regulatory, self and market disciplines to deliver its objectives. Market discipline has been achieved principally by requiring banks to publish disclosure statements at quarterly intervals. The disclosure statements contain comprehensive information on a bank's financial position and risk profile, director attestations as to the adequacy and proper application of a bank's risk management system and also include the disclosure of a bank's credit rating.

To instil regulatory discipline, registered banks are required to comply with conditions of registration such as minimum capital requirements and limits on lending to connected parties.

Should a registered bank experience financial distress, the Reserve Bank, with the approval of the Minister of Finance, has wide-ranging powers to intervene for the purpose of avoiding significant damage to the financial system. These powers include giving the bank directions, removing directors and implementing statutory management.

Before April 1987, New Zealand had four authorised banks. Bank registrations rose to a peak of 23 in August 1990. Since then, a number of banks have merged with other banks or withdrawn from the market, although this decline in numbers has been partly offset by new registrations. As at January 2010, there were 19 registered banks. Sixteen of these were subsidiaries or branches of foreign banks.

Most banks offer banking services on the Internet. Most of the registered banks and a few other financial institutions operate in the wholesale banking area, while some registered banks provide mainly retail banking services.

The Reserve Bank has recently implemented the Basel II international framework for bank capital adequacy. The four large international banks were accredited to use the advanced Basel II approaches to determine minimum capital requirements. Banks not using their own models use the standard approach prescribed in Basel II. The Reserve Bank has implemented a liquidity policy for the subsidiaries of the large banks and locally incorporated banks. The Reserve Bank is now assessing the appropriate liquidity policy for dealing with all other registered banks.

All inter-bank settlement and cheque-clearing is performed using modern and well-integrated computerised systems. Systems are in place to allow all large value payments to be settled on a real-time gross basis. Given their importance, the Reserve Bank oversees the operation of payment systems for the purposes of soundness and efficiency in the financial system.

Non-bank Financial Institutions

At present, it is not necessary to become a registered bank or to obtain a licence to accept deposits from the public. Non-bank financial institutions taking deposits from the public are subject to prospectus and trust deed requirements under the Securities Act 1978.

In September 2008, new legislation was passed increasing the prudential regulation of non-bank deposit takers. Under the new regime, 'deposit-taker' is defined in legislation and deposit-takers will have to be licensed by the Reserve Bank. They will also be subject to minimum prudential requirements formulated by the Reserve Bank. Capital, related party and credit rating requirements will be introduced by regulation in 2010 and consultation on liquidity requirements for non-bank deposit-takers will begin in early 2010. Trustees will oversee compliance with the prudential rules. Further legislation will be put in place to require all registered deposit takers to maintain policies and processes to check the suitability and integrity of prospective directors and senior managers. It is proposed that the Reserve Bank will have the power to disapprove proposed appointees and remove directors and senior managers who have already been appointed.

Another key feature of the non-bank deposit-taking framework requires registered deposit takers to obtain and disclose a credit rating from an approved rating agency (unless they have liabilities of less than \$20 million).

The new regime is expected to be fully in place by 2011.

The Cabinet also agreed that the Reserve Bank will be the prudential regulator and supervisor of the insurance sector. The key features of this regime have been the subject of consultation and legislation is expected to be passed in 2010.

Business Law Environment

Company Law

The **Companies Act 1993** provides the framework for the formation and governance of companies.

Securities Law

The **Securities Act 1978** applies to securities that are advertised or offered to the public. The Act places restrictions on advertisements for securities and requires a prospectus to be prepared before securities can be offered. It also requires an investment statement, which summarises the key features of the offer, to be distributed to an investor before they subscribe to the securities.

The Act also establishes the Securities Commission, which has powers of investigation and enforcement, as well as the power to issue exemptions from some securities law requirements.

The **Securities Markets Act 1988** regulates the operation of securities markets and trading behaviour on those markets. The Act establishes a system for registration of securities exchanges and approval of the rules of securities exchanges and provides for oversight of exchanges by the Securities Commission. It contains prohibitions on insider trading and requires exchanges to have specific rules for continuous disclosure of price-sensitive information. It also requires disclosure of substantial security holdings and directors' and officers' shareholdings.

Both the Securities Act and the Securities Markets Act were amended in October 2006 to overhaul the law on insider trading, introduce new law on 'market manipulation' and require more effective disclosure by investment advisers and brokers. These changes came into effect on 29 February 2008.

Capital Market Development Taskforce: The Capital Market Development Taskforce was established in July 2008 and released its final report in December 2009. The Taskforce proposed a number of actions the government and the private sector could take to:

- improve the quality of the products available to retail investors, and the advice they receive;
- improve businesses' access to the capability and capital they need at each stage of their development; and
- improve the regulatory and tax environment for capital markets.

The summary and full text of the Taskforce report is available at: http://www.med.govt.nz/templates/MultipageDocumentTOC____42335.aspx.

The government has prepared an Action Plan outlining its response to the proposals in the CMD Taskforce report, which can be accessed at: http://www.med.govt.nz/templates/MultipageDocumentTOC____42528.aspx.

Many of the recommendations will be incorporated in a review of the Securities Act which commenced during 2009.

The **Takeovers Act 1993** applies to takeovers of listed companies and those with 50 or more members or shareholders. The Takeovers Code, established under the Act, regulates acquisitions of over 20% of the securities in those companies. The Code seeks to ensure that all shareholders are treated equally and, on the basis of proper disclosure, are able to make an informed decision as to whether to accept or reject an offer made under the Code.

The **Financial Advisers Act 2008** regulates financial advisers, regulating who may provide financial advice and what information financial advisers must disclose to potential investors. This Act also makes financial advisers accountable for the advice they provide and includes extensive public enforcement provisions to protect investors, including providing the Securities Commission with the ability to apply to the Court for various orders and seek civil penalties and remedies for a breach of the Act.

Competition Law

The purpose of the **Commerce Act 1986**, as amended by the Commerce Amendment Act 2008, is to promote competition in markets for the long-term benefit of consumers within New Zealand. Very broadly, the Act prohibits:

- agreements that have the purpose, effect, or likely effect of substantially lessening competition in a market;
- the taking advantage of a substantial degree of power in a market to prevent a person entering or engaging in competitive conduct in that or any other market; and
- business acquisitions that would have, or would be likely to have, the effect of substantially lessening competition in a market.

The Act also provides for:

- the authorisation of restrictive trade practices or business acquisitions that would substantially lessen competition if the public benefits of allowing such practices or acquisitions to go ahead would be expected to exceed the detriments;
- the control of goods and services in markets where competition is limited and where it is in the interest of consumers to do so;
- other kinds of regulatory intervention, including information disclosure and arbitration;
- information disclosure by the major airports; and
- a targeted control regime for regulating electricity lines and gas pipelines businesses, where regulated businesses are required to adopt either a default price-quality path set by the regulator or else one customised for the business and sanctioned by the regulator.

Financial Reporting Law

Issuers of securities and large profit-oriented reporting entities in New Zealand are required to fully comply with International Financial Reporting Standards (IFRS). The arrangements to achieve this and to cater for entities pursuing public benefit rather than profit and small and medium-sized entities are described below.

The **Financial Reporting Act 1993** applies to “reporting entities”, which are defined as issuers of securities under the Securities Act, and companies and other entities whose legislation requires them to comply with the Act.

The Act places obligations on such organisations to prepare financial statements that comply with generally accepted accounting practice within five months of their financial year or balance date. Smaller companies that meet proscribed criteria (except issuers of securities and overseas companies) can comply with less stringent reporting requirements, as the benefits of full financial reporting are unlikely to justify the costs for small privately held companies.

The Act also requires issuers of securities and overseas companies to have their financial statements audited and to file those financial statements with the Registrar of Companies on a public register. However, the obligation on small overseas companies to audit and file financial statements under the Act has been removed. The auditing requirements for other entities are found in other legislation (for example the auditing requirements for New Zealand companies are found in the Companies Act 1993).

The Act establishes the Accounting Standards Review Board (ASRB) to approve Financial Reporting Standards (which form the basis of generally accepted accounting practice). While any entity can submit standards to the ASRB, the practice has been for the Institute of Chartered Accountants New Zealand, a professional body, to develop and submit Financial Reporting Standards for approval by the Board.

These procedures have the effect of requiring large profit-oriented reporting entities to fully comply with the IFRS. The ASRB may also agree to approve additional reporting requirements for these entities. A number of amendments to these standards cater for financial reporting requirements of public sector entities and not-for-profit entities. The set of approved standards are collectively known as “New Zealand equivalents to International Financial Reporting Standards”.

The decision to adopt IFRS was taken in 2002 and the New Zealand equivalents to the IFRS were fully operational for issuers and for publically accountable and large entities for reporting periods beginning on or after 1 January 2007.

Small entities have the option to delay the adoption of the New Zealand equivalents to IFRS pending a government review of the financial reporting requirements applying to small and medium companies under the Financial Reporting Act. The Ministry of Economic Development has recently issued a discussion paper on the review. The paper proposes changes to the institutional arrangements for standard setting and the allocation of statutory responsibilities, as well as the rationalisation of reporting obligations for many New Zealand entities.



A milk tanker collects milk from a Westland dairy farm in the early morning light. *Andris Apse*

Monetary Policy

Objectives

The Reserve Bank of New Zealand Act 1989 stipulates that the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices. The Act requires that there be a Policy Targets Agreement (PTA) between the Minister of Finance and the Governor of the Reserve Bank. The most recent PTA was signed in December 2008 after the new government took office. There were no substantive changes to the Agreement. For the purpose of the PTA, the policy target is to keep future CPI inflation outcomes between 1% and 3% on average over the medium term.

Section 3 of the PTA notes that there is a range of events that will cause the actual rate of CPI inflation to vary about its medium-term trend. When such disturbances occur, the Bank is tasked with responding in a manner consistent with meeting its medium-term target.

The PTA requires the Bank, in pursuing the price stability target, to seek to avoid unnecessary instability in output, interest rates and the exchange rate and to implement policy in a sustainable, consistent and transparent manner.

The Reserve Bank Act provides the Bank with a considerable degree of autonomy to carry out the price stability objective. However, the Act contains certain provisions that enable the government to override the price stability objective and the PTA, provided this is done in accordance with a set of procedures that would make the override publicly transparent.

Implementation

The OCR is the interest rate set by the Reserve Bank to meet the inflation target specified in the Policy Targets Agreement. The OCR influences the price of borrowing money in New Zealand and provides the Reserve Bank with a means of influencing the level of economic activity and inflation. The OCR is a fairly conventional tool by international standards.

The OCR was introduced in March 1999 and is reviewed eight times a year by the Bank. The Bank issues “Monetary Policy Statements” with the OCR announcement on four of these occasions. Unscheduled adjustments to the OCR may occur at other times in response to unexpected or sudden developments but, to date, this has occurred only once – following the 11 September 2001 attacks in the United States.

During 2006, the Bank moved to a new liquidity management regime. Under the regime, the Reserve Bank sets no limit on the amount of cash it will borrow or lend at rates related to the OCR. The Bank stands ready to lend cash overnight at 50 basis points above the OCR when secured over government liabilities in its overnight reverse repurchase facility. Overnight balances in exchange settlement accounts are remunerated at the OCR.

The Bank publishes an assessment of economic conditions at quarterly intervals in its Monetary Policy Statements. The Statements contain projections that incorporate a forward path for interest rates that is consistent with achieving the inflation target. These projections are highly conditional, being based on a range of technical assumptions, but they serve to provide some indication of the Bank’s current thinking on the policy outlook.

From 2004 until mid-2008, monetary policy was in a tightening phase with the Reserve Bank increasing the OCR by a total of 325 basis points from 5.0% in January 2004 to a peak of 8.25% in July 2007. The policy tightening reflected a prolonged period of strength in the domestic economy which left productive resources stretched and led to a rise in non-tradable inflation.

Following a long period of growth, economic activity began to decline in the first quarter of 2008. Initially this reflected three concurrent shocks: a correction in the housing market, sharply rising commodity prices and drought over much of the country. The global credit crisis exacerbated the decline in economic activity with real GDP declining a cumulative 3.3% in the five quarters to March 2009. Modest growth of 0.2% was recorded in the June and September quarters 2009.

Annual CPI inflation declined from 5.1% in the September 2008 quarter (a result due principally to high international oil and food prices) to 2.0% in the December 2009 quarter. Reflecting the worsening international financial crisis and the consequent outlook for economic activity and inflation, the Reserve Bank reduced the OCR from 8.25% to 2.50% between July 2008 and April 2009.

At its most recent policy announcement in January 2010, the Reserve Bank left the OCR unchanged at 2.5%. The economy is believed to be growing again but the after-effects of the financial crisis are expected to weigh on growth for some time to come. As a result, the Bank said it expected to keep the OCR at 2.5% until the second half of 2010. Annual CPI inflation is expected to continue to remain comfortably within the target range over the medium term.

Interest Rates and Money and Credit Aggregates

The following tables show developments in major interest rates and money and credit aggregates since the March quarter of 2004.

Key Interest Rates: Monthly Averages

Month		Overnight	90-Day Bank	Government Loan Stock Rates			Bank Base
		Cash Rate	Bill Rate	2 Year	5 Year	10 Year	Lending Rates(1)
2005	March	6.67	6.99	6.39	6.29	6.16	10.40
	June	6.75	7.03	6.05	5.84	5.71	10.41
	September	6.75	7.09	5.95	5.74	5.71	10.49
	December	7.19	7.66	6.64	5.95	5.83	10.98
2006	March	7.25	7.49	6.37	5.80	5.72	11.00
	June	7.25	7.47	6.00	5.97	5.84	11.07
	September	7.25	7.56	6.64	6.19	5.80	11.07
	December	7.51	7.66	6.49	6.22	5.77	11.04
2007	March	7.59	7.88	6.79	6.50	5.87	11.31
	June	8.10	8.32	7.33	7.13	6.72	11.82
	September	8.02	8.81	6.93	6.55	6.16	12.11
	December	8.18	8.90	7.47	7.16	6.40	12.15
2008	March	8.10	8.91	6.74	6.68	6.36	12.25
	June	8.21	8.68	6.58	6.45	6.42	12.42
	September	7.52	7.95	5.77	5.77	5.82	12.32
	December	5.05	5.23	4.52	4.58	4.88	11.23
2009	March	3.08	3.24	3.35	4.02	4.77	10.03
	June	2.45	2.78	3.78	4.80	5.97	9.99
	September	2.58	2.77	4.01	4.84	5.63	10.03
	December	2.43	2.78	4.21	5.41	6.02	10.05

(1) Weighted average base lending rates of the four largest registered banks.

Money and Credit Aggregates: Annual % Change

Quarter		M1(1)	M3	Private Sector Credit	Domestic Credit
2005	March	0.7	6.3	13.2	13.7
	June	0.0	8.4	11.9	11.1
	September	0.3	9.8	8.3	8.5
	December	(1.8)	7.3	10.2	9.9
2006	March	(1.8)	9.8	7.3	6.7
	June	2.3	10.9	10.7	9.1
	September	3.7	13.4	11.5	9.4
	December	4.1	16.5	12.5	11.2
2007	March	3.4	12.7	13.4	11.6
	June	(2.0)	10.7	13.8	12.1
	September	(0.5)	9.4	13.5	12.2
	December	1.2	7.4	12.8	10.9
2008	March	2.4	6.5	11.6	9.4
	June	4.3	7.4	10.5	8.9
	September	6.9	6.9	9.5	9.7
	December	3.0	7.3	7.3	8.8
2009	March	2.5	6.8	4.4	6.3
	June	(2.6)	2.8	2.4	3.8
	September	1.4	2.7	1.3	1.7
	December	1.3	(1.1)	0.9	2.3

(1) M1 figures include currency in the hands of the public and cheque account balances only.