Alan Bollard: Delivering sound and innovative financial services for New Zealand

Background paper for an address by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand, to the Canterbury Employers' Chamber of Commerce[1], Christchurch, 26 January 2007.

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An important issue for the economic performance of New Zealand is whether New Zealand has the financial services on offer that will best enable the allocation of our resources to their most productive uses – both from the perspective of the investment product choice set an individual faces when saving and the options available to firms when raising capital.

New Zealand's rather unique financial market and institutional structure suggest that there is room for further development. This includes expanding the width and breadth of New Zealand's capital market, enhancing the performance of the non-bank financial sector, and raising the total pool of financial savings and financial literacy. In doing so, New Zealand's financial system will be more dynamic and sound, potentially raising our sustainable economic growth performance.

This paper outlines the important influence the financial system has on economic growth, highlights some of the unique features of our system, and discusses how the potential gaps and vulnerabilities in New Zealand's financial system could be addressed (including actions the Bank is undertaking).

The important role of the financial system

It is well known that New Zealand is, and has been for a long time, dependent on foreign savings for its investment capital. New Zealand finances around a third of its national investment spending through domestic savings, with the remaining two thirds financed from abroad. Given the many positive features of New Zealand's economic and institutional structures, foreign savers have remained prepared to invest in New Zealand. In part we choose to access global savings because of the relatively small scale of New Zealand's capital demands compared to the global pool.

Both the price of capital and its means of delivery (or intermediation) are some of the most important determinants of the *quantity* and *quality* of investment in New Zealand.

The financial system plays the central role in informing and facilitating these saving and investment decisions. It enables the vast majority of economic exchange to occur – both between people and across borders, and through time. As such, the financial system plays a pivotal role in the efficient allocation of economic resources and risk – thus influencing the long-run growth performance of an economy. Developed economies tend to have efficient and sophisticated financial systems.

The financial system comprises three interconnected components:

- *financial markets* in which financial contracts are entered into or traded directly between buyers and sellers (or borrowers and lenders). These includes debt (i.e., bond), foreign exchange, and equity (i.e., share) markets;
- *financial institutions* which intermediate between borrowers and lenders and provide financial services. This sector includes banks (which dominate the institutional sector in New Zealand) and other non-bank financial institutions such as finance companies, credit unions and building societies; and
- *payments systems* which allow financial transactions within markets and between institutions to be settled.

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[1] Declarations of interest: Dr Bollard's wife, Jenny Morel, runs a venture capital business, No 8 Ventures Limited; at the time of drafting this speech Adrian Orr had been appointed as Chief Executive of the Guardians of the New Zealand Superannuation Fund.

This paper focuses primarily on the interaction between the *financial markets* and *financial institutions*.

The *efficiency* of any financial system relates both to its role in allocating risk and resources throughout the economy (i.e., allocative efficiency), the economic costs of providing these services (i.e., productive efficiency), and the incentives for ongoing innovation (i.e., dynamic efficiency). When a financial system is operating efficiently, investors will receive the highest risk-adjusted returns on their investments, borrowers will minimise the cost of raising their capital, and the financial system will make its greatest contribution to economic growth.

Countries with efficient financial systems also tend to be less prone to financial (e.g., banking or currency) crises, and tend to recover more quickly at less cost if such a crisis does occur.[2] A *sound* financial system is thus one that has the resilience to continue to efficiently provide financial services under a plausible range of economic circumstances. We define the conditions for financial system efficiency and stability as existing when all relevant financial system risks are adequately *identified, priced, allocated, and managed.*[3]

Financial product offerings and New Zealand's uniqueness

In a developed economy firms, the government, and individuals will supply and demand a financial portfolio that includes debt (government and private sector), equity, and bank (i.e., loans and deposits) products. A range of financial services allow firms to raise capital in various forms and individuals to invest in a portfolio of these products so as to best meet their savings needs.

Marvin Goodfriend provides an exposition on the reasoning for the creation of this financial product set in a developed economy, and the benefits it brings in terms of financial system soundness and efficiency.[4] Essentially firms, as they grow, have increasing demands for capital that cannot be supplied from within their firm alone (i.e., retained earnings), and as such they go in search of various forms of external finance.

First and perhaps foremost, banks play an important role in the provision of external finance. However, the provision of external finance involves information-intensive processes such as credit evaluation, loan monitoring, and a premium for the risk of default, all of which add to the cost of borrowing. Bank lending thus comes at a price to the borrower over and above internal finance.

However, as firms become more widely known they can afford to partially bypass bank lending (which is often relatively more expensive) and gain direct access to savings through capital markets. Firms with a sound public image (perhaps because of a good credit rating) may thus have a price incentive to directly issue their own debt securities.

At some point it is also going to be the case that too much reliance on debt financing alone – no matter the form – will constrain a firms' flexibility. Hence, many firms will inevitably rely on some combination of both external equity and debt for their financing. Naturally equity finance comes at an additional cost, which is essentially a share of future profits. This portfolio of capital raising products provides a firm the flexibility to choose its optimal gearing ratio, and mix of dividends and debt service.

From a saver's (or investor's) perspective, a broad portfolio choice of debt and equity products is also desirable. An investor has the ability to combine these products – and their unique range of risk and return features – to best match their savings needs. The portfolio choice an individual makes generally comes down to issues such as their investment time horizon and income needs. Investor access to these capital raising products also provides an important market discipline on firms and financial institutions that promotes the dynamic and sound allocation of scarce resources.

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[2] Mario I Blejer, *Economic growth and the stability and efficiency of the financial sector*, Journal of Banking and Finance 30 (2006).

[3] See Leni Hunter, Adrian Orr and Bruce White (2006), "Towards a framework for promoting financial stability in New Zealand" Reserve Bank of New Zealand Bulletin (Volume 69, Number 1).

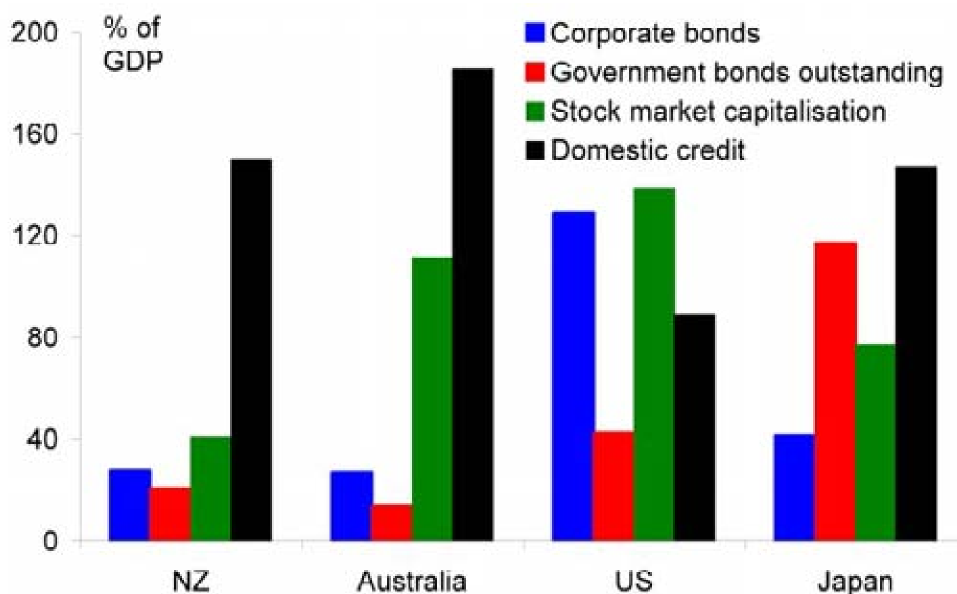
[4] Marvin Goodfriend (2005) "*Why a corporate bond market: growth and direct finance*" remarks made at the BIS/PBC seminar on "Developing corporate bond markets in Asia" held in Kumming, China, 17-18 November 2005.

New Zealand's unique financial services

It is thus instructive to assess the relative role that these financial products play in New Zealand. Doing so highlights just how unique – although not necessarily concerning – New Zealand's financial intermediation is in some respects. While the profile looks similar to Australia, domestic credit[5] accounts for around 150 percent of GDP in NZ, compared to 180 percent in Australia, and our stock market capitalisation is less than half of theirs, relative to GDP.

Relative to most developed economies, banks play a very dominant role in New Zealand's intermediation process, with bank credit (especially mortgage credit) our preferred capital raising instrument. Domestic bank credit is comparatively large relative to the size of the economy and our capital (i.e., bond and equity) markets (see Figure 1).

Figure 1: Channels of local currency funding (2005)



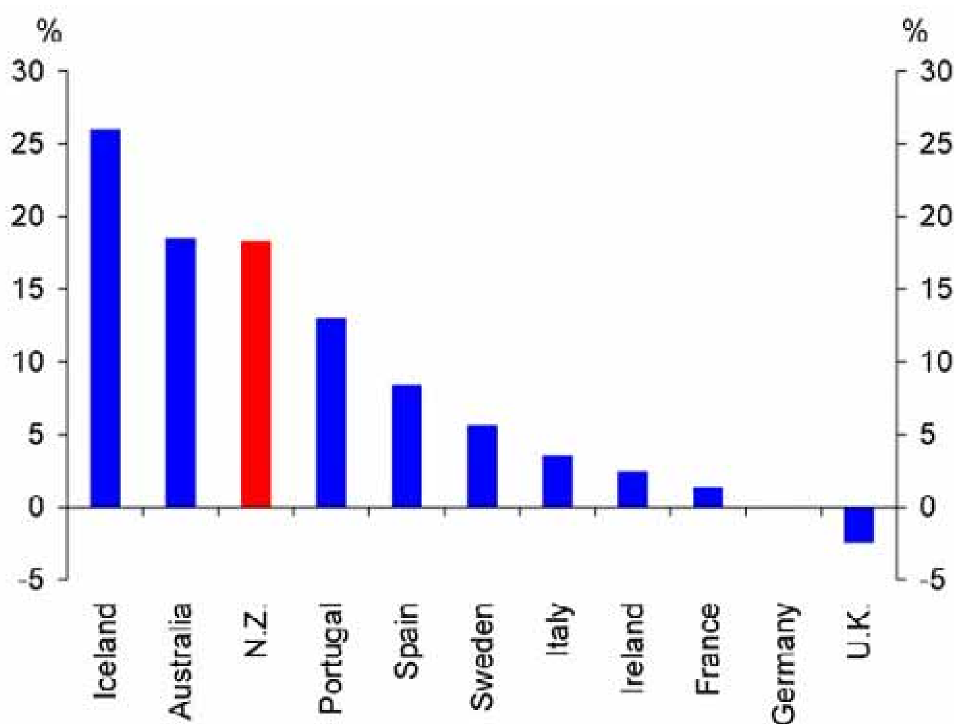
Source: RBNZ, Bank for International Settlements

In aggregate, banks own around 75 percent of New Zealand's total financial assets, with around 90 percent of these owned by the largest four banks. By contrast, funds under management account for less than 20 percent of financial system assets, and the non-bank financial sector accounts for only 7 percent.

The registered banks operating in New Zealand also have a relatively high reliance on foreign funding for their lending activities. The banking sector's net foreign liabilities account for around 20 percent of New Zealand's total liabilities, which is very high by international standards.

[5] Domestic credit consists of claims (lending) of M3 institutions on central government, and of M3 institutions and the Reserve Bank on the private sector.

Figure 2: Offshore funding of banks (2003)

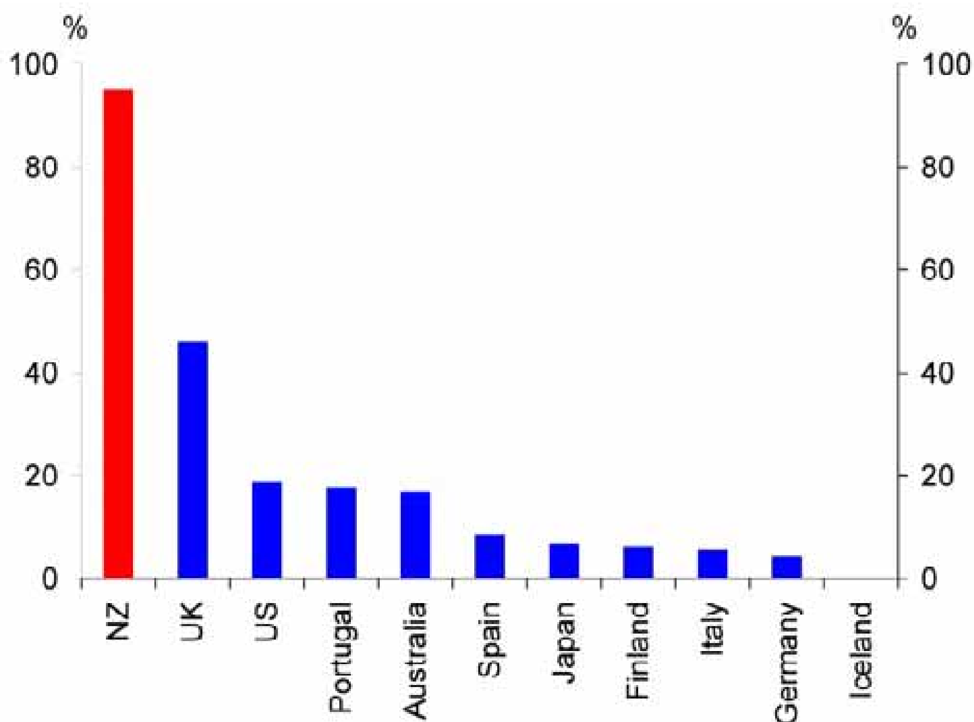


Net banking sector non-resident liabilities / gross financial system liabilities

Source: OECD. Bank Profitability – Financial statements of the Banks. RBNZ calculations

New Zealand has a very high level of foreign ownership by developed country standards, with more than 90 percent of the banking sector owned by foreigners.

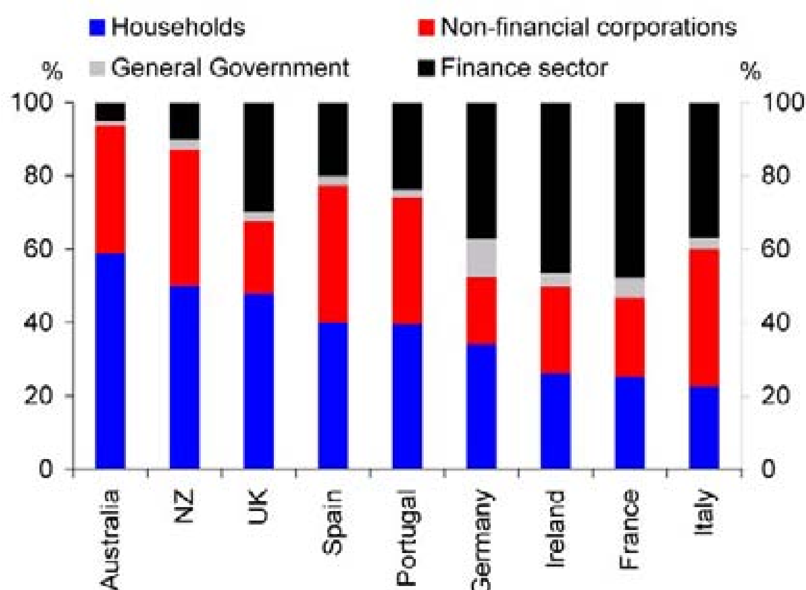
Figure 3: Share of foreign bank assets in domestic banking systems (2001)



Source: World Bank. Foreign banks are banks with more than 50 percent foreign shareholding.

Similar to Australia, a relatively high proportion of lending is to households, with the bulk of this mortgage lending.

Figure 4: Breakdown of lending by financial institutions (2005)



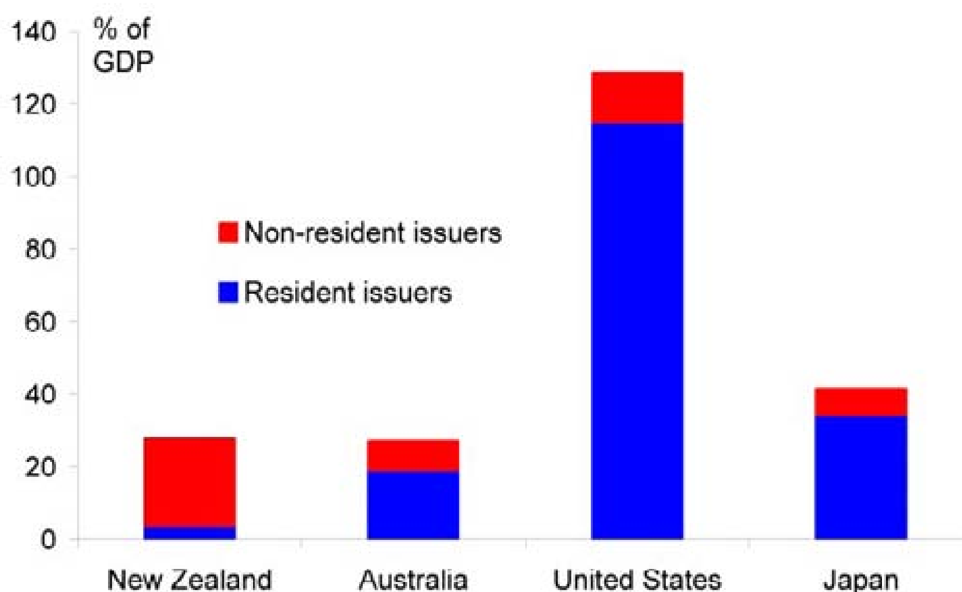
Source: RBNZ for NZ and Australian credit figures (which include securitisation), National Central Banks

In summary, the banking sector dominates the New Zealand financial system, with this sector highly country concentrated in its ownership, strongly reliant on (largely short-term) foreign funding, and focussed primarily on lending to the household sector for housing mortgages.

Compared to other countries, New Zealand's capital markets are relatively small. While the amount of New Zealand dollar corporate bonds (or securities) outstanding relative to the size of the economy is similar to that of Australia, very few of these are actually issued by local businesses. Instead, the vast majority of New Zealand dollar debt securities are issued by non-resident entities in offshore markets – mainly Eurokiwi and NZ dollar Uridashi bonds. In relative terms, New Zealand's businesses are low users of the capital markets for fund raising.

The Eurokiwi and Uridashi debt securities are issued into, for example, the Japanese retail financial sector on behalf of an international institution (such as the World Bank) wanting to raise capital. The Japanese investor gets access to New Zealand interest rates (and NZ/Yen currency fluctuations), while only facing World Bank credit risk. Meanwhile, the NZ Dollar denominated capital that has been raised by the World Bank is usually 'swapped' for US dollars with a local NZ bank, with the latter then on-lending this capital within New Zealand. From New Zealand's perspective, this issuance provides a mechanism for hedging the interest rate and exchange rate risks associated with our offshore borrowing.

Figure 5: Corporate bonds outstanding (2005)

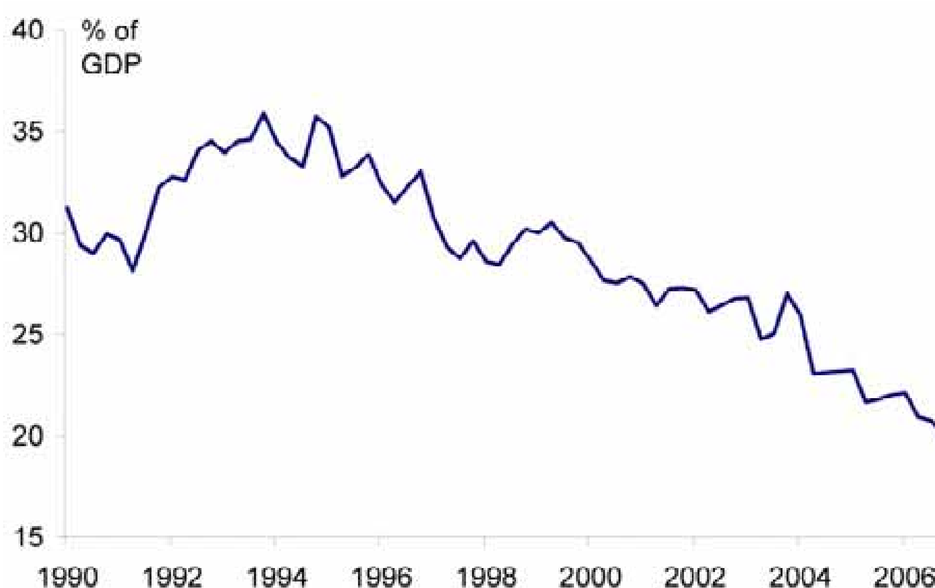


Source: Bank for International Settlements

Government bonds are the dominant product in New Zealand's debt market. However, the New Zealand government bond market has become less liquid over recent years, which is a reflection of the Government's reduced funding requirement, having run fiscal surpluses for the past 10-15 years.

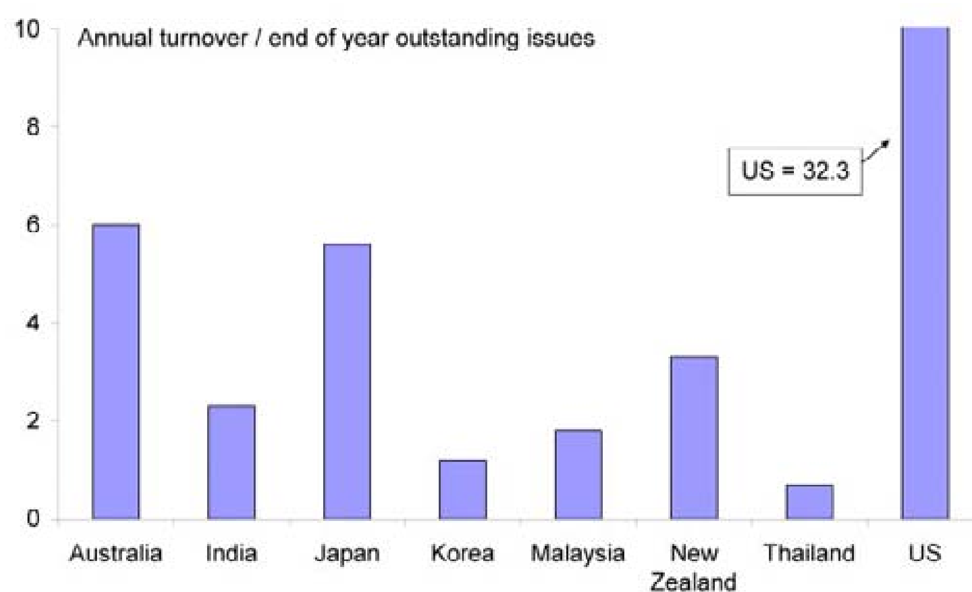
The amount of government bonds outstanding has shrunk from more than 35 percent of GDP in the early 1990s, to around 20 percent currently. In addition, at present close to 70 percent of government bonds outstanding are held by offshore investors, many of whom are not active traders of their holdings. In line with this, turnover in the New Zealand government bond market is also lower than in other developed markets.

Figure 6: New Zealand Government securities



Source: RBNZ

Figure 7: Government bond turnover ratio (2004)



Source: Bank for International Settlements

Equity market

Unsurprisingly given the relative size of our economy and high level of foreign ownership, New Zealand's stock market is small by global standards, with the total capitalisation of the market less than that of many individual corporations overseas. But it is also small relative to the size of our economy.

As shown in the chart, the capitalisation of the stock market is very low as a proportion of GDP – something that limits options for New Zealand businesses and New Zealand investors. Whether as a symptom or consequence of this, the direct and indirect holdings of equity by New Zealand households appear to be relatively low by global standards.[6]

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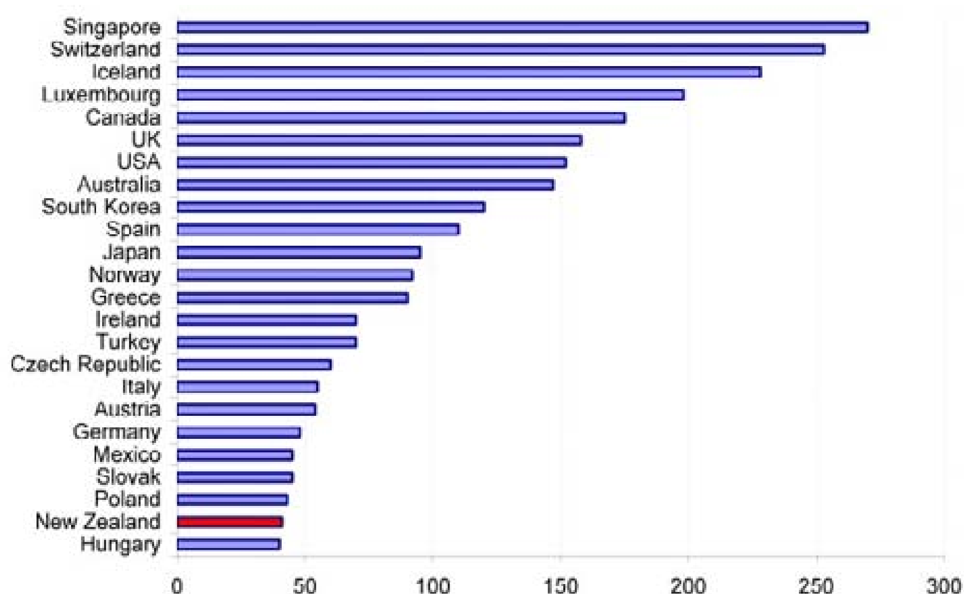
[6] "Why Kiwis like buying houses more than buying businesses" speech to Trans-Tasman Business Circle, October 2005.

Figure 8: Equity market capitalisation as a % of GDP (2006)



Source: IMF

Is New Zealand well serviced by the financial product offering?

New Zealand's financial product range, and the way the products are used, raises some questions about its soundness and efficiency. In particular, the intermediation process in New Zealand is largely dominated by the banking sector which is primarily focussed on mortgage lending to households. Meanwhile, both the non-bank financial sector and capital markets are relatively small. Concerns have been raised by some commentators that the dominance of one intermediation channel may constrain financial market development.

Whether or not banks have crowded out other market developments, the product range has implications for, amongst other things:

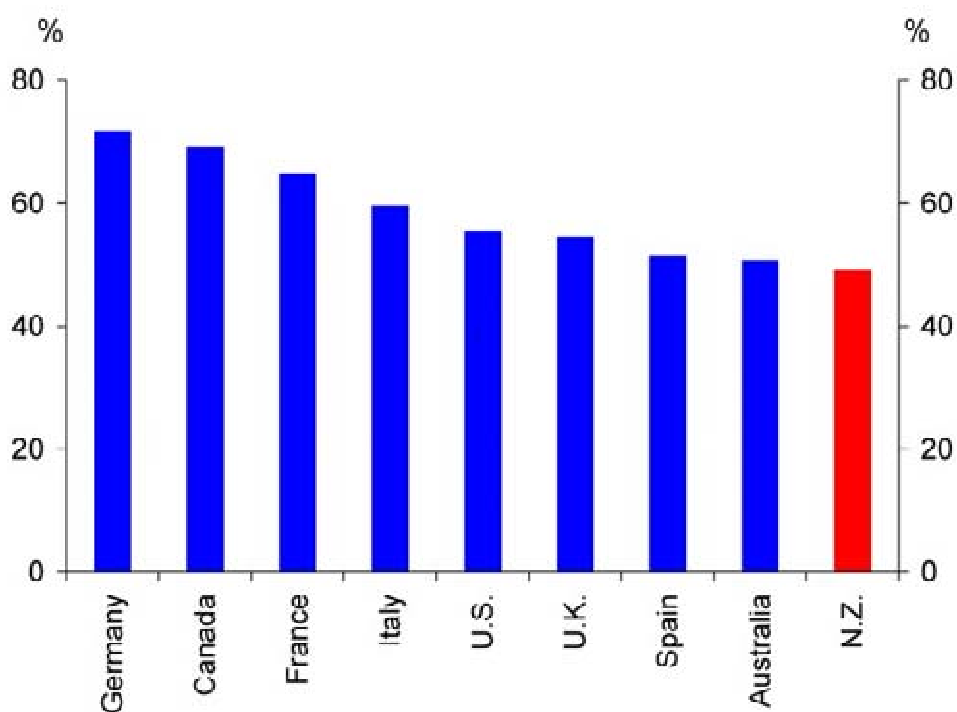
- The operation of monetary policy, with regard to information regarding expectations gathered through financial market product prices;
- Financial system efficiency and innovation, with regard to competition in product offerings and financial service completeness; and
- Financial system soundness, with regard to alternative forms of financing or intermediation when this is dominated by only one or two channels (i.e., banks and derivatives markets) that have their own specific credit risks and operational drivers.

Of course, a full range of desirable investment products will not necessarily evolve in any economy if there is no demand for them. That is, there is a potential 'chicken and egg' relationship between the size of the total pool of financial savings in a country and the range of financial product offerings available. Some have argued that the pool of capital created by a rise in household financial savings in other countries – notably Australia in recent years – has provided an important impetus for capital market development, via increased demand for investment products. Raising New Zealand financial savings is another important topic in itself.

The concentration of bank lending

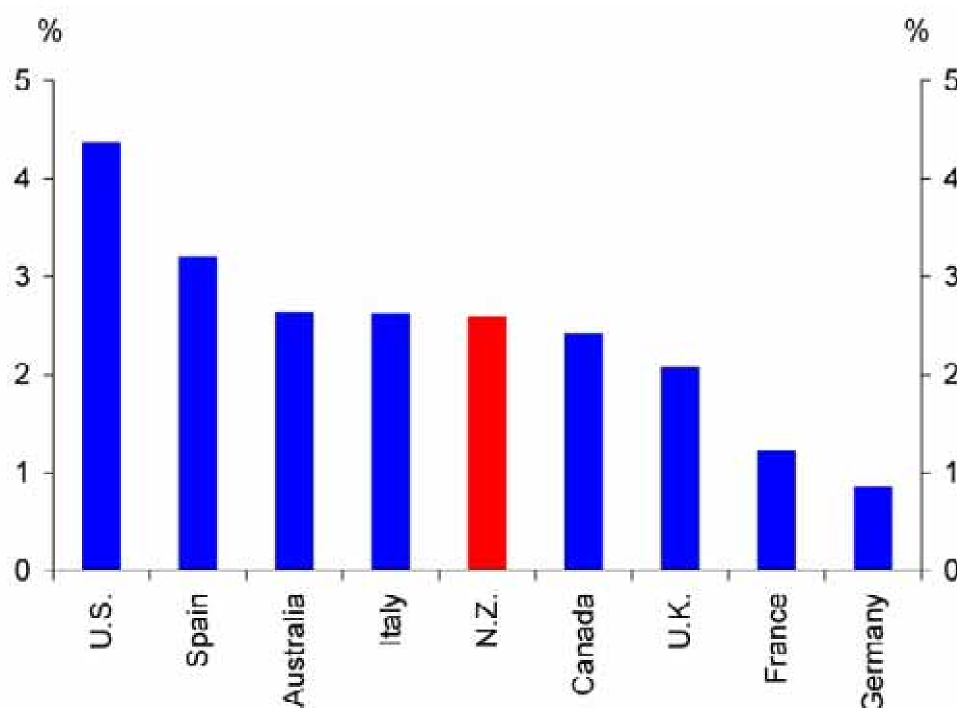
New Zealand is well served by its banks, which are well capitalised and very profitable over the cycle. The sector is also relatively efficient by some standard measures. A common measure of bank efficiency – the ratio of non-interest expenses (cost) to revenues – indicates that New Zealand banks are comparatively efficient. Moreover, bank margins are around the average for developed economies.

Figure 9: Bank efficiency: Cost / income rations (2005)



Source: RBNZ (for New Zealand), Standard and Poors. Based on the largest banks in each country.

Figure 10: Bank margins: Net interest margins (2002)



Earnings from all interest bearing assets (including debt securities) minus the cost of all funding, as a ratio of average assets.

Source: West LB Global Bank Chartbook

However, the banking sector is very dominant in New Zealand's financial intermediation process, and heavily industry and country concentrated in its ownership structure. This raises questions around overall financial system efficiency and soundness. For example, given that bank lending is dominated

by residential mortgages, it may be the case that small to medium-sized firms will find it difficult to raise bank loans. In part this might explain the relatively high use of home mortgages for raising business capital, with around 10 percent of total mortgage lending estimated to be going into financing business.

Banks' dominant intermediation position appears to enable them to price standard loans and offer deposit rates very aggressively at times for short-term competitive reasons. This activity may potentially limit the room for the alternative forms of investment products to develop and create pro-cyclical lending behaviour, thus accentuating asset price and business cycles.

Banks also play an important role in the development of new financial products. However, the relatively small role that capital markets and the non-bank lending sector play in New Zealand may reduce this impetus domestically. Recently, for example, Professor Dick Herring identified a number of potential financial developments that would help improve New Zealand's financial stability, including longer-term mortgages and various investment products (including mortgage securitisation).[7]

The role of domestic capital markets

A well functioning capital market offers a number of advantages. A broad and deep corporate debt market will generate an observable benchmark for firms raising capital and for investors seeking a fixed interest investment with a corporate credit risk premium. The existence of longer-term financing options that capital markets provide is also useful for firms who have long-term growth prospects, as for example infrastructure businesses. A well functioning capital market also provides incentives for innovation in banking products, as discussed already. And, the more means by which savings can be transformed into capital investment in a prudent manner, then the more back up there is if any single channel fails.

However, as highlighted by the statistics discussed earlier, New Zealand's domestic corporate bond market has been relatively stagnant since the early 1990s, and remains small in relative and absolute size. This market also remains relatively illiquid, with private placements often preferred and low turnover in the secondary market. The situation could be summarised as too few willing institutional investors on one side of the market, and too few quality issuers on the other side.

One constraint on investor demand for access to corporate debt has been the shape of New Zealand's interest rate yield curve, with the highest returns to investors often being seen at the shorter-end of the lending spectrum. This in part reflects New Zealand's low savings rate and favours short-term bank deposits as the preferred savings instrument.

However, other more structural challenges to the development of a deep and liquid New Zealand corporate bond market include tax effects that favour both non-financial investments and bank offshore debt raising.

One of the main competitors to the corporate bond market is New Zealand's well developed *derivatives market* in both foreign exchange and interest rates. These markets have developed in response to a demand for risk mitigation from banks and corporates. These markets have enabled larger domestic companies to access offshore capital markets directly for their funds, and then manage the associated foreign currency and interest rate risks.[8]

Such financing activities have proved reasonably efficient for the larger companies and banks. For example, the major New Zealand registered banks have quite legitimately set up offshore subsidiaries for the specific purpose of accessing offshore capital markets to fund their lending activities. These legal structures enable banks to avoid the 2 percent Approved Issuer Levy (AIL) that is levied on the interest paid to raise the capital, as the capital raised by the subsidiary is then loaned back to its parent.[9] Similarly many New Zealand corporates rationally choose to borrow directly in offshore

[7] Richard J. Herring (University of Pennsylvania) "Property Prices, Lending and Vulnerability to Financial Crises." speech to RBNZ workshop on Financial Sector Balance Sheets and Vulnerability to Financial Crises, September 25, 2006. Available at http://www.rbnz.govt.nz/research/workshops/25sep2006/2827569.html

[8] Tyler, Simon (2005) "The New Zealand corporate bond market" BIS Kunming conference.

[9] AIL was introduced in 1992 as a mechanism to make New Zealand fixed income more attractive for foreign investors, by enabling investment free of "non resident withholding tax".

markets, often in a foreign currency that has a lower interest rate structure so as to minimise the cost of the AIL.

While these activities make financial sense under current tax structures, they do constrain the amount of domestic capital raising activity and the access to high quality debt securities by domestic savers.

A deep and liquid foreign currency and interest rate swap market is a strong virtue of the New Zealand financial system. However, it is by no means a perfect substitute for a deep and liquid bond market. In particular, interest rate swap trades are only as good as the credit risk associated with the institutions or parties (e.g., the local bank) involved in the swap. The swaps market is also subject to liquidity pressures at different points in the business cycle. It may not be as reliable in times of adverse economic conditions, when financial system robustness and a 'spare tyre' is most needed.

Enhancing financial system efficiency and soundness

To recap, there are several areas of interest with regard to possible constraints on the efficiency and soundness of the New Zealand financial system. These include:

- The dominance of the banking intermediation channel and concentration of bank ownership to one country, Australia;
- The dominance of the derivatives market (foreign exchange and interest rate swap markets) in intermediating between foreign savings and domestic borrowing; and
- The relatively small size and role of domestic capital markets.

The remainder of this paper highlights some possible actions that may better promote a sound and dynamic financial system. Some of these actions sit directly with the Bank and progress is being made. However, in doing so, we are acutely aware that just as markets can fail, so can regulatory interventions. Our experience suggests that market-based solutions – sometimes with regulatory prompting and encouragement – often result in a better performing financial system. So, with that caveat in place, let me highlight some near-term challenges.

Banking

A near-term issue for bank regulators (here and abroad) is whether bank regulatory rules accentuate the pro-cyclicality of bank lending. That is, credit booms and busts are positively correlated with the economic cycle and banks often face incentives to offer credit more generously in booms and less generously in busts. Regulators do not want their rules to magnify the cyclicality of bank lending, and hence the extent of economic cycles and any associated strains on the financial system. However, some aspects of the new Basel II capital framework have the potential to provide banks with additional incentives if not monitored closely.[10]

Under Basel II, it is possible that overly optimistic assessments of risk at a good point in the economic cycle might feed through to the capital banks hold and encourage further pro-cyclical lending. For example, if banks were to underestimate the long-run risk of borrowers defaulting or overestimate the realisable value of collateral (e.g., a mortgage over a house) and that fed through to their capital requirement they might be encouraged to lend more.

When implementing Basel II capital requirements in coming months, we will be working to ensure that the average level of capital a bank is required to hold for regulatory purposes is sufficient for all stages of the business cycle and any changes do not accentuate the lending cycle.

On a different topic but still with banks, we are also looking at the role securitisation plays in the New Zealand financial system as part of our Basel II activity. In simple terms, securitisation is the parcelling up of a stock of assets (such as bank mortgages) and the on-selling of such parcels to interested investors.

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[10] Basel II is a new set of bank capital adequacy requirements being implemented in many developed countries. For more details see: Yeh, A, J Twaddle and M Frith (2005), "Basel II: a new capital framework", Reserve Bank of New Zealand *Bulletin*, 68 (3), 4 –15.

Given the dominance of banks in New Zealand, and the concentration of their activity in mortgage lending, the securitisation of some of their mortgage books has the potential to reduce the concentration of mortgage loans on banks' balance sheets and to distribute the credit risk associated with those loans more widely. In addition to spreading risk more widely, securitisation gives investors another product in which to invest their funds and provides banks with another way of sourcing funding and reducing maturity mismatches on their balance sheets arising from a preponderance of short-term funding and longer-term lending (e.g. fixed rate mortgages).

It is unclear exactly why New Zealand banks have not been more active users of securitisation. Possible reasons include New Zealand banks' current credit ratings and the pricing of bank debt and subordinated debt that make it more attractive for banks to keep mortgage loans on their own balance sheet. There are also up front costs to securitisations and banks may be looking for a more liberal treatment of securitisations with originator-provided credit enhancements for regulatory capital purposes.

Our work on implementing Basel II capital adequacy rules is designed to more closely link the risk banks are taking with their regulatory capital requirement. For securitisation, the key element is determining the extent that a bank has passed on the risks associated with the mortgage loans to the investors in the securitisation and whether it retains exposure to the risk of the loans in form or substance. In carrying out our review of capital adequacy requirements relating to securitisations we will aim to ensure that banks are required to hold an appropriate level of capital to cover the risks they incur, without overlooking the extent to which the securitisation may result in risk reduction for the institution.

Non-bank sector

Meanwhile, non-bank financial institutions (such as building societies, credit unions, and finance companies) may also potentially fill gaps in the range of financial services offered in New Zealand. This tends to occur through specialising in the provision of services to particular sectors, groups, or regions. These institutions also increase competition, add to financial depth and liquidity, and provide a wider choice of product set for capital raising and investors. Hence, it is in New Zealand's interest to have a sound and dynamic non-bank financial sector.

At present the Bank is playing its role in the Government's review of the regulation of many aspects of New Zealand's financial system.[11] The main aim of this review is to ensure that the myriad of legislation in this area does not create unintended and undesirable distortions in the competitive environment, that unnecessary compliance costs remain are reduced, that the objectives of regulation are clear, and that investors are well informed in order to make good investment decisions.

While final decisions related to the review are some months off yet, we are confident that the outcomes will include improved information flows to investors and some improved efficiencies for non-bank financial institutions.

Capital markets

There appears room for New Zealand's capital markets to develop. One area to better understand is the drivers that have led to the development of two New Zealand dollar debt markets: one with resident issuers and one with non-resident issuers (e.g. Eurokiwis and Uridashi). Attracting domestic and offshore issuers and investors into New Zealand's capital market would promote financial efficiency, allow larger domestic borrowers to reduce their reliance on the banking system, and continue New Zealand's integration into the global economy.

Evidence internationally and theoretically suggests one important component of a robust capital market is the existence of a reliable and liquid government bond benchmark yield curve. A challenge for New Zealand is to consider the overall net benefit of the government continuing to borrow (i.e., issue debt) even as it is starting to build a significant net asset position. This challenge is increasing as the New Zealand government debt market becomes increasingly illiquid.

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[11] The government is undertaking a review of financial products and providers. The key objective for the review is to develop an effective and consistent framework for the regulation of non-bank financial institutions, intermediaries and products.

The Australian government recently decided to continue issuing debt despite its persistent financial surpluses due to the perceived welfare enhancing features of a liquid government benchmark yield curve. The Australian experience also suggests that once broad based credit markets develop around the risk-free government yield curve, it is possible to scale back the government debt on offer.

The New Zealand Treasury does not undertake its government bond funding with the primary objective of maintaining a benchmark yield curve. More recently, however, the Debt Management Office have shown a willingness to re-issue bonds that the market has expressed demand for and is working towards offering facilities that will help ensure that debt market participants can borrow parcels of government securities when they are unavailable on the open market. In addition, the Reserve Bank recently reduced the need for banks to hold government bonds as collateral in the inter-bank payment system, freeing up the supply of government bonds in the secondary market. We also introduced a 'bond lending facility' that improves the liquidity in the government bond market. Market participants have indicated a preference to see fewer but larger tranches of government bonds offered by the Treasury to consolidate liquidity in a few key sectors of the yield curve.

Moreover, unlike Australia, where the supply of commonwealth government bonds is similarly tight, New Zealand has not developed a liquid government bond futures market to provide a substitute. Bond futures (as opposed to physical government bonds themselves) are the most actively traded instruments in well developed bond markets internationally and, as such, play an important role in allowing a wide range of market participants to manage and allocate interest rate risks. The advantage of bond futures is that their trading is not constrained to the total amount of government securities on issue, meaning that liquidity problems are less common once the futures market is developed.

The futures market in New Zealand has struggled to develop because of a few factors. An important issue is the 'chicken and egg' syndrome again, where market participants have been reluctant to trade futures until liquidity has improved, but liquidity will not improve until more participants enter the market and trade.

Another issue has been the historically dominant position of the Over-The-Counter inter-bank market for physical government bonds in New Zealand, which has tended to attract the trading activities of local banks who are the price-makers in that market. The recent reduction in local interbank government bond trading (reflecting a lack of availability of physical government bonds to trade) may mean local banks will have more of an appetite to trade and offer bond futures trading services in the future.

Regarding the potential for rejuvenating the corporate bond market, there may be reason to reassess the efficacy of the Approved Issuer Levy placed on securities issued. In 1993 the New Zealand Treasury announced that they would pay the AIL on New Zealand government bonds, which led to the rapid expansion of the New Zealand government bond market. Subsequently, the AIL has remained an impediment to non-government securities issues and has driven many corporate to borrow in lower interest rate offshore capital markets purely to lower their AIL commitments.

It is interesting to note that in Australia a "public offer test" was introduced to enable Australian companies to issue local currency bonds to foreign investors free of any non-resident withholding tax or levy. This enables Australian companies to issue local currency bonds that are treated equally by both domestic and foreign investors. Given the efforts New Zealand borrowers take to avoid the AIL, and given that it collects only marginal revenue, it may be appropriate to reassess it. We note that the government is currently seeking submissions on the appropriate calibration of taxation on Non Resident Withholding Tax and the AIL regimes. From a capital markets development perspective we see merit in changes that reduce the incentives for security issuers to issue outside of the domestic market.

More generally, other crown initiatives will have an important bearing on the development of New Zealand's capital markets. The investment activities of the New Zealand Superannuation Fund, along with the other government investment vehicles (including ACC and the Government Superannuation Fund), are a significant component of the demand for investment products. Their evolving requirements, particularly with regards to investment products that are currently outside the mainstream, will play a role in the development of our markets. Moreover, Kiwisaver has the potential to further boost demand for investment products.

The ongoing review of the regulation around financial product provision may also lead to some improved cost-efficiencies for firms wanting to offer debt securities. This includes the potential for savings on offer documentation costs (with the potential combining of both investment statements and

prospectuses), and revisiting the definition of ‘habitual investors’. In addition, a Treaty was recently signed between New Zealand and Australia for the mutual recognition of securities regulations.

Across many aspects of New Zealand’s financial system, there is also a general push for improved investor information that enables the assessment of financial product features, including risk and return. These include ongoing improvements to bank disclosure statements, improved disclosure requirements for non-bank financial institutions, and more consistency and timeliness in investment prospectuses. The whole area of credit ratings and their use is also under review as part of the financial regulatory review.

As part of the broader financial sector reforms under way, Government is placing greater emphasis on the role of investor education, to promote greater financial literacy and capacity for non-expert investors to make well-informed and well-considered risk/return decisions. A number of initiatives are planned or already under way in this area. Similarly, the move to strengthen the regulation of financial advisers and planners could be expected to produce longer term benefits in terms of potentially higher quality investment advice to investors.

Overall, New Zealand’s financial system remains sound and dynamic. However, there is room for improvement across many aspects of it, in particular the non-bank financial sector and capital market development. These improvements can come about through more effective regulatory arrangements currently being considered, through a better understanding of the influence of the current tax environment, through the promotion of deeper and more liquid bond markets, and through improved financial literacy.

However, some of these improvements may also occur as a natural consequence of financial innovation and the necessary recovery of private savings. As we have noted in the Bank’s *Financial Stability Report* and in speeches, while the government and corporate sectors have been net savers in recent years, the household sector has been a heavy net borrower, and this has been a driver of New Zealand’s external indebtedness. Aside from the potential financial stability or soundness concerns this raises, it may also have implications for product and service innovation, and ultimately the dynamism of our financial system.

We asked at the beginning of this paper how well our financial services industry works for us. To conclude: banks deliver basic banking services in New Zealand reasonably efficiently. However our capital markets do not all look so sophisticated: there are some financial services that our businesses and our investors cannot easily access on-shore. Our financial system currently looks sound. The industry has adapted to our rather unique circumstances. Because of this, and in particular our lack of household savings, we probably remain more vulnerable to financial shocks than most developed countries.