



# Report of the Parliamentary Inquiry into Banking

November 2009



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## Executive Summary

The multiparty Parliamentary Inquiry into Banking held hearings on September 2<sup>nd</sup> and 3<sup>rd</sup> 2009, and has considered submissions from 50 organisations and individuals. A significant number made oral presentations, including representatives from Federated Farmers, the New Zealand Manufacturers and Exporters Association, the New Zealand Council of Trade Unions (CTU), and Kiwibank. Other submissions came from economic consulting firms, independent ATM companies and from David Tripe, Professor of Banking at Massey University.

While the issues raised were quite wide ranging, there was a remarkable degree of agreement on a number of key banking and monetary policy issues.

On the issue which had sparked off the Inquiry, the statistical evidence produced confirmed that since the late 2008 international financial crisis, while most interest rates had fallen, the major banks have not passed on into the short term interest rates charged to customers the full effect of the New Zealand reductions in the Official Cash Rate (OCR). The factors behind this set of decisions appeared to be complex, including domestic and offshore funding costs, bad debt provision and margins.

The implication, however, was that changes in the OCR are no longer a reliable indicator of trends in New Zealand bank interest costs. The impact of overseas borrowing costs, and changes in the composition of bank domestic funding arrangements is opaque because available information on the actual level of overseas funding costs is fragmentary and inadequate.

Even so, it appeared that to some degree the banks have also retained an additional margin on borrowing costs in order to offset other factors reducing their profit levels, such as increased provisions for bad debts. In a more fully competitive banking sector this would be less likely to happen. A number of submissions suggested that the government should consider a range of measures including a possible increase in the capitalisation of Kiwibank to enhance competition on interest rate margins.

Two other issues came through strongly in submissions to the Inquiry:

1. The present monetary policy framework was seen to have serious unintended consequences for the New Zealand economy. These include a possible contribution to the overvalued and volatile exchange rate, adverse conditions for exporters, and mounting overseas debt. Failure of the OCR system to control credit expansion is also perceived to have contributed to an asset price bubble, notably in the housing sector.
2. Demand factors have accentuated monetary imbalances. Tax policy was seen to favour investor purchase of housing and as a consequence discriminates against businesses investing to produce goods and services. The interaction of this with selectively easier credit access conditions for housing in the banking sector was contributing to a serious misallocation of resources in the New Zealand economy.

The Inquiry proposes that on each of these issues further policy work be done to explore reforms which will promote a more efficient and equitable economy. It is recognised that any reform of these significant policy issues would need to have due

regard to transitional and political economy issues. For this reason bipartisan consultation processes may lend themselves to more durable solutions.

The Inquiry also proposes that the Reserve Bank collect more information relating to the cost of overseas borrowing by the banking system, and make this information public on its website. Ongoing Reserve Bank monitoring and publication of bank net interest margins would assist the public to understand whether full pass through of future OCR changes is occurring.

## 1. Introduction

The Parliamentary Banking Inquiry was initiated by three Parliamentary parties (Labour, Greens and Progressives), with invitations to all others, to examine aspects of operations of the banking system in the New Zealand economy. A particular concern had been the extent to which reductions in the OCR since the October 2008 international financial crisis appeared not to have been fully passed on in short term bank lending rates.

Prior to the launching of the Parliamentary Banking Inquiry, following briefings received from the Governor of the Reserve Bank in June 2009, Parliament's Finance and Expenditure Committee (FEC) reported significant bipartisan concern about the apparent failure of banks to pass through in full recent cuts to the OCR. Concern was also expressed by the FEC on related issues of bank margins, profits and lending terms. The FEC's report on the June 2009 Reserve Bank of New Zealand's Monetary Policy Statement Report and June 2009 Financial Stability Report received wide public attention.

Consideration was given by the FEC to initiating a full Select Committee inquiry on interest rates and further briefings were received from the Reserve Bank. However, despite early broad indications of support, the proposed inquiry was blocked by government members of the Committee.

In view of the seriousness of the impacts of interest rates on New Zealand households New Zealand businesses during the recession, and the need for fuller public discussion of the contextual issues, the Parliamentary Banking Inquiry was set up and an accompanying website ([www.bankinquiry.org.nz](http://www.bankinquiry.org.nz)) launched.

While the primary focus of the Banking Inquiry has been on the pass through of recent cuts to the OCR to short term variable interest rates, a number of other contextual issues were deemed relevant, notably:

- Lending margins, including the cost of wholesale funding from various sources;
- Banking profitability, and how that has changed over time;
- Bad debt and risk provisioning by the banks;
- Lending terms and practices; and
- Other matters considered relevant by the submitters.

The Inquiry was held in Parliament Buildings on September 2<sup>nd</sup> and 3<sup>rd</sup> 2009, and attracted 50 submissions from a diverse range of organisations and individuals. Most of the individuals provided written submissions only, or used a telephone conference link, but a number of key national and regional organisations, professional groupings, and research organisations presented in person to the Inquiry. These 15 oral presentations included Federated Farmers of New Zealand, the New Zealand Manufacturers and Exporters Association, Kiwibank, the New Zealand Council of Trade Unions, Finsec, the Productive Economy Council, Business and Economic Research Limited, and Research New Zealand, The Family Centre, and Budgeting and Family Support Services also presented submissions. Written submissions were also received from Professor David Tripe of the Centre for Banking Studies at Massey University and the New Zealand Employers and Manufacturers Association (Northern).

A striking feature of the submissions from quite diverse organisations was the high degree of agreement on the key issues.

Although Kiwibank made a submission, the four major banks were not represented, nor was the Reserve Bank of New Zealand. This is to be regretted. On the last day of the Inquiry one major bank did provide Inquiry member parties a detailed paper, which covered most of the issues focussed on by the Inquiry, though they subsequently requested that it not be classified as a submission to the Inquiry. Also, the bank concerned did not provide a representative who could answer questions on this paper.

The day after the hearings ended one major bank reduced interest rates in line with some of the submissions to the Inquiry. However, the bank concerned stressed that the timing was coincidental.

The assistance of the Reserve Bank in making available to the Inquiry team its publicly available research material is acknowledged.

## **2. The Challenge: Has OCR Pass-Through Occurred?**

From peak levels reached in mid 2008 after a series of OCR increases, New Zealand interest rates fell rapidly up to mid 2009. However, most interest rates administered by the banking system did not fall as much as the reductions in the OCR. The Reserve Bank cut the OCR by 575 basis points from its mid 2008 level of 8.25 per cent to only 2.5 per cent by April 2009, at which level it has remained. In the period to mid 2009 the equivalent changes in a range of interest rates were;

**Table 1: New Zealand Interest Rate Changes from Peak (in basis points)**

Official Cash Rate	-575
90 day bank bill rate	-630
6 month term deposit	-470
Floating mortgage	-430
Business base lending rate	-250
Credit card	-190

*Source: Reserve Bank of NZ website (See Annex I for details)*

The pattern was one where the banks reduced interest rates administered by them, but by less than the fall in the OCR, notably for floating rates. This pattern led to criticism of the banks by the Governor of the Reserve Bank for not matching the reductions in the OCR. An estimate at the time was that the true difference amounted to around 135 basis points. These concerns fed into the current Inquiry.

As will be noted from the section which follows, there are structural reasons why the New Zealand banking system is somewhat less responsive to competitive pressures on interest rates than might be desired by many borrowers. These are set out as a background to identifying a number of the reasons for some OCR changes not being “passed through.”



### 3. The New Zealand Banking System: Context

#### 3.1: Market Structure

The banking system in New Zealand plays a particularly dominant role in the provision of credit to businesses and households. This role has tended to grow over the years. Banks have long been the predominant lender to business, and are now also the predominant providers of mortgage finance to households and investors for housing purchase purposes. The recent failure of around 30 finance companies and the introduction of new regulations requiring registered finance companies to have a minimum credit rating has also meant there is likely to be less competition from this sector in the future. Hence for the foreseeable future the banking system is likely to continue to be the most important source of credit in the New Zealand economy. The New Zealand public thus has a large interest in the performance of the banking sector.

Currently there are 19 registered banks in New Zealand. This number somewhat overstates the real situation since, in four cases, both the parent overseas bank and its New Zealand subsidiary are counted in the total. Further, the ANZ and National Banks are effectively merged into a single group with the same joint ownership. Hence, in practice there can be said to be 14 separate banking groups operating in New Zealand. Of these, the “big four” Australian owned banks have the dominant position.

**Table 2: Bank Assets**

Banking Group	NZ Assets (\$ billion)	% of Total
Big Four Australian Owned Banks:		
• ANZ National	133.0	33.4
• Westpac	77.9	19.6
• BNZ	73.3	18.4
• ASB / CBA	72.8	18.3
<b>Sub-Total</b>	<b>357.0</b>	<b>89.8</b>
Other Overseas Banks:		
6. Bk. Tokyo-Mit UJF	1.1	0.3
7. Citibank	3.8	0.9
8. Deutsche Bank	4.3	1.1
9. HSBC	6.1	1.5
10. JP Morgan	0.2	-
11. Kookmin	0.4	0.1
12. Rabobank	8.6	2.2
<b>Sub-Total</b>	<b>24.5</b>	<b>6.2</b>
NZ Owned Banks:		
13. Kiwibank	9.8	2.5
14. SBS Bank	2.5	0.6
15. TSB	3.8	0.9
<b>Sub-Total</b>	<b>16.1</b>	<b>4.0</b>
<b>Total Bank Assets</b>	<b>397.6</b>	<b>100.0</b>

Source: Reserve Bank of New Zealand website Financial Disclosure tables G1 and G2.

The statistics on New Zealand bank ownership shown above illustrate this situation. The asset figures include other items (e.g. property) as well as loans and advances,

though these credit aggregates are the main assets of the banking system as a whole. More details are given in Annex I, tables 12 and 13. The figures above show the combined New Zealand assets of parent and subsidiary in respect of banking groups with overseas parents.

In 2008 the “big four” Australian owned banks had 89.8 per cent of banking assets in New Zealand. Seven other overseas banks with modest local presence had 6.2 per cent of the banking assets between them. The three New Zealand owned banks had 4 per cent of banking assets.

The high degree of concentration of the banking industry into four main banking groups raises some concerns about the degree of effective competition between the banks. In such a structure convergent behaviour may be more likely.

The advent of Kiwibank appears to have stimulated some additional competition, due to Kiwibank consistently offering better deposit rates and lower lending rates than the “big four” banks, and has increased pressure on them. Kiwibank Chief Executive Sam Knowles commented to the Inquiry that Kiwibank had offered housing lending interest rates which had usually been 0.5 per cent below those of its major competitors. On occasion Kiwibank had lowered its rates even before OCR reductions. Kiwibank arguably has a significant cost advantage as it uses the extensive Post Office network and Post Office staff to keep down costs. Knowles described Kiwibank’s role to the Inquiry as being that of a “challenger bank” facing “comfortable established incumbents”. Under these circumstances the interests of the challenger bank were to gain market share by accepting more modest lending margins. Conversely, the larger established banks would naturally wish to maintain their existing profit margins, and would only tend to trim margins where competitive pressures induced this.

Kiwibank is currently a relatively small player in the banking industry, and is only a very minor participant in business and farm lending. A number of submissions to the Inquiry including the New Zealand Manufacturers and Exporters Association suggested that the government should increase the capital of Kiwibank to encourage greater competition on interest rate margins.

Less than two thirds of the lending resources of the New Zealand banking system come from domestically funded deposits, with most of the balance coming from overseas borrowing by the banking system (refer to Annex I, table 12). This reflects the New Zealand balance of payments situation, with a large current account deficit funded in large part by inflow of financial capital from abroad.

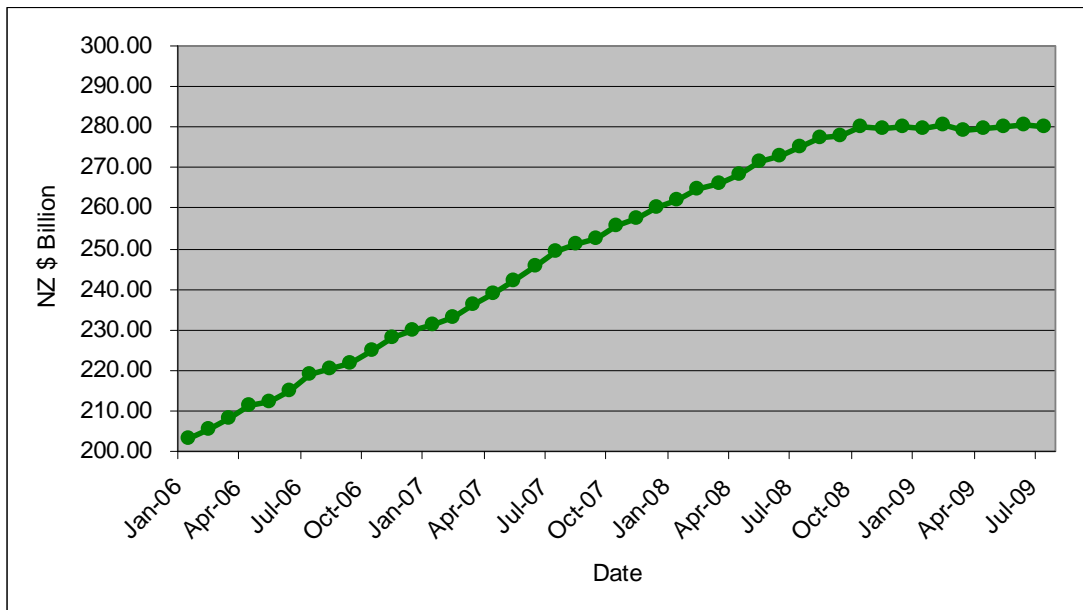
**Table 3: Sources of Funding of Registered Banks as of June 2009**

Balance Sheet Source of Funding	\$ Billion	%
NZ Dollar funding - NZ Residents	189.997	49.4
NZ Dollar funding – Non Residents	41.419	10.8
Foreign Currency funding – NZ Residents	7.992	2.0
Foreign Currency funding – Non residents	80.606	21.0
Capital and Reserves	21.516	5.6
Other Liabilities	43.133	11.2
Total as per balance sheet	384.592	100.0

Source: Reserve Bank of NZ Website SSR Part A

By international standards the New Zealand banking system is regarded as financially stable and most of its constituent banks have very high credit ratings (refer to Annex I, table 18). In part, because New Zealand banks are net borrowers rather than net lenders abroad, they avoided significant entanglement with the U.S.A. sub-prime loans and complex financial derivatives which caused so much financial havoc elsewhere.

Nevertheless, the New Zealand banking system was impacted by the International Credit Crisis which came to a head in October 2008 with the collapse of Lehman Brothers, and a wave of major bank crises. The local impact saw credit growth virtually stop overnight after October 2008, and bank lending levels to the domestic economy have so far remained static for nine months. This credit freeze imposed by the banks themselves followed a period of very rapid credit expansion funded by high levels of overseas borrowing. The graph below shows domestic lending by M3 institutions excluding lending to other M3 financial institutions. The M3 statistics include the main banks plus some other savings organisations.



**Figure 1: Domestic Lending of M3 Credit Institutions**

The freeze on aggregate domestic lending levels since the advent of the international financial crisis has not impacted evenly. There has been further increase in lending for housing and farming, albeit at a slower pace than previously. However, new lending to the business sector has been cut back.

### **3.2: The Reserve Bank**

The Reserve Bank of New Zealand is the regulator and supervisor of the banking system on behalf of the government. The *Reserve Bank of New Zealand Act 1989* sets out the functions and the powers of the Reserve Bank as follows. Broadly the Reserve Bank is empowered to:

- a. act as the Central Bank
- b. formulate and implement monetary policy
- c. deal in foreign exchange and direct registered banks about dealing in foreign exchange, especially to avoid disorder in the foreign exchange markets
- d. have the sole right to issue notes and coins in New Zealand, and to call in currency
- e. be the lender of last resort
- f. provide settlement account services for financial institutions
- g. undertake all or part of the banking business of the Government
- h. provide registered security services
- i. register banks and undertake prudential supervision
- j. regulate deposit takers (building societies, credit unions, etc)
- k. oversee payment systems
- l. carry on the business of banking and issuing securities

The powers of the Reserve Bank do not appear to include the ability to regulate interest rates, although this is a matter on which a legal opinion would be needed. For the purpose of this Inquiry is assumed that this power is not given in the Act. (This Inquiry is not recommending that regulation of interest rates should occur).

For the purposes of the Inquiry the main relevant powers of the Reserve Bank are:

- A supervisory role for banking institutions. This includes issues such as requiring capital adequacy related to the degree of risk, a key focus of Basel II accords on banking supervision. These are the current international standards on banking prudential supervision,
- Providing a settlement facility for interbank settlements. Registered banks settle claims on each other by using their settlement accounts. If they have a surplus on the Reserve Bank settlement account, the Reserve Bank will pay them interest at a rate set by the OCR (usually the OCR less a small margin). If they are short, they can borrow from the Reserve Bank at a rate usually set at a small margin above the OCR,
- Acting as “lender of last resort” to the banking system,
- Acting as the Government’s monetary policy manager.

### **3.3: Information Disclosure**

Under section 93 of the *Reserve Bank of New Zealand Act 1989* the Reserve Bank may require a registered bank to provide information, data or forecasts to the Reserve Bank.

This section has been used to obtain a fairly substantial set of statistics on the domestic activities of the banks. However, for a banking system which is so heavily

dependent on external funding there is relatively limited information on what this funding actually costs. The limited level and opaque nature of reporting on overseas borrowing costs underlies the difficulties the public have in understanding what is really going on in the banking system.

Because of the importance of overseas borrowing to the New Zealand banking system funding, this is an area where more information is needed. Key areas where additional information would be useful to policy makers and to borrowers include:

- the actual full cost of overseas borrowing, including wholesale interest rates, risk premia paid, exchange rate cover, and any other fees associated with this borrowing,
- the actual flow of funds into and within the banking system,
- how much bank lending classified as “housing” is actually lending to the small business sector,
- the impact on bank borrowing costs of Basel II requirements to fund more of their lending from longer term deposits and debentures,
- It was also noted in submissions that banks’ periodic disclosure statements are complex documents that are not readily understood by the New Zealand public.

### **3.4: Government Support for the Banking System**

The stability of the banking system is supported by the government in a variety of ways. In addition to the general enforcement of capital adequacy rules, and the supervisory role of the Reserve Bank, several other government policies have had a significant impact:

- In terms of aggregate value of deposits covered, the banks were the main beneficiaries of the Government provided Crown Retail Deposit Guarantee Scheme introduced following the 2008 international financial crisis and the setting up of an equivalent Australian scheme. This avoided any large scale panic withdrawals of funds from New Zealand banks and other financial institutions. Interest was charged for provision of the facility.
- The banks also benefitted from the November 2008 wholesale guarantee on overseas funding. Interest was charged for the facility, but as with retail guarantees, this created significant contingent liabilities for the New Zealand Government.
- Under the somewhat more stable financial conditions which have since re-emerged, the banks may no longer need to avail themselves of the Retail Deposit Guarantee scheme, which covered 95 separate institutions and funds on June 10, 2009. However, it was a major form of government assistance to the banks during the financial crisis period.
- Of much longer term duration is the impact of the Work and Income administered Accommodation Supplement Scheme. While its primary purpose is to provide housing cost assistance for beneficiaries and low income earners, a side effect is its role in underwriting the bankability of housing mortgages.

-The Ministry of Social Development Statistical Report for 2008 shows that as of June 2008 Accommodation Supplements were provided to 48,901 homeowners, almost all with mortgages, and 148,173 people renting from private landlords. Most of the homeowners and many of the landlords would have funded their housing purchase with bank

loans. Numbers on the Accommodation Supplement are understood to have since risen with rising unemployment.

-Elsewhere, particularly in the U.S.A., the combination of falling house prices and rising unemployment has meant the emergence of many non performing “sub prime” mortgage loans, with a severe impact on the financial institutions which funded these loans or purchased “derivatives” based on the home loans mortgage securities. In the New Zealand case the safety net of the Accommodation Supplement has helped protect the banks from high rates of impairment on housing mortgage loans. Despite the crisis, defaults on New Zealand housing loans, though rising, have so far been less significant than business defaults.

- The New Zealand government has a direct stake in the banking market through Kiwibank (see section 3.1), which has played a market leading role in some retail interest rates, but which currently has only a 2.5 per cent market share (by assets).
- In practice the government is also the implicit protector of last resort for the large banks which are regarded as “too big to fail.” This was shown in the 1990/91 government financial rescue of the Bank of New Zealand. This implied that the reserve function is not priced into the market.

In short, the taxpayer has a large financial interest in the banking system since taxpayer funding and explicit and implicit guarantees underlie much of the banking system’s favourable financial situation. In turn the taxpayer is entitled to expect that the banks will act as good corporate citizens.

## **4. The Official Cash Rate**

### **4.1: The OCR and Interest Rates**

The existence of the OCR and its linkage to bank settlement accounts with the Reserve Bank normally has a major impact on the level of local interest rates. The effect of this is that generally banks will not offer short term loans at a rate which is significantly higher than the OCR, because if they did so, a competing bank could undercut such a rate by borrowing from the Reserve Bank. Conversely, the banks are unlikely to offer rates for short term loans which are significantly below the OCR, because they can lend to the Reserve Bank at the higher OCR-related rate.

Movements in the OCR tend to reflect quickly into short term rates, and there is normally a close relationship between 90 day bill rates and the OCR.

The situation with longer term loans is more complex, because the banks have other sources of funding than the Reserve Bank or domestic deposits. Offshore “wholesale” interest rates and the cost of covering for exchange rate risks may provide a different impact. Long term rates are normally higher than short term rates, but this can change when the international economy is very illiquid. The cost of longer term sources of domestic funding may also move in a different manner to the OCR.

In “normal” times the trend of movement in the OCR will reflect in movements in other interest rates, particularly at the short end. However, this relationship weakened noticeably following the October 2008 international financial crisis. While the crisis was the biggest factor, there were also some ongoing internal structural factors, including a rise in the proportion of fixed term deposits, which are more expensive sources of

funding for the banks. These deposits rose from 20.3 per cent of deposits in July 2005 to 30.4 per cent by July 2009.

Submissions to the Inquiry indicated that the relationship between the OCR and domestic interest rates is no longer as straightforward as the OCR model assumes. Since mid 2008 changes in domestic interest rates have diverged significantly from changes in the OCR. This reflects a number of factors. In part the OCR is no longer a very good measure of overall interest rate costs, which are now significantly affected by external borrowing costs as well as variations in the proportion of longer term domestic deposits and debentures accessed by the banks. However, there also seems to be an element of the banks seeking to maintain profitability by using increased domestic margins on some types of loans (essentially short term and variable rate loans) to offset the impact of other adverse profit factors such as increased bad debts. This development is questionable in terms of equity to customers. As noted earlier, it would be less possible in a more fully competitive and less concentrated banking system.

#### **4.2: The OCR and Monetary Policy**

The OCR is the major instrument used by the Reserve Bank to influence monetary conditions. When economic conditions assessed by the Reserve Bank call for monetary tightening, the OCR is raised. When easing is required, the OCR is lowered. In theory this should influence credit expansion and borrowing levels in the economy via interest rate changes.

The main target set for the Reserve Bank in operating the OCR mechanism is the Consumer Price Index. The Policy Targets Agreement with the Minister of Finance requires this to move at an annual rate of between one and three per cent per year. Normally this means that if CPI inflation looks like moving above three per cent a year, the OCR is raised. If it looks like falling below one per cent, the OCR is reduced.

A concern which a number of submissions placed before the Inquiry is the effectiveness of the OCR as a monetary policy instrument. A general concern is that the effect of the OCR on monetary conditions has been declining over time leading to limited or even negative effectiveness of the OCR as a regulator of credit growth. Factors contributing to the decline in the effectiveness of the OCR as a driver of the retail interest rates include:

- i. the high and growing proportion of fixed term (rather than variable rate floating) mortgages in the residential market.
- ii. the apparent weakening of the OCR as a determinant even of variable rate floating mortgages and business loans, as evidenced by the only partial pass-through of OCR changes to retail rates during 2008/09.

An emerging conclusion from the lending behaviour of the New Zealand banks after October 2008 is that to some extent it is now the availability and cost of external funding, rather than the OCR which predominantly determines the supply side impacts on the rate of credit expansion in New Zealand.

Submissions by a number of economists and national organisations also indicated that OCR changes have had unintended adverse side effects. These included:

- OCR increases stimulating increased capital inflow, which caused the exchange rate to appreciate inappropriately
- The capital inflow funding a price bubble in the property sector
- An overvalued and volatile exchange rate squeezing the profitability and sometimes viability of the export sector

Further discussion of these issues, based on submissions, follows at section 5 below.

## 5. Submissions: Key issues

A range of concerns emerged in the submissions made to the Banking Inquiry, which are grouped by key subject area rather than listed by submission. Nearly all submissions are publicly available for review at [www.bankinquiry.org.nz](http://www.bankinquiry.org.nz).<sup>1</sup>

### 5.1: General Interest rate margins

A number of submissions cited concerns about the interest rates being charged by the banks not falling as much as cuts in the OCR or in deposit rates. The impact of this on parts of the economy was stated to be significant.

- Federated Farmers noted that with current \$46 billion debt levels in farming, a one percentage point higher margin on loans added \$460 million to the net interest costs of the farm sector.
- For the other business sector a one percentage point extra interest cost margin added \$787 million to costs.
- The biggest cost addition affected the housing sector, where a one per cent extra interest cost added \$1.645 billion to mortgage service bills. This was a mix of homeowner and landlord investor costs, which are not differentiated in the debt statistics. However, both the Family Service Centre and the Budgeting and Family Support Services stressed the impact of even quite small changes in mortgage costs on low income homeowners.

All these estimates are based on the assumption that interest rate changes up and down affect all of the total credit to each sector. In practice fixed rate loans do not change and fixed term rates change only on the anniversary date specified. Hence, the magnitudes involved are always somewhat less than these figures suggest. Even so, interest rate changes are a significant issue for many borrowers in the community and in any short term period the actual interest cost charge is less than these estimates suggest.

A weighted gross interest margin may be obtained by weighting both the average funding rate of interest and the average loan rate by the banks' total assets.

The Reserve Bank's statistics show that the weighted gross interest margin over longer periods of time has averaged 2.92 per cent (June 1990 – June 2009). Table 22 in Annex I sets out the data for the period 2003-2009.

Interest.co.nz has provided a statistic of net interest margins as reported by the four major banks and Kiwibank for both 2008 and 2009. Kiwibank's margin was 1.90 per cent in each of these years, as it did not have to pay higher interest rates on overseas funding. The four other banks had an average net margin of 2.16 per cent in 2008, which declined to 2.035 per cent in 2009.

It should be remembered that gross bank profits are determined not only by the interest margin, but also by the risk premia charged for lending risks, less provisions for bad and doubtful debts.

The gross interest margin less operating costs results in the net interest margin.

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<sup>1</sup> The Inquiry team has withheld several from publication which, in its view, contain elements that may contain legal risk or other concerns.



## 5.2: Interest Rate Differentials

Other submissions also cited interest rate issues which may be grouped under the heading of the heterogeneity of bank interest charges. These included:

- Small and medium businesses being required to pay higher interest rates than housing loan borrowers. This was suggested to be the case even when the housing borrowers were in fact landlord investors rather than owner-occupiers. This aggravated the tendency for people to invest in property rather than businesses producing goods and services;
- Small business owners being required to mortgage their homes to get business finance;
- Farm finance being more expensive than housing lending;
- Very high interest rates on credit card debt; and
- High interest rates on student loans when the borrowers were overseas.

Finsec commented that people on low incomes can be particularly dependent on credit card debt. Credit card interest rates were exceptionally high, and had dropped little following the large cuts in the OCR. If credit card interest rates had fallen as much as the 90 day bill rate, then the standard credit card rate would be 15.75 per cent rather than over 20 per cent, though even this would be a hardship for some borrowers.

Finsec also noted that the amount students owed on credit cards had increased by 32 per cent between 2004 and 2008 according to the NZUSA Income and Expenditure Survey released in 2008.

The Inquiry notes these concerns. However, it is also recognised that there are often valid commercial reasons for charging differential rates to some groups of borrowers, notably if there are higher default risks. As will be noted later, some of the risk differentials also actually relate to the preferred tax position of residential property purchase.

## 5.3: Bank Charges and Operational Policies

A third group of concerns related to charges levied by the banking system:

- High break charges for people who refinanced or repaid their mortgage. A lack of consistency or explanations for such policies was also cited.
- Delays in crediting money transferred out of other accounts.
- High fees for dishonoured cheques.
- Additional credit card charges for spending above limits.
- Some borrowers being required to pay charges which were waived for other customers.
- Potentially tighter credit terms for New Zealand based businesses than their Australian equivalents
- Transfer of decision-making during 2009-09 on credit access from local to Australian based credit managers

Les Howard of Grey Power complained about a five day delay in clearing cheques, and suggested that with modern technology the gap should be reduced to two days. He also proposed that all transaction fees on smaller accounts should be abolished, and only a monthly fee charged.

Finsec proposed a new code of lending practice, and suggested that oversight in the retail lending area should be shifted to an independent Financial Consumer Agency.

This should be funded by government and the industry jointly, but be fully independent of the banks.

#### **5.4: Economic Outcomes and Impacts**

A fourth group of submissions covered damage to the New Zealand economy resulting from high levels of borrowing abroad by the banking system. These concerns were raised primarily by business association groups, and by professional economists including those from BERL and Research New Zealand. The areas of concern included:

- The exchange rate being driven up by financial capital inflows. This was seen as disadvantaging New Zealand exporters and those in the tradable sectors.
- High overseas borrowing and local relending by the banks being a major factor in the inflation of housing prices, and the boom-bust scenario affecting housing.
- A high current account deficit in the balance of payments, and a rapidly rising ratio of net external liabilities to GDP. By March 2009 this had reached 98 per cent of GDP, of which 90 per cent was net debt, the balance being net equities. All of the increase took the form of banking sector borrowing. Gross debt to GDP had risen to over 140 per cent by March 2009, with one submitter projecting this to increase by a further 10 per cent of GDP per annum on previous trends.

The New Zealand Manufacturers and Exporters Association submitted that much of the decline in the tradable sector in the recent period could be attributed to currency instability and consequent uncertain returns in export markets.

BERL also made submissions on the same issue, and pointed out that the New Zealand dollar was the second highest trade currency in the world in relation to the size of GDP. This fed into high volatility in the exchange rate.

The submission also noted that Singapore had managed to achieve a high degree of stability in its trade-weighted exchange rate in conjunction with a free and open economy, and asked why this was not also possible for New Zealand.

The New Zealand Manufacturers and Exporters Association proposed a “counter cyclical” reserve ratio policy, to limit the ability of the banks to over lend in an economic upswing.

A related comment in a submission from Interest.co.nz suggested that the recent slump in business lending in 2009 was further skewing an already unbalanced economy towards greater investment in property purchase, and away from business investment and exporting.

### **5.5: Competition**

A submission was received from a group of companies distributing independent ATMs, with the aim of increasing competition in the ATM market. Independent ATM companies are willing to provide machines in rural areas not serviced by individual banks; however they require each bank to allow their cardholders to access the machines. Currently two major banks have not allowed this, preventing their customers from accessing independent machines.

### **5.6: Other Concerns**

Other concerns raised in the submissions included:

- The lack of information on the real costs to the banks of overseas borrowing, and the extent to which this was affecting bank lending rates.
- The difficulty for small businesses to get capital, especially at present with much tighter bank lending criteria, and offshore decision making on lending.
- The need for greater prudential and other supervision of the banks to manage credit expansion.
- Conflict of interest issues where bank employees had acted as investment advisors.
- A proposal to separate out retail banking and investment banking into separate institutions.

Some of these issues are central to the current Banking Inquiry, and others would need to be looked at in other contexts.

## **6 Increased Interest Rate Spreads: Additional Information**

Reserve Bank statistics indicate that the spread between funding costs relating to New Zealand sourced funds and earnings on New Zealand dollar claims have risen since early 2008 to a peak level in June 2009, after having fallen in the previous two years. The peak eased back a little in July, as shown below. A longer time series is shown in Annex I, table 11.

## 6.1: Reserve Bank Data

**Table 4: Recent Interest Rate Spread (New Zealand Dollar Claims)**

Date	Funding	Spread	Claims
2007			
March	6.32	2.04	8.36
June	6.65	1.95	8.60
September	7.04	1.75	8.79
December	7.19	1.73	8.92
2008			
March	7.35	1.67	9.01
June	7.44	1.71	9.14
September	7.19	1.86	9.05
December	5.82	2.36	8.17
2009			
March	4.11	2.85	6.96
June	3.54	2.99	6.52
July	3.52	2.91	6.43

Source: Reserve Bank of NZ website table C10

In simple terms the prima facie interest spreads rose from a long-run average of around two per cent up to September 2008, to nearly three per cent by mid 2009. To date there has been no significant reported movement to reverse this widened spread since then.

This statistic forms the basis of strong concern earlier expressed by the Reserve Bank, and a number of submitters that there could be potentially up to 75 basis points of unexplained margin increase in short term variable loan rates, contemporaneous with an apparent failure to pass through full reductions in the OCR.

This prima facie case must, however, be considered in the context of two sets of qualifiers, which are discussed below:

- a) Limitations in publicly available data, including the transparency of offshore funding costs
- b) Banks' claims that this increased spread is (at least partly, and potentially wholly) offset by bad debts and other recession-related costs.

## 6.2: Data limitations

The "spread" figure may not necessarily correlate very well with actual trends in bank profits for a number of reasons, including the following:

- The figures show official borrowing and lending rates. However, in practice some customers get loans at different rates and may receive different interest rates on large deposits. True margins may be less than the spread statistics.
- The figures relate to New Zealand funds. In practice over a third of the funds lent out in New Zealand come from abroad, a ratio which rose to nearly half of the increase in lending during the credit boom period of 2003 to 2007. The proportion of offshore funds appeared to peak around January 2009.

- There are no published figures on true overseas borrowing costs. These include the costs of swaps to cover exchange rate risks plus any premiums or fees required by lenders. Collation and publication of such data by the Reserve Bank would assist independent commentators and the public to gain a fuller picture of true interest rate margins.
- The proportion of longer term deposits, which are more expensive for the banks, rose from 20.3 to 30.4 per cent between July 2005 and July 2009. These costs do not drop automatically with OCR reductions.
- Much of the income of the banks comes from trading activities such as foreign exchange transactions and from domestic fees rather than net interest. In 2008 non interest income represented 29 per cent of income before expenses.
- Bad debt ratios also vary. For example in the fiscal years ending in 2008 the banks increased their provision for bad debts from \$258 million to \$881 million. This latter figure was the equivalent of 16 per cent of bank profit before adjusting for bad debts. This increased bad debts provision had the effect of turning an increase in profits before this provision into a decrease in bank profits (refer to Annex I, table 17).

In relation to provisions for bad debts there are some unexplained variations in “impaired asset” ratios reported by different banks in 2008 (refer to Annex I, table 18). Some of the difference may reflect variations in the timing of the banks reporting dates. Others would appear to need more clarification. It is however notable that part year reports by major banks in 2009 to date have indicated larger bad debt provisions.

### **6.3: Interim Assessment**

These qualifications noted, it is clear that the major cuts in the OCR which occurred after mid 2008 were not matched by the same degree of reduction in lending rates charged by the banks, at least in relation to short term and floating rates. Also, the apparent fall in “wholesale” interest rates on external borrowing after the main international financial crisis passed does not seem to have been followed by a subsequent reduction in the higher interest rate margins which applied during and immediately after the crisis.

### **6.4: Offsetting Cost Increases**

The banks in turn may claim that this interest rate difference since late 2008 reflects special factors in the recent period as follows:

- Higher bad debts in the past year. During the 2008/09 financial year the banks had to increase their provision for bad debts from \$258 million to \$881 million or 16 percent of bank profits. This seems to be correct, although some submissions suggested that bank customers considered that they should not be asked to pay via interest rates for the consequences of some bad lending decisions taken by the banks during the boom. A comment was that other businesses have to carry the financial consequences of their own bad business decisions. Questions were also raised in oral submissions as to whether bank cost provision might include offsets for patented tax liabilities at that time before the courts.<sup>2</sup>

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<sup>2</sup> The High Court of New Zealand held on 15 July 2009 that BNZ was liable for tax debt of \$654m in relation to structured finance transactions, and on 7 October 2009 held that Westpac was similarly liable for \$961m related to similar transactions. Both banks have indicated they will appeal these judgements. Other cases are pending before the High Court in respect of ANZ National and ASB, with potential tax liabilities of up to \$560m and \$285m respectively.

- Higher offshore borrowing costs. The gap between LIBOR and overnight rates rose over 300 basis points at the peak in September 2008 before falling back to around 75 basis points. Most banks say that their current 'extra' margin on wholesale funding (external) is still between 50 to 100 basis points above pre-crisis levels (Reserve Bank and Interest.co.nz submission).
- Some increases in local fixed deposit interest rate margins over the OCR.

Month	OCR %	Six-month deposit rate %	Spread deposit rate over OCR in basis points
March 2008	8.25	8.22	- 3
April	8.25	8.46	+ 21
May	8.25	8.38	+ 13
June	8.25	8.46	+ 21
July	8.00	8.14	+ 14
August	8.00	7.94	- 6
September	7.50	7.51	+ 1
October	6.50	6.63	+ 13
November	6.50	5.78	- 72
December	5.00	4.81	- 19
January 2009	5.00	4.18	- 82
February	3.50	3.79	+ 29
March	3.00	3.62	+ 62
April	3.00	3.79	+ 79
May	2.50	3.83	+133
June	2.50	3.83	+133
July	2.50	3.78	+128
August	2.50	4.10	+160
September	2.50	n/a	n/a

Source: Reserve Bank of New Zealand

The table shows a marked change in behaviour since January 2009. The aggressive lowering of the OCR was followed broadly by the banks until and including January 2009. During the following months, however, the banks have increased the rate of their six months term deposits over the OCR. This might indicate a switch from external to domestic funding as well as a sharper competition for domestic funds among the banks.

Cost consequence of the need for higher capital and reserves to meet Basel II prudential guidelines. The major change for New Zealand banks will have been the Reserve Bank requirement that they should hold additional capital equal to 15 per cent of the capital they have modelled for the credit risk arising from residential mortgage lending to recognise improvements needed. They also had to make sure that they could cope with a 30% fall in house prices (See Reserve Bank *Financial Stability Report of May 2008*).

It is possible that this would have caused them to increase risk premia on mortgage lending.

## 6.5: Bank Profitability Impacts

Registered Bank Profit figures for recent years were as follows: (for detail refer to Annex I, table 17)

**Table 5: Registered Bank Profit Figures**

\$ Million	2005	2006	2007	2008
Profit Before Tax and Bad and Doubtful Debts	4,185	4,756	5,117	5,537
Less bad and doubtful debt expenses	195	162	258	881
Profit before tax	3,990	4,603	4,860	4,655

Source: RBNZ website Financial Disclosure table G3

For the longer term the bank earnings pattern was one where bank profits doubled in a period when lending grew much faster than money GDP. The rise in profits seems to be associated with the growth in lending volume rather than any uptrend in lending margins, which fluctuated over the period. However, this rise in lending was also associated with significant asset price inflation in the economy.

A rather striking figure cited in several submissions was that the combined profits of the “big four” banks now exceed the combined profits of all other companies listed in the Stock Exchange NZX 50 series. The 2008 earnings of the registered banks were \$3.26 billion, compared with the earnings of the NZX 50 (excluding ANZ and Westpac) were \$2.89 billion (data provided by New Zealand Manufacturers and Exporters Association, Christchurch).

A number of submissions commented that the banks should have absorbed more of the cost impact of the economic downturn rather than passing it on to their customers. Various submissions have drawn attention to the banks charging higher costs to business and farmers. As the risks of business/farming defaults appears to have risen the risk premium for such loans appears to have risen as well, as pointed out by Federated Farmers and interest.co.nz.

This raises questions about the working of the Basel II Capital Framework prudential guidelines including whether the risk assessment systems in place allow for the interaction between classes of lending. Should, for instance, the default risk consequent on an increase in risk premiums charged to business customers contribute to the actual demise of a business enterprise and, hence, to the unemployment of its employees, then, the latter might be unable to meet their mortgage servicing requirements.

## 7: Economic Impacts

Submissions relating to the impact of the banking system on the economy included the following:

### 7.1: Bias against the productive sector

A number of submissions considered that the present bank lending criteria discriminate against lending to the productive sector and have favoured housing lending. This has been reflected in both higher margins charged to the business and farm sectors, and slower growth in lending to business compared with housing lending. Submitters

contend that banks found it easier to quantify risk in housing lending; and preferred to secure even business loans with personal (property) guarantees.

While these assertions appear statistically correct, there are also some other factors at play as far as the banks themselves were concerned:

- Lending default rates appear to be higher in the business sector.
- The Basel II criteria require higher asset and reserve ratios for business lending.

Hence, some of the difference in credit treatment arguably reflects factors which a prudent commercial organisation could be expected to react to when allocating out a supply of credit.

However, a larger set of factors on the demand side for credit were also cited as seriously distortionary by many of those making submissions. These were the range of New Zealand tax laws which favour landlord investment in housing, including high depreciation rates, ability to offset losses against other income, including Loss Attributing Qualifying Companies (LAQCs), and the absence of any capital gains tax on investment properties. It was striking how many of both business submissions and representations by professional economists cited a New Zealand tax law bias in favour of investment in housing. This bias was seen as diverting investment resources away from directly productive investment in the production of goods and services. The consequent inflation in housing prices was also seen as pushing home ownership out of the reach of people with modest incomes, and contributing to the downturn in home ownership proportions.

These tax law issues technically lie outside the scope of the Inquiry. However, Inquiry members consider that the issue is so serious that it should be the subject of further policy analysis and inter-party discussion.

A very large number of the submissions (including those from BERL, the Productive Economy Council, Interest.co.nz, CTU, and the New Zealand Manufacturers and Exporters Association) focussed on how high overseas borrowing by the banks, particularly when combined with an alleged allocation bias towards the real estate sector, had a major impact on the exchange rate during the period of rapid credit expansion which preceded the crisis. The exchange rate both appreciated substantially, and was subject to extremely high volatility. Both factors worked against the interests of the export sectors and the tradable sectors in general.

It was understood by Inquiry members that exchange rate levels and volatility correlate with a range of other factors in addition, including investor risk preferences, and structural shifts in the global economy including the weakening US dollar.

The outcome of this exchange rate change was cited by both exporter groups and the professional economists who made submissions as contributing to a deterioration in the position of the tradable sectors, and a rising deficit on the current account of the balance of payments. This reached nearly 10 per cent of GDP in 2008, a situation which is clearly unsustainable. These trends are now a very serious problem for New Zealand.

Some submissions noted that the high volatility in the New Zealand Dollar exchange rate was related to exceptionally high trading ratios in the New Zealand dollar, the net costs of which fell on the export sector.



There was discussion of options including adopting a more managed float of the currency and options for managing the demand for domestic liquidity. One submitter noted that the New Zealand dollar was the second most highly traded currency per capita GDP in the world. Submissions raised alternative ways of managing the currency.

## 7.2: Massive rise in Overseas Debt

Several submissions commented that an inevitable consequence of the process of overseas borrowing to fund property price increases was a rise in overseas debt.

Between 2003 and 2009 net overseas liabilities rose from \$100.6 billion to \$176.3 billion. As a percentage of GDP the rise was from 76.8 per cent to 98.0 per cent. The debt component of this (excluding net equities) rose from 60 per cent to 90 per cent of GDP. These proportions are still rising.

O/seas Borrowing NZD Million	March year 2002/03	March year 2008/09	O/seas Lending NZD Million	March year 2002/03	March year 2003/09
General Government	17,335	19,227		4,247	7,844
Banks	72,006	160,206		28,308	37,790
Other Sectors	52,601	75,465		25,140	31,053
Total Borrowing	141,950	255,994		63,365	94,943
Total International Liabilities	193,550	317,073	Total International Assets	92,972	143,551

Net Overseas Debt NZD Million	March year 2002/03	March year 2008/09	Percent difference 2003-2009
General Government	- 13,088	- 11,383	- 13.0
Banks	- 43,698	-122,416	+180.1
Other Sectors	- 27,461	- 44,412	+ 61.7
Total Borrowing	- 78,585	-161,051	+104.9
Total net liabilities	- 99,758	-173,522	+ 75.6
As % of GDP	- 76.1	- 98.2	

Source: Statistics New Zealand (revised data as per releases of GDP and Balance of Payments September 2009).

Between the 2003 and 2009 March years the banks increased their borrowing from overseas from \$72.0 billion to \$160.2 billion (+122.5 per cent). Their lending to overseas rose from \$28.3 billion to \$37.8 billion (+33.5 per cent). Over the same period, General Government increases its borrowing from overseas by 10.9 per cent, from \$17.3 billion to \$19.2 billion, whilst their lending to overseas rose 84.7 per cent, from \$4.2 billion to \$7.8 billion. As a result, the banks increased their overseas exposure by 180.1 per cent, whereas the Government reduced its exposure by 13.0 per cent.

For the country as a whole, net overseas liabilities rose from \$99.8 billion to \$173.5 billion. As a percentage of GDP the rise was from 76.1 per cent to 96.5 per cent of

GDP. The debt component of this (excluding net equities) rose from 60 per cent to 89.6 per cent of GDP.

The rise in the ratio of debt to GDP was entirely a consequence of bank borrowing abroad. Government debt fell, while the ratio of Business Debt and Equity remained roughly constant as a percentage of GDP. (refer to Annex I, table 20).

Other submissions from exporter groups noted that because of the way much of the lending was directed (particularly into investor house purchase), a high proportion of the extra credit which was funded by overseas borrowing ended up financing an asset price bubble and a burst of unsustainable consumption spending rather than productive investment.

## **8: Monetary Policy and the OCR**

There was a virtually unanimous view by those presenting that the present Reserve Bank Monetary Policy Framework with its focus on Consumer Price Index (CPI) movement and its use of the OCR as the main monetary policy instrument is not now working in a way which assists the economy as intended. Statistical material presented to the Inquiry gave the following findings:

1. Raising the OCR to counter inflation had no reliable effect on domestically generated inflation over the five years to mid 2008, when OCR rates had been moving upwards. In practice all the price impact fell disproportionately on the tradable sectors of the economy via exchange rate appreciation. This squeezed the profitability and in some cases viability of export industries and those competing with imports. This was seen as being highly counterproductive for an economy whose longer term growth prospects depended heavily on exports.
2. Raising the OCR also failed to control credit expansion as it could have been expected to do if New Zealand had been a closed economy. Each time the OCR was raised prior to 2008, and domestic interest rates went up, then with open capital markets more overseas capital flooded into the banking system. As the banks had to lend this money out to make a profit, they then loosened lending criteria, and helped fund an upsurge in indebtedness and a bubble in property prices. Only exceptionally large interest rate changes could now impact on local demand for credit, and these would have the side consequence of severely squeezing the export sector and pushing the real economy into recession. Conversely, the cuts in the OCR since mid 2008 had not resulted in credit expansion to the business sector, which had in fact found it harder to get bank funding as business conditions weakened.
3. The OCR was not working well to influence interest rates. Since mid 2008 there had been only a partial pass through of OCR reductions into domestic interest rates. Other factors impacting on the banks and their costs and profitability, and the lag associated with interest rate charges and the high and growing proportion of fixed term mortgages, had emerged to dilute the effectiveness of OCR changes on domestic interest rates.

Submissions to the Inquiry suggested that a revised monetary policy framework would have the following characteristics;

- There would be more policy focus on the rate of expansion in bank credit as well as an OCR system targeted at interest rates.

- Ensuring that real exchange rates better reflected the underlying performance of the New Zealand economy, and reducing the volatility of the real exchange rate would be a key focus of policy.

A range of possible instruments were suggested to the Inquiry, including an additional tranche of higher Basel II capital and reserve requirements, a restored Reserve Asset Ratio system, and mandatory deposits related to capital inflow. Other suggestions included broadening the Reserve Bank Policy Target Agreement to include growth and employment objectives; and complementing the OCR with domestic liquidity management tools (including a possible enhanced or compulsory savings scheme).

The Inquiry makes no judgement on which additional instruments would be the best for New Zealand. However, it considers that this should be the focus of further analysis and discussions on monetary policy. The Reserve Bank should be involved in this review.

## **9: Transitional and other constraints**

Submissions acknowledged various practical, technical and political-economy constraints around the policy options discussed above.

Monetary policy is an extremely sensitive area. Any evolution of policy would need to be appropriately analysed and its advantages, disadvantages and implementation requirements carefully explored before any decisions were made. Maintaining the strength and integrity of the banking system and the confidence of international markets would be very important. In this context it would appear highly unlikely that a major political party would wish to compromise the independence of the Reserve Bank of New Zealand.

However the importance and sensitivity of the issue should not be considered sufficient to preclude any consideration of adjusting policy settings, or considering complimentary tools, to enhance its effectiveness in the current economic environment.

Further careful analysis would be required in the broader, and equally sensitive areas of exchange rate policy and the sectional neutrality of the tax system.

In consideration of any options to address perceived property tax advantages, sufficient lead times, avoidance of retrospectivity, allowance for reasonable CPI effects, and exemptions for (first) family homes, would all need to be considered carefully in the assessment of options.

The Inquiry recognises existing processes underway in the Government-appointed Tax Working Group and the 2025 task Force and awaits their recommendations with interest.

Submitters expressed a preference for the political process to embody a long term, and if possible bipartisan, perspective on New Zealand's national interests.

## **10: Findings of the Inquiry**

The Banking Inquiry has found that reductions in the OCR since mid 2008 have not been fully passed on by the banks into domestic interest rates. Combining table 7 (OCR per quarter) and table 8 (Interest Rates on Bank Loans) in Annex I shows that from the March quarter of 2008 to the June quarter of 2009 the OCR was lowered by 575 basis points. Over the same period, the Floating Rate (weighted average) fell only 408 basis points, the Floating Rate for new customers 415 basis points and the Fixed

Rate Average 61 basis points. If we allow for an increase in the costs of overseas borrowing of approximately 100 points, which would apply in particular to the floating rates, an unexplained remainder results of around 60 to 70 basis points (floating rate 67 and 60 for the floating rate for new customers).

It stands to reason, of course, that the average fixed rate would fall much more slowly than the floating rates.

However, there is mixed evidence regarding the reasons for this. A number of cost factors impacting on the banks have moved in different directions from OCR changes. Further, overseas borrowing costs are now a very significant factor (although the total proportion of offshore financing appears to have peaked). In this area the information about what is actually happening to bank costs is very opaque. However, even after allowing for legitimate interest cost increases faced by the banks which do not reflect in OCR changes, there still seem to have been a clear move to increase margins between the borrowing costs of the banks and short term interest rates charged to customers.

For most bank customers a more competitive interest rate structure with lower margins between borrowing and lending rates would clearly be an advantage. However, this does not seem to be something which can be currently achieved by changes in Reserve Bank policies. The Reserve Bank has made clear statements in this area but the major banks have chosen not to respond. Rather, it is an area where a more competitive institutional structure could assist. One option suggested to the Inquiry in several submissions was for government to expand the capital base of Kiwibank in order to promote a more active competition amongst banks.

While the Banking Inquiry had a primary focus on interest rates charged to customers in relation to OCR changes, submissions to the Inquiry opened up a much wider set of critical issues.

The Inquiry produced submissions on a large range of matters affecting the banking system, not all of which are focussed on in this report, though they may require other official attention. However, several matters came through as being of top policy priority:

- The OCR system is not currently working in the way it was supposed to. In practice changes in OCR rates have not adequately controlled credit expansion, and recent reluctance to fully pass through OCR cuts has exacerbated this problem. Evidence was presented of an asset price bubble in housing, and a massive rise in external indebtedness. Other collateral damage of this perceived systemic failure in monetary policy has included serious impairment of the viability of the export sector, and contributing to a rising current account deficit.
- Submissions to the Inquiry have called for a new approach to monetary policy which adds in an instrument or instruments to provide for quantitative control of credit expansion, and includes exchange rate stability at an appropriate real level as an important policy objective. Further analysis is required to examine international benchmarks and policy options.
- Outside of the banking system itself, distortions in the tax system which heavily favour landlord investment in housing and hamper investment in more directly productive activities were identified by large numbers of submissions, particularly from producers and exporters, as a key problem. The Inquiry also

suggests that a wide ranging review in this area be a focus for a multi party discussion.

- Reducing New Zealand's unsustainable current account deficit on the Balance of Payments will have implications for the future way bank lending is financed. In particular it will require a higher proportion of locally sourced funding, and a lower reliance on overseas borrowing.

Submissions recognised the sensitivity of these broader issues and the need for appropriate management of policy development and political process, including adequate transaction measures.

## **11: Draft Recommendations**

### **11.1: Noting Recommendations**

- That the Inquiry has confirmed that the banks did not pass on all of the reduction in domestic borrowing cost associated with the reductions in the Official Cash Rate. The unexplained remainder appears, on balance of evidence, to be in the order of 50-70 basis points.
- That the reasons for this are complex, and include some factors associated with overseas borrowing costs and a higher proportion of longer term domestic deposits, but also include increases in margins absorbed by the banks in relation to short term and floating loans.
- That bank profits have not moved in line with these higher margins because of higher provisions for bad and doubtful debts, particularly in Q2 09. However, trading the increased interest margin off through provisioning raises certain equity issues: for example, whether current borrowers should underwrite the risks and costs of previous (highly profitable) lending to other borrowers. This question is sharpened by the possibility of provisioning to offset potential impacts of tax litigation facing the major banks.
- That the Inquiry has focussed attention on a series of serious defects in the current monetary policy framework. These include ineffective control of credit expansion, and an excessively volatile exchange rate which is disadvantaging exporters and the tradable sector.
- That a bias in the tax system in favour of property purchase and against investment in the production of goods and services is interacting with the credit allocation system to produce poorer outcomes for New Zealand.
- That transiting out of this inappropriate policy mix will require careful work to ensure that an agreed new policy mix can be developed, with due regard to process quality and transitional factors.

### **11.2: Operative Recommendations:**

#### **On Information Provision**

- That the Reserve Bank of New Zealand obtain and publish regular statistics on the cost of overseas borrowing by New Zealand registered banks, including details on the composition of this cost in relation to amounts borrowed.
- That the Reserve Bank of New Zealand prepare and publish a study on the flow of funds in the New Zealand interbank market.
- That the Reserve Bank of New Zealand undertake a regular survey amongst the business community to ascertain to what extent business owners finance

their businesses on the basis of mortgage on their house(s), and establish empirically what the pros and cons of such capital financing are.

### **On Bank Competition Policy**

- That the Government actively consider increasing the capital funding of Kiwibank in order to promote more effective competition on bank lending margins, and contribute to a greater share of local funding of lending.
- That an appropriate agency conduct a full review of competitive conditions in the New Zealand banking industry

### **On Monetary Policy**

- That further work be undertaken to explore an enhanced monetary policy framework which considers ways of achieving effective control of credit expansion and explores options for achieving a more stable and competitive exchange rate.
- That this dialogue explores international precedents on the additional policy instruments the Reserve Bank of New Zealand would need to implement such a policy.

### **On Investment and Taxation Policy**

- That a multi party dialogue be established to discuss a more balanced tax regime which encourages productive investment and discourages speculative purchase of housing property, including any relevant recommendations from the Tax Review Working Group.

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**Table 6: Recent Interest Rate Spread (New Zealand Dollar Claims)**

Date	Funding	Spread	Claims
2002			
March	4.18	2.67	6.85
June	4.52	2.82	7.34
September	4.70	2.68	7.38
December	4.70	2.64	7.34
2003			
March	4.68	2.60	7.28
June	4.46	2.59	7.05
September	4.22	2.55	6.77
December	4.25	2.49	6.83
2004			
March	4.31	2.60	6.92
June	4.59	2.57	7.11
September (Series Break)	-	-	-
2004			
December	5.05	2.36	7.41
2005			
March	5.14	2.38	7.51
June	5.48	2.32	7.80
September	5.66	2.24	7.89
December	5.91	2.15	8.06
2006			
March	6.04	2.10	8.14
June	6.08	2.10	8.18
September	6.14	2.09	8.22
December	6.21	2.07	8.28
2007			
March	6.32	2.04	8.36
June	6.65	1.95	8.60
September	7.04	1.75	8.79
December	7.19	1.73	8.92
2008			
March	7.35	1.67	9.01
June	7.44	1.71	9.14
September	7.19	1.86	9.05
December	5.82	2.36	8.17
2009			
March	4.11	2.85	6.96
June	3.54	2.99	6.52
July	3.52	2.91	6.43

Source: Reserve Bank of NZ website table C10, Up to Sept 2004 figures are M3 institutions



**Table 7: Official Cash Rate by Quarters 2002-2009**

Year	March	June	September	December
2002	5.00	5.50	5.75	5.75
2003	5.75	5.25	5.00	5.00
2004	5.25	5.75	6.25	6.50
2005	6.75	6.75	6.75	7.25
2006	7.25	7.25	7.25	7.25
2007	7.50	8.00	8.25	8.25
2008	8.25	8.25	7.50	5.00
2009	3.00	2.50		

Source : Reserve Bank of New Zealand website: "Official Cash Rate (OCR) Decisions and Current Rate"

**Table 8: Registered banks – Interest Rates on Loans on Balance Sheet**

Date	Floating Rate Weighted Average	Floating Rate New Customers	Fixed Rate Average
2004 December	8.51	8.67	7.04
2005 March	8.59	8.94	7.12
June	8.78	8.94	7.25
September	8.79	8.94	7.34
December	9.13	9.47	7.43
2006 March	9.30	9.51	7.52
June	9.28	9.51	7.58
September	9.29	9.51	7.65
December	9.28	9.51	7.73
2007 March	9.36	9.74	7.79
June	9.86	10.16	7.94
September	10.29	10.42	8.09
December	10.29	10.42	8.20
2008 March	10.41	10.59	8.31
June	10.69	10.74	8.47
September	10.52	10.28	8.56
December	8.55	7.90	8.45
2009 March	6.63	6.44	8.15
June	6.33	6.44	7.70

Source: Reserve Bank of New Zealand website, Table "Specified Loans on Balance Sheet"

**Table 9: Registered banks – Interest Rates on Loans off Balance Sheet**

Date	Floating Rate Weighted Average	Floating Rate New Customers	Fixed Rate Averages
2004 December	8.56	8.63	7.02
2005 March	8.58	8.75	7.08
June	8.98	8.75	7.14
September	8.86	8.90	7.32
December	9.17	9.35	7.36
2006 March	8.86	9.55	7.39
June	8.91	9.55	7.52
September	8.91	9.55	7.57
December	9.52	9.55	7.63
2007 March	9.73	9.80	7.67
June	9.74	10.30	7.83
September	10.33	10.55	8.02
December	10.34	10.55	8.22
2008 March	10.42	10.72	8.41
June	10.63	10.85	8.37
September	10.64	10.35	8.55
December	9.32	7.60	8.44
2009 March	6.77	6.40	8.28
June	6.45	6.40	8.19

Source: Reserve Bank of New Zealand Website, "Specified Loans Off Balance Sheet"

**Table 10: Wholesale Interest Rates by Quarter 2002-2009**

Date	Overnight Cash Rate	30 day Bill	90 day Bill	5 year Government Bond*	10 Year Government Bond*
2002 March	4.84	5.02	5.31	6.67	6.88
June	5.50	5.76	5.96	6.48	6.64
September	5.75	5.85	5.86	5.92	6.17
December	5.75	5.91	5.92	5.93	6.28
2003 March	5.75	5.84	5.81	5.47	5.91
June	5.28	5.38	5.23	4.84	5.23
September	5.00	5.14	5.15	5.55	5.95
December	5.00	5.19	5.32	5.93	6.05
2004 March	5.25	5.47	5.54	5.59	5.74
June	5.68	5.93	6.07	6.16	6.29
September	6.18	6.46	6.64	6.18	6.16
December	6.50	6.67	6.71	5.98	5.95
2005 March	6.67	6.90	6.99	6.29	6.16
June	6.75	6.96	7.03	5.84	5.71
September	6.75	7.02	7.09	5.74	5.71
December	7.19	7.58	7.66	5.95	5.83
2006 March	7.25	7.40	7.49	5.80	5.72
June	7.25	7.43	7.47	5.97	5.84
September	7.25	7.48	7.56	6.19	5.80
December	7.51	7.62	7.66	6.22	5.77
2007 March	7.59	7.76	7.88	6.50	5.87
June	8.10	8.18	8.32	7.13	6.72
September	8.02	8.68	8.81	6.55	6.16
December	8.18	8.75	8.90	7.16	6.40
2008 March	8.10	8.80	8.91	6.68	6.36
June	8.21	8.59	8.68	6.45	6.42
September	7.52	8.11	7.95	5.77	5.82
December	5.05	5.44	5.23	4.58	4.88
2009 March	3.08	3.43	3.24	4.02	4.77
June	2.45	2.80	2.78	4.80	5.97
July	2.43	2.79	2.79	4.72	5.75

\*Sale on secondary market

Source: RBNZ Website Table B2

**Table 11: Retail Lending Rates by Quarter 2002-2009**

Date	Floating First Mortgage - New Customer Housing	Business Basic Lending Rate	6 Month Term Deposit Rate
2002 March	7.20	8.02	4.97
June	7.75	8.88	5.55
September	7.83	8.98	5.50
December	7.83	8.94	5.58
2003 March	7.83	8.94	5.38
June	7.33	8.56	4.78
September	7.08	8.36	4.99
December	7.18	8.47	5.22
2004 March	7.50	8.70	5.25
June	8.02	9.12	5.61
September	8.52	9.75	6.28
December	8.76	9.97	6.28
2005 March	8.96	10.21	6.69
June	9.01	10.21	6.85
September	9.01	10.32	6.61
December	9.55	10.79	6.82
2006 March	9.55	10.84	6.85
June	9.55	10.91	6.87
September	9.55	10.91	6.96
December	9.55	10.87	7.23
2007 March	9.79	11.15	7.20
June	10.29	11.65	7.98
September	10.55	11.95	7.99
December	10.55	12.00	8.36
2008 March	10.71	12.09	8.22
June	10.90	12.25	8.46
September	10.40	12.18	7.51
December	8.12	11.14	4.81
2009 March	6.44	9.85	3.62
June	6.44	9.79	3.83
July	6.44	9.85	3.78

Source : Reserve Bank of NZ website Table B3.

**Table 12: Sources of Funds of Registered Banks**

<b>Balance Sheet Source of Funding</b>	<b>\$ Billion</b>	<b>%</b>
NZ Dollar funding – NZ Residents	189.997	49.4
NZ Dollar funding- Non Residents	41.419	10.8
Foreign Currency funding - NZ Residents	7.992	2.0
Foreign Currency funding - Non Residents	80.606	21.0
Capital and Reserves	21.516	5.6
Other Liabilities	43.133	11.2
<b>Totals as per balance sheets</b>	<b>384.592</b>	<b>100.0</b>

**Composition of Other Liabilities (\$ Billion)**

Items in Transit and statistical adjustments	0.334
Revaluations	39.920
Accruals	2.029
All other	0.820
<b>Totals</b>	<b>43.133</b>

Source: Reserve Bank of New Zealand Website SSR part A

**Table 13: Assets, Liabilities and Capital of M3 Institutions**

Specified commercial banks and savings institutions  
As per June 2009 balance Sheet

Sources of funding	\$ billion	%
NZ Dollar Funding – NZ Residents	185.924	49.9
NZ Dollar funding - Non Residents	38.901	10.4
Foreign currency funding – NZ Residents	7.719	2.1
Foreign currency funding – Non Residents	76.329	20.5
Capital and Reserves	21.552	5.8
Other Liabilities	42.311	11.4
<b>Totals</b>	<b>372.736</b>	<b>100.0</b>
<b>Use of Funds</b>		
NZ Government bonds and treasury bills	6.583	1.8
NZ Notes and Coin	0.594	0.2
Claims on the Reserve Bank	8.942	2.4
NZ Dollar claims on NZ M3 Institutions	16.786	4.5
Other NZ Dollar claims on NZ Residents	280.746	75.3
NZ Dollar claims on Non residents	7.110	1.9
Foreign Currency claims on NZ Residents	4.216	1.1
Foreign Currency claims on Non Residents	4.315	1.2
Foreign currency fixed assets and equity	0.119	-
Shares in NZ companies	0.475	0.1
Other Assets	43.029	11.5
<b>Total Assets</b>	<b>372.736</b>	<b>100.0</b>

**Note:** While the Reserve bank M3 series includes the main commercial banks, it does not include all registered banks operating in NZ. Hence some of the amounts included in the registered bank statistics are not included in the M3 series,

Source: Reserve Bank of NZ website table C4

**Table 14: Funding of M3 Institutions – As at 30 June (\$ billion)**

Year	NZ Dollar funding – NZ Residents	NZ Dollar funding Non Residents	Foreign currency NZ Residents	Foreign currency Non Residents	Capital and reserves	Other Liabilities
2000	93.846	13.796	3.258	35.946	10.337	7.579
2001	101.718	21.681	3.558	38.448	11.358	14.609
2002	105.349	29.791	3.688	32.980	12.706	10.352
2003	114.589	27.032	5.885	33.365	13.826	14.279
2004	126.141	26.025	4.694	36.032	18.398	13.229
2005	134.052	32.386	6.431	43.905	18.357	8.161
2006	149.945	36.417	8.875	46.713	19.424	12.858
2007	163.369	40.979	9.550	56.123	20.138	22.583
2008	176.761	40.529	9.431	72.470	22.252	17.090
2009	185.924	38.901	7.719	76.329	21.552	42.311

Source: Reserve Bank of NZ Website Table C4

**Table 15: Sector Credit - \$ billion – as at end of June**

Date	Agriculture	Business	Housing	Consumer	Total of 4
2002	16.548	39.708	73.622	7.961	137.839
2003	19.332	40.926	82.576	8.977	151.811
2004	21.890	45.133	96.767	9.736	173.526
2005	25.215	52.275	112.028	10.551	200.069
2006	29.412	58.574	128.565	11.379	227.930
2007	33.308	69.144	147.134	11.982	261.568
2008	40.216	76.114	159.989	12.716	289.039
2009	46.063	78.726	164.449	12.337	301.546
<b>Annual % Change</b>					
2002	19.1	7.3	8.3	10.9	9.2
2003	16.8	3.3	12.2	13.2	10.2
2004	13.3	10.5	17.2	9.1	14.3
2005	15.3	15.6	15.9	8.9	15.3
2006	15.9	11.7	14.9	6.1	13.9
2007	13.3	17.8	14.4	3.8	14.8
2008	20.7	9.9	8.7	4.8	10.5
2009	14.5	3.4	2.8	-3.0	4.3

**Note:** The total is of the four listed categories and is not total credit for the whole economy. It includes credit from some institutions not listed in the M3 institution statistics shown in the next table,.

Source: Reserve bank of NZ website Table C5



**Table 16: Money Supply and Credit Aggregates \$ billion**

Annual as at June	M3 Money Supply	Private Sector Credit	Domestic M3 Credit (Excluding to other M3 Institutions)
2000	98.045	129.050	121.683
2001	112.238	139.221	126.914
2002	125.996	155.147	137.179
2003	131.541	165.220	148.516
2004	143.085	180.469	166.119
2005	155.166	202.029	190.366
2006	172.249	223.514	214.970
2007	190.962	254.293	245.950
2008	205.179	281.008	273.018
2009	210.707	287.586	280.476
<b>Quarterly</b>			
2007 March	187.572	246.653	236.426
June	190.962	254.293	245.950
September	193.458	262.603	252.572
December	199.481	268.720	260.311
2008 March	199.934	275.112	266.224
June	205.179	281.008	273.018
September	206.867	287.617	277.878
December	212,215	288.347	280.292
2009 March	213.340	287.078	279.329
June	210.707	287.586	280.476
July	211.423	288.653	280.100

Source: Reserve Bank of NZ website Tables C1, C2, and C3

**Table 17: Registered Banks Income Statements - \$ Million**

Income Types	2004	2005	2006	2007	2008
Interest Income	15,060	18,156	21,629	25,220	29,153
Less Interest Expenses	9,563	12,721	15,716	19,090	22,249
Net Interest Income	5,407	5,425	5,914	6,160	6,905
Plus Non Interest Income	2,460	2,597	2,554	2,827	2,804
Total Income	7,867	8,031	8,467	8,987	9,708
Less Non Interest Expenses	3,786	3,846	3,702	3,870	4,171
Profit before tax and bad and doubtful debts	4,081	4,185	4,765	5,117	5,537
Less bad and doubtful debt expenses	256	195	162	258	881
Profit before tax	3,825	3,990	4,603	4,860	4,655
Less tax	1,186	1,199	1,404	1,623	1,401
Net Profit after Tax	2,639	2,791	3,199	3,237	3,255
Less distributed profits	849	1,181	2,993	2,197	2,887
Retained profit	1,790	1,602	206	1,040	367

Source: Reserve Bank of NZ website Table G3

**Table 18: Credit Status of Registered Banks in 2008**

Bank group	Credit status – Standard and Poor	Impaired Assets \$m	% of Total Assets
ANZ National	AA	629	0.5
Westpac	AA	710	1.3
BNZ	AA	378	0.5
ASB	AA	258	0.4
Bk Tokyo Mit	A+	1,116 b yen	0.7
Citibank	A+	29,600 U.S.	2.6
Deutsche Bank	A+	3,008 b Euro	0.1
HSBS	AA	13,080 b HK	0.3
JP Morgan	AA-	31,311 b U.S.	1.9
Kookmin	A	2,648 b Euro	1.3
Rabobank	AAA	6,455	1.1
Kiwibank	AA-	9	0.1
SBS Bank	BBB(1)	22	0.9
TSB	BBB+	2.4	--

(1) SBS is rated by Fitch

Source: Reserve Bank of NZ Website Disclosure tables G1 and G2.

**Table 19: Accommodation Supplement recipients at end of June 2008**

Category	Number
Renting Privately	148,173
Renting from another organisation	7,162
Boarding	48,901
Own their own home(1)	41,454
Unspecified	20
<b>Total</b>	<b>245,510</b>

(1) Virtually all of these clients are receiving assistance with mortgage costs

Source: Ministry of Social Development Statistical Report 2008 Table 4.2.

**Table 20: NZ International Investment Position by Year**

\$ Million Annual as at 31 March

Year	NZ Investment Abroad	Foreign Investment in NZ	Net Position	% GDP
2003	80,808	181,836	-100,578	76.8
2004	88,540	198,303	-109,763	78.4
2005	93,413	214,434	-121,021	80.7
2006	104,928	234,670	-129,742	82.5
2007	111,022	254,179	-143,157	86.2
2008	134,707	288,588	-153,880	86.4
2009	138,222	314,849	-176,268	98.0

Source: Statistics New Zealand website Tables "Balance of Payments and International Investment Position" and Statistics of Gross Domestic Product.

**Table 21: NZ International Investment Position by Category**

\$ Million Annual as at 31 March

Composition by categories	2008	2009
Equity Assets	51,045	46,673
Lending:		
Banks	26,673	36,655
General government	8,525	7,935
Monetary authorities	19,737	18,396
Other sectors	28,727	28,563
<b>Total International Assets</b>	<b>134,707</b>	<b>138,222</b>
Equity Liabilities	64,316	61,306
Lending:		
Banks	138,363	163,221
General government	17,616	19,227
Monetary Authorities	540	1,166
Other Sectors	67,752	69,921
<b>Total International Liabilities</b>	<b>288,588</b>	<b>314,849</b>
<b>Net International Liabilities</b>	<b>-153,880</b>	<b>-176, 628</b>

Source: Statistics New Zealand website Tables "Balance of Payments and International Investment Position" and Statistics of Gross Domestic Product.

**Table 22: Gross Weighted Interest Margin 2003-2009: Registered Banks**

Date	Funding %	Claims %	Funds NZD Million	Claims NZD Million	Assets NZD Million	Weighted gross interest rate margin %
June 03	4.46	7.05	141,622	176,466	208,977	2.93
June 04	4.59	7.11	152,166	190,979	224,519	2.94
June 05	5.48	7.8	166,439	215,475	243,293	3.16
June 06	6.08	8.18	185,912	239,473	273,800	3.39
June 07	6.65	9.14	204,348	270,133	312,742	3.55
June 08	7.44	6.52	217,290	295,711	338,533	0.92
June 09	3.54	6.43	224,826	304,373	372,736	3.12

Source: Reserve Bank of New Zealand.

The table shows that between June 2007 and June 2008 the costs of funding rose, whilst the average rate on claims fell, making for a dramatic fall in the gross weighted interest margin. However, by June 2009, the normal rate had been restored, basically due to a halving of the funding rate.

## Annex II - The OCR and Monetary Policy Framework

### Description of Monetary Policy

Since 1999 the Reserve Bank has been using the Official Cash Rate (OCR) as its key monetary policy instrument.

Registered banks settle claims on each other by using their settlement accounts at the Reserve Bank. If they have a surplus on their Reserve Bank account, the Reserve Bank will pay them interest at a rate set by the OCR. Conversely, if they are short they can borrow from the Reserve Bank at rates related to the OCR rate (the actual rate depends on the security offered by the banks). The Reserve Bank stands ready to borrow and lend at OCR related interest rates without any limit on the amounts involved. The effect of this is that no bank will offer short-term loans at a rate that is significantly higher than the OCR, because if they did, a competing bank would undercut such a rate by borrowing from the Reserve Bank. Conversely, banks are unlikely to offer rates for short-term loans that are far below the OCR, because they can lend to the Reserve Bank at the higher OCR rate.

In this way, the OCR, being a critical very short-term interest rate, sets the pattern of interest rates applying in the New Zealand wholesale money market. Typically, rates for longer terms will be higher than for short-terms (positive yield curve). The higher the rates for wholesale funding the higher will be the rates for medium-and long-term loans such as floating or fixed mortgages.

The Reserve Bank assumes that banks will set their rates for new loans on the basis of the marginal cost of funds, say the 90 day bill rate. If the banks do this (most likely), then, an increase or a decrease in the OCR will move all interest rates. It is a conceptually simple mechanical system of operating monetary policy.

Complications may arise due to the fact that banks have other sources of funding than the RB. As the Reserve Bank acknowledges New Zealand banks borrow off-shore. Hence, interest and exchange rate movements may provide an incentive to switch from domestic to overseas funding or vice-versa.

In its document of 6 July 2009 (*'New Zealand bank funding costs and margins'*, a response to a Westpac paper), the Reserve Bank discusses three major funding channels:

1. **Deposit Rates.** The costs of deposits have risen due to competition between banks for funds to maintain or expand their loans. Recent corporate bond issues targeted at retail investors have sharpened this competition to the point that six-month deposit rates are now priced at 40 basis points over bank bills instead of at 40 points below them.
2. **Short-term wholesale funding costs** have risen, reflecting the increased spreads between off-shore short-term funding rates and expected policy rates. Although the spreads have fallen since they reached a peak shortly after the fall of Lehman Brothers in October 2008, they are still higher than usual.
3. **Long-term wholesale funding.** These costs, proxied by movements in Australian bank bond spreads, with a margin added to reflect the higher cost for

New Zealand bank issues, have eased from the highs seen in late 2008, albeit to levels that are still significantly above those prevailing prior to the crisis.

Whilst admitting that the international financial crisis of 2008/09 created special circumstances, it appears that the mechanical control system designed by the RB may not always work as smoothly as expected. However, it is meant to work over the medium term and according to the current Policy Target Agreement between the Governor of the Reserve Bank and the Minister of Finance should be implemented 'without unnecessary instability in output, interest rates and the exchange rate'.

The Reserve Bank monetary policy has the ultimate target a rate of CPI inflation (year-on-year) of 1 – 3 per cent. This is presumed to be an indicator of the general price level. However, it only covers the prices of currently produced and sold goods and services. Asset prices are not included in the CPI, although they are a very important part of the economic life and dispositions of economic subjects. Although a statistical measure of the general price level, including asset prices, is difficult to design, the ultimate target for monetary policy should specify also a range for asset prices.

In practice there will be a fairly long transmission line from the OCR to the ultimate target. To judge the effectiveness of its policy settings, the Reserve Bank uses a measure called the 'output gap'. This involves a calculation of the economy's potential output and its actual output. If the latter exceeds the former, inflation is likely to increase and vice versa. By now, the Reserve Bank should have empirical data that shows that there is a reliable link between changes in the output gap and changes in the ultimate target.

However, in its popular explanation of monetary policy ([www.rbnz.govt.nz/monopol/pta/](http://www.rbnz.govt.nz/monopol/pta/)) the Reserve Bank says: 'By setting the OCR, the Reserve Bank is able to influence interest rates and exchange rates, which in turn affect the level of economic activity and inflation'.

This suggests two intermediate targets: the NZD exchange rate, followed by changes in the output gap.

From the banks point of view, the question must be in what way they can operate without being restrained by the Reserve Bank monetary policy? Overseas funding provides an obvious escape, as long as overseas rates are lower than the OCR. In fact, if they import more capital than is required to finance the balance of payments current account deficit, the NZD exchange rate will appreciate, making it easier to repay the loans. It has as a side-effect also a fairly direct effect on the Reserve Bank ultimate target, the CPI.

Other escape routes include:

- a. raising loan margins or risk premia, regardless of increases in funding costs or changing criteria for lending such as the ratio of deposits required for obtaining a mortgage.
- b. obtaining more capital so as to support a higher level of loans or to finance more risky but potentially more profitable lending. As long as such loans are serviced and repaid on time, the return on capital may be sufficient for investors.
- c. Issuing more debt, both domestically and abroad.

The OCR approach to monetary policy assumes that all prices of funding and loans are flexible. If a bank offers loans at fixed rates and short-term interest rates are rising, they face potential losses. Banks may offer fixed rates mortgages if they speculate on decreases in the OCR or believe that they can secure overseas funds at sufficiently low interest rates. They might also issue debt at maturities that match the fixed terms. Clearly, such actions by banks reduce the effectiveness of the OCR.

It is worth noting that according to its paper of 6 July 2009 (quoted above) the Reserve Bank has been introducing a 'new prudential liquidity policy', which 'sets various balance sheet requirements and disclosure obligations for banks around their internal liquidity management. The purpose of the policy is to ensure that banks maintain strong liquidity positions, making them more resilient to both short-term and long lasting funding shocks'. The Reserve Bank believes that the resulting increase in funding costs is a once-off event.

In itself this is an extraordinary statement. It appears to imply that the Reserve Bank allows the banks sufficient leeway to subvert its monetary policy objective.

### **Summary and critique**

The Reserve Bank may well believe that the lack of pass through of decreases in the OCR will correct over time as the sources of higher funding costs, mostly the result of the international financial crisis of 2008/09, but also of sharp domestic competition for funds, return to normal patterns.

The events indicate that the OCR is not an instrument that will always work as designed. At best the policy will increase or decrease the price of money. The banks may continue to expand their lending in case of an increase in the OCR. As long as they are all doing so at the same rate they may avoid having to borrow from the Reserve Bank. It may also pay them to borrow more from overseas.

By lending primarily to households for mortgages, they may push up the price of houses, thereby making the borrower better off and also improving the security for their loans. In the housing market the banks and their borrowers are clasped in a firm embrace. Since asset prices are not part of the CPI (except through charges such as rents), the ultimate target is not hit.

In general, monetary policy should use a number of instruments in order to have effective control over the monetary system. The Reserve Bank should be able to change directly the amount of liquidity held by the banks.

Finally, the banks are able to monitor the monetary and economic situation as well, if not better, as the Reserve Bank. They will also forecast the CPI. By telling the public what they expect the Governor to do about the OCR they may set the scene and raise the public's expectations about a possible change. The Governor may be led more than that he is actually leading. A higher OCR may be in their interests if they have a high forex exposure or even want to increase such exposure through betting on an appreciating NZ Dollar exchange rate. The Reserve Banks use of the exchange rate as an intermediate target makes them a target for such manipulation.

Conversely, it could be in the interests of the bank to talk up the possibility of a decrease in the OCR if they want the costs of funds to fall.

## Annex III - Peer Review - Professor John Quiggin

<sup>3</sup>The Parliamentary Banking Inquiry was initiated by three parliamentary parties (Labour, Greens and Progressives), with invitations to all others, to examine aspects of operations of the banking system in the New Zealand economy. A particular concern was the extent to which reductions in the OCR since the October 2008 international financial crisis appeared not to have been fully passed on in short term bank lending rates.

The Draft Report of the Inquiry examines evidence on bank margins and the structure of the New Zealand banking system, as well as on aspects of monetary and taxation policy seen as contributing to excessive reliance on international borrowings to finance domestic consumption and speculative real estate investment.

As part of the process, the inquiry has commissioned reviews of the Draft Report, of which this document is one. The review will provide

- A discussion of the global context in which the Draft Report has been produced, including observations on related developments in Australia and the United States
- An assessment of the accuracy of evidence produced in the Draft Report the soundness of the analysis, and the feasibility of the policy recommendations
- Some suggestions for possible further avenues of inquiry

### Global context

The financial crisis that developed in the United States in 2007, and culminated in the near-meltdown of September 2008, exposed numerous weaknesses in national and global systems of financial regulation, and necessitated emergency rescue measures in all countries. Even countries where the direct effects were relatively modest, such as Australia and New Zealand were forced to introduce unlimited guarantees of bank deposits. Such measures had been explicitly rejected by the Wallis Committee in Australia in the late 1990s, and by the Reserve Bank of New Zealand in 2000 (<http://www.rbnz.govt.nz/news/2000/0092594.html>).

A year after the rescue of the global financial system very little progress has been made, at national and global levels, towards reform of the system of the financial regulation system. The incentives that encouraged banks and other financial institutions to engage in unsound practices, and led to the overexpansion of the financial sector relative to the business sector as a whole remain in place.

The result is that institutions where the proportion of bad investments was below the average (though still significant) have enjoyed exceptionally favorable conditions, considering the general decline in economic activity and profitability. On the one hand, they have benefited substantially from the bailout.

The most direct source of benefit has been the introduction of guarantees. An indirect, but equally important source of gain has been the absorption by the public of the losses banks would otherwise have suffered from the defaults of financial counterparties.

The combination of government guarantees and reductions in the interest rate set by central banks, such as the Official Cash Rate (OCR), in New Zealand has substantially reduced the cost of funds faced by major banks.

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<sup>3</sup> Professor Quiggin thanks Nancy Wallace, for helpful comments and criticism.



## Assessment

### Introduction

The introduction sets out the background to the inquiry, noting the primary initial focus on the interrelated issues of bank margins and incomplete pass-through of reductions in the OCR. The introduction also notes the very limited participation of major banks in the inquiry.

### Has OCR pass-through occurred?

The evidence presented in Table 1 shows, fairly unequivocally, that OCR pass-through has occurred, but that pass-through has been incomplete with respect to rates administered by the banks. The market-determined 90-day bank bill rate shows (more than) full pass-through of the OCR rate. The most notable contrast is with the floating mortgage rate which should, other things equal, closely reflect changes in short-term market interest rates. The margin between the OCR and the floating mortgage rate has increased by 145 basis points, confirming the validity of the concerns that led to the establishment of the inquiry

A particularly clear indication of increasing margins is the fact that the reduction in the 6 month term deposit rate, which should respond more slowly to changes in short-term rates than the floating mortgage rates, has been 40 basis points greater than the reduction in the average floating mortgage rate.

### The NZ Banking System

This section illustrates the dominance of the four major Australian banks in the NZ market and mentions the beneficial, but limited, effects of competition from Kiwibank. Given the extent of integration between the Australian and New Zealand economies, it might be worth mentioning the very similar Australian situation, with the same group of banks exercising similar dominance. In this context, it is notable that the effect of the GFC has been to greatly reduce competition in the Australian financial sector, by shutting down the mortgage securitization market. I am not aware of whether there have been similar developments in New Zealand - the report suggests that Kiwibank has been the only significant challenge.

I would also point to the view, expressed by former RBA governor Ian MacFarlane that Australia's 'four pillars' policy preventing mergers between the four major banks had the (unanticipated) beneficial effect of discouraging high-risk investments that might have been undertaken in the hope of securing a dominant position in merger negotiations (that of an acquirer rather than a target). This viewpoint implies that competition between the major banks is likely to be even more limited in the future, now that concerns about systemic risk are more marked, and therefore that alternative mechanisms are needed.

The report correctly notes the dependence of banks on overseas funding which forms the basis of their case for not passing on reductions in the OCR. It might be worth examining whether this analysis can be applied symmetrically to the period of easy international credit prior to the crisis which ought, on this analysis, to have seen a contraction in margins relative to the OCR.

In addition, it might be useful to treat funding from Australia (largely unaffected by the crisis) separately from funding derived from outside

The Report correctly notes the assistance given by government to the banking sector. Since banks deal in risk, guarantees and other forms of contingent support have a direct monetary value to them, even if the guarantees are not exercised. The presence

of a guarantee permits borrowing at lower rates, and it is not apparent that these benefits have been passed on to borrowers.

The conclusion that

In short, the taxpayer has a large financial interest in the banking system since taxpayer funding and explicit and implicit guarantees underlie much of the banking system's favourable financial situation. In turn the taxpayer is entitled to expect that the banks will act as good corporate citizens.

may be a little too weak. There is a strongly held view in some sections of the business community that notions of 'good corporate citizenship' and 'corporate social responsibility' are misguided, and that the primary, or even sole, obligation of corporate managers is their fiduciary obligation to act in the interests of their shareholders, subject to compliance with legal and regulatory requirements. Even where this view is not held explicitly, it may guide actual practice, given the pressure on managers to maintain share prices.

In this context, it may be naïve to rely on moral suasion to elicit more socially responsible behaviour from regulated institutions. Rather, what is needed is a regulatory structure that ensures a proper return to society for the support given to the financial system. Hence, a better conclusion might be 'the taxpayer is entitled to **require** that the banks will act as good corporate citizens.'

## **OCR**

The analysis indicates some factors that have made the OCR less effective as an instrument for monetary policy. More generally, it seems likely that the gradual emergence of a new global financial architecture will require substantial modifications to the monetary policy framework that emerged during the 1980s and 1990s and failed, in most countries, to constrain the development of a bubble economy or to adequately offset the adverse effects of the bursting of that bubble.

## **Other issues**

Among the other issues noted in submissions, the fact that the current monetary policy regime has been associated with sustained current account deficits is the greatest cause for concern. The *laissez-faire* or 'consenting adults' view that current account deficits arising as the outcome of lightly regulated markets should be presumed to be benign can not stand in the light of the pervasive market failure revealed by the crisis. Continuing current account deficits remain an important source of vulnerability for English-speaking economies including Australia, New Zealand, the UK and the US. A more comprehensive inquiry into the financial system should examine this issue.

## **Conclusion**

Overall, the evidence supports the inference that banks have failed to pass on the full benefit of reductions in the OCR and of lower costs for other sources of funding, partly the result of public guarantees. The most plausible reason for this failure is that banks are seeking to recoup past losses from bad debts. In a competitive industry this would not be possible. Firms would have to bear the losses associated with their past mistake, since competitors would not follow them in raising prices. By contrast, in an oligopoly, where all the major banks have incurred significant losses, none is likely to prefer competing for market share to restoring accustomed levels of profitability.

## **Annex IV - Peer Review – Professor Tim Hazledine**

### **Evidence on widening of interest rate margins**

While the Inquiry does appear to have documented a failure of domestic lending rates in NZ to fall as much as has the Reserve Bank's Official Cash Rate (OCR), it has had to note difficulties in generalising from this to any conclusive statement about widening or not of retail interest rate margins (ie differences in interest rates paid by the banks and rates charged by the banks for the retail use of the monies, for matched term structures of the loans).

This is because of the limitations of the OCR as a cost of capital measure in the context of longer term loans (eg fixed term mortgages), and also because much of the major banks' lending is sourced offshore.

It may well be true that the costs of offshore-sourced money has fallen by even more than the OCR and/or than the costs of raising term capital in the domestic NZ money market. Or not. We don't know, because the Reserve Bank does not collect data on the cost of imported capital.

As possible means of finding out more on this very important issue, I suggest that future work could:

- look for official or unofficial Australian data on the costs of that country's offshore borrowing (this being of course directly relevant to NZ because 90% of the banking here is done by the four Australian-owned subsidiaries of Australian retail banks)
- assemble what should be readily available information on the relevant interest rates (eg house mortgages) in the major financial markets from which the "carry trade" of supplying loanable funds to NZ is sourced (eg, US, Japan, UK, EU, as well, of course as Australia)

### **Increased lending margins to offset bad debts**

Under what circumstances might an unexpected increase in "bad debts" -- ie, defaults in repayments of existing loans -- affect the profit margin on new loans made with new borrowings?

There is no direct link between yesterday's business deals and today's. To fix ideas, look at the two extreme types of market structure -- monopoly (single seller) and what economists call "perfect competition".

Suppose the retailing lending business in NZ was under the full control of a monopolist. If this monopolist were alert and profit-seeking they would be setting their current lending rates for new loans so as to maximise total profits from this line of business, given costs of current borrowing, and given demand for loans (ie, the relationship between the price charged [interest rate] and the number of loans taken out).

Given that these interest rates maximise profits there would be no effect on them of any unexpected change in the profits yielded by irreversible past decisions, due to bad debts or whatever, simply because any change to current rates would reduce profits.

[If the monopoly's managers were a little lazy, interested in what some call "a quiet life" rather than squeezing the last cent of profit out of their market, subject to delivering an adequate profit return to the owners, then an unexpected increase in bad debts might

indeed spur them to raise prices in the new loan business in order to maintain total profits at acceptable levels, and given that existing loan rates were lower than profit-maximising levels, higher prices or interest rates would up to a point deliver higher profits.]

At the other extreme form of market – so-called perfect competition – we have a very large number of sellers of very similar products such that no-one seller can maintain any significant profit margin over costs, because any higher price will simply induce its myriad of similar competitors to undercut by, say, 5 cents, and steal all the price-raising firm's customers. That is, large scale competition keeps price and cost very close together, and therefore leaves no possibility of any sustained increase to recoup losses on old loans or for any other reason.

It is in the intermediate case known as oligopoly that things can get a bit more complex. A classic oligopoly – which is indeed the prevalent form of industry structure in most mature markets – has a small number (say, 2, 3 or 4) of relatively large firms which dominate the market, along with a “fringe” of very small operators -- some supplying special niches of the market, some new start-ups of which a very few will be the major oligopolists of tomorrow but most will eventually fail, and some non-standard small operators such as co-ops.

The retail banking industry in New Zealand, with the four largest banks owning 90% of the market, is of course a classic oligopoly. So too, for example, is the retail petrol industry, where the big-4 have an even larger share. Note that a 4-firm oligopoly is actually fairly unusual – most mature markets have evolved -- by merger, takeover and rationalisation -- to a situation of duopoly or triopoly. Well known examples are: supermarket chains, airlines, brewing, breakfast cereals. What banking and petrol have in common is their need for a large number of regionally dispersed and therefore small retail outlets, and this may support larger numbers of competitors, large and small.

In oligopolies, prices and thus profit margins usually fall between the extremes of monopoly and perfect competition. The oligopolists are generally able to refrain from competing away all profit margins, but they can't usually achieve the heights of monopoly pricing, because they do compete with each other for market share. The big firms suffer from what is called “the oligopoly problem” – they may be able to figure out that they would all be better off if they jointly raised their prices, but any one firm taking the lead in doing so risks having its competitors “cheat” on it – refrain from matching the increase in order to steal customers and market share. And competition law prevents them from solving this problem by making price-setting agreements amongst themselves or even from so much as talking to each other about pricing.

Of course, from the consumer perspective, we like the oligopolists having this “problem” -- the more problematic the better! But given that the oligopolists are well aware of where their joint interests lie, we should not be surprised if from time to time they are able to come up with schemes or devices that can facilitate coordinated pricing, without of course breaking the laws proscribing explicit collusion or cartel behaviour.

An event such as an outbreak of “bad loans” on previous business – an event from which all the banks will suffer to some extent when it is due to a macroeconomic shock such as the “global meltdown” -- could just possibly be the trigger for coordinated action to increase lending margins, especially when such is in the context of overall falls in all interest rates, so that it is simply a matter of reducing the loan rates by less than the borrowing rates.

However, I do not have any direct evidence of this happening, though if the Banking Inquiry did hear of bad loans being used as a reason for increasing margins on current new lending, this might constitute a “smoking gun” of suspicious circumstantial evidence.

As a counter, it could be argued that past and present loans are indeed linked. If the unexpected increase in bad (past) loans is actually a signal of a systemic change in the riskiness of the retail lending business, then banks would be justified in building an allowance for this increased riskiness into their margins.

However, I note that banks do not just use price (interest rates) to allocated loanable funds. They also make use of various non-price instruments, such as credit checks and equity collateral requirements. If they have also tightened up these non-price supply side criteria, then the overall risk of bad loans could well have decreased, not increased.

Also, it is not clear just how accurate is the quite sharp increase in the “provision” for bad loans from \$258million to \$881million during 2008/09. Could these provisions be pessimistic? Of course we would all hope so, including the banks, and would be pleased if this increase in defaults does not come to pass, but annoyed if it turned to have been used as a ploy for justifying unnecessary increases in lending margins (and/or decreases in taxable profits).

### **Possible policy changes**

I will comment briefly on a number of policies or other government actions arising from the Inquiry and either suggested in it, or coming to my mind independently.

*Kiwibank* - Our state owned national bank comes across as something of a hero in the domestic banking scene, but it is very much a David & Goliath story, with however as yet no sign of David overcoming his very substantial size differential with respect to the Big-4. It has been suggested that capital be pumped in to Kiwibank to enable it to increase its retail market share and thus be even more effective as what I would call a “fighting brand” to keep competitive pressure on the Australian-owned oligopolists.

I am sympathetic and think it would be great if New Zealanders continue to choose to switch to Kiwibank from overseas-owned competitors, but caution against using it as an instrument of government competition policy, either by pushing (cheap) funding onto it or by encouraging or requiring it to operate under other than a sustainably profitable commercial business model.

### **Effectiveness of OCR-based monetary policy**

Submissions suggested that the main macroeconomic policy instrument available to the Reserve Bank -- the Overnight Cash Rate (OCR) -- has become decreasingly effective as a means of controlling the Reserve Bank’s sole macro performance target -- inflation -- and that efforts to use it for such may also have been destabilising for the (real) exchange rate and the tradable goods sector which is deeply affected by this. It was also noted that the Kiwi dollar is “in play” in world money markets to a large and worrying extent.

These are serious concerns and they warrant -- in my view -- giving serious consideration in future research and policy analysis to the standard solution for a small country, which is simply to get out of the (macro-economic) monetary policy business altogether, by giving up the independent currency (and thus giving up an independent interest rate policy). An “Anzac” dollar could have much to recommend it from this

perspective, including eliminating the interest rate differential with Australia, and eliminating all exchange rate volatility with our largest trading partner (currently responsible for more than 20% of our export and import flows, a percentage that other countries' experience suggests would increase substantially, perhaps even doubling, under a common currency regime).<sup>4</sup>

There are pros and cons to giving up our "independent" currency. It seems to me that many people in NZ who announce themselves as opposed to the idea have not in fact given the matter sustained thought and analysis. As a thought experiment for such people I would suggest they ask themselves the following question: "Suppose that when NZ and Australia introduced their decimal currency to replace the old pound they had chosen to share the same currency. Do you think it likely that there would now be significant political and policy interest in NZ breaking away from this currency union to introduce an independent dollar?"

### **Capital gains tax**

The lack of a tax on profits generated by house price increases may have encouraged over-"investment" in housing and in turn increased the demand for mortgages which has had to be supplied from foreign lenders. A suitable capital gains tax may now be a timely policy option.

### **Savings incentives**

On the supply side of the domestic capital markets, incentives to increase saving for retirement (beyond the useful Kiwisaver) could be justifiable on their own terms and would also reduce reliance on possibly destabilising foreign borrowings.

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<sup>4</sup> Note: This is the view of Professor Hazledine and does not represent the view of the Inquiry



# Report of the Parliamentary Inquiry into Banking

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