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Report for the Retirement Commissioner

The Impact of and Issues arising from

the

Global Financial Crisis

July 2010

1. Executive summary

1. This report has been prepared as background for the 2010 Review of Retirement Income Policies being undertaken by the Retirement Commissioner, in accordance with the requirements of the Retirement Income Act 2001. One of the matters that the Government has asked the Commissioner to address is how the global financial crisis may affect the adequacy of retirement income provision for individuals at various life stages. In that connection, the Commissioner has sought an independent assessment covering four matters, as summarized below.¹

1.1 What has been the impact of the Global Financial Crisis (GFC) on households' savings and worth (considering, if possible, both the wellbeing of the current retired population and the retirement preparations of the non-retired)?

2. Taking the impact of the global crisis from abroad and the failure of New Zealand finance companies together, the initial, direct, impact of the GFC on households' aggregate net worth was significant (-9% in 2008). But recoveries in equity and house prices in 2009, albeit with some reversal in first half 2010, have offset a good part of that initial impact. Overall the impact to date has been moderate compared with that in harder-hit economies in the Northern Hemisphere, and probably less than that following the 1987 share market 'crash'.

3. New Zealand, which ultimately means New Zealand households, has weathered the GFC comparatively well because:

- going into the crisis, the core domestic banking system, and corporate balance sheets, were relatively robust;
- of strong financial sector links to Australia, with equally strong banks and corporations;
- both economies, particularly Australia, but also New Zealand, including through Australia, are linked to Asia, which has rebounded from crisis more strongly than any other region.
- The Government's financial position going into the crisis was reasonably strong, which helped to underpin financial market confidence and meant that there was room for the Government to ease fiscal policy to help support the economy.

4. But the moderate impact in aggregate masks a wide dispersion of outcomes across individual households. Some households have suffered substantial losses, a few will

¹ These matters also overlap significantly with another of the Commissioner's terms of reference, namely: the role of New Zealand's financial services sector in relation to retirement income provision, specifically what might be done to enhance markets' and consumer trust in the sector.

have augmented their wealth, and most will have been only moderately affected. Prominent amongst the losses have been those incurred by some households on fixed interest, and in particular finance company, investments. Compared with equity and real estate assets, which can be expected to fluctuate in value, these investments will have been viewed as relatively safe, and the losses incurred may have impacted on public *confidence* more than the amounts involved (losses of around \$3 ½ billion - 4 billion) might indicate.

5. Fiscal (and monetary) policy has absorbed much of the impact that otherwise would have been felt by household incomes (and saving). In other words, much of the impact has been absorbed by government dis-saving; household saving, if anything, has increased, with the rate of household debt accumulation having slowed quite sharply. The projected deterioration in government net worth over the five years to 2013, at nearly 20 per cent of GDP, is three times the fall in household net worth over 2008-2009; in effect a transfer of the impact to future taxpayers (today's younger to middle-aged cohorts).

6. A full assessment of the impact of the GFC across different age cohorts is complicated by a need to trace through effects felt via a number of different channels, and data limitations. But broadly:

- Losses on financial assets will disproportionately have impacted older cohorts, given that they account for a disproportionate share of aggregate financial assets (having been accumulating for longer, and given that a larger share of the saving by younger cohorts typically is channeled into servicing a mortgage).
- But older cohorts will have benefited disproportionately from the sustained increase during the run-up to the crisis in the real value of houses. Middle-aged cohorts also will have benefited, but will also be carrying more debt, while younger cohorts aspiring to home ownership face larger borrowing requirements and uncertain prospects for house values (but for a period at least, lower mortgage interest rates than have prevailed for some time).
- Today's older (retired and near retired) cohorts are benefiting from the government's commitment to maintain the terms of the New Zealand superannuation scheme, whilst the GFC has increased uncertainty about those terms being able to be sustained in the longer term, owing to the significant deterioration in the Government's fiscal position, with less being ear-marked than previously as funding for future NZ Superannuation payments.

1.2 Causes of the failure of finance companies

7. A number of specific factors can be listed as having contributed to the large number of finance company failures since 2006 but, taken together, they boil down to finance companies having been able to represent the investments they offered to the public as something different from the assets that backed them. In many countries, the

investments offered would have been referred to as ‘high yield’ or ‘junk’ bonds, and could not have been referred to as ‘deposits’.

8. More specifically:

- The finance companies that failed, predominantly, were property development financiers, which, typically, lent on a non-amortising, deferred interest, and ‘mezzanine’ (ie, second tier in point of security) basis, in some cases, with a significant amount of the loan portfolio accounted for by large and/or related-party exposures. All this is the antithesis of the prudent lending one normally would expect of a ‘deposit-taker’.
- The applicable governance, regulatory, and supervisory arrangements were not of a standard commensurate with being in the business of taking ‘deposits’.
- Investors, and/or their advisers, did not themselves adequately assess the risks, in part because they did not perceive a need to do so, in part because the risks were not adequately disclosed, and, in part, because they did not have the capability required.
- The investment mantra that ‘high return = high risk’ may have been (mistakenly) extrapolated by the investing public to also mean ‘moderate return = moderate risk’. To the extent this was the case, finance companies will have been able to pitch their interest rates for what were high risk investments just a few percentage points above bank deposit rates. This will have left finance companies with ample interest margin to cover the cost of high-profile brand advertising (that reinforced a no more than moderate risk profile) and commission payments to induce advisers to recommend their investment products.

1.3 Important lessons from the crisis for current and future retired populations in their management of savings and retirement income

9. The GFC has ‘stress-tested’ most aspects of financial sector policy and practice, including some established principles relating to individual saving and investing for, and in, retirement. Two lessons relate to:

- A need for realistic assessment of the level of investment returns that can be expected in a low-inflation environment;
- A need to reassess the limits of do-it-yourself investing (by non-experts).

10. The years running up to the GFC have been widely described, globally, as a period during which investors were ‘searching for yield’. Interest rates were relatively low by historical standards, and investments offering some additional yield held particular attraction. Examples include the global appetite for high yielding currencies (including the NZD and AUD); for asset-backed securities (eg, CDOs) and, in New

Zealand, for finance company deposits. What was not so much appreciated at the time, but is hardly surprising, is that the search for yield was accompanied with increased risk.

11. Which points to a need now to reassess whether the ‘risk-free’ rate of return might be a notch or two lower than previously thought. If so, there are implications for both those seeking to accumulate a ‘nest-egg’ for retirement, and for those in retirement and relying on their investment nest-egg to provide a regular *and reliable* cash-flow that substitutes for previous employment income. If reasonable expectations of returns on savings need to be scaled back, those saving for retirement may need to save more than previously thought. And the lesson for those in retirement is that they may need to be more willing to run down their capital, given that the alternative, of taking greater investment risk in an attempt to generate more investment income, can result in outright loss of capital.

12. Similarly, the fact that many investors were enticed into new, in some cases complex, areas of investment, where risks were lurking below the surface and were under-appreciated, suggests a need for a re-assessment of the limits of do-it-yourself investing (by non-experts). That carries implications for:

- policymakers, specifically a need to reassess the extent to which a regulatory regime that assumes investment capabilities on the part of ‘non-expert’ investors can be effective;
- savers/investors, who may need to be more willing to seek, and to be prepared to pay for, advice, or confine themselves to relatively ‘vanilla’ products; and
- the financial services industry, in which the public may have higher expectations than hitherto regarding its responsibilities for providing trustworthy and value-for-money advice.

1.4 Has the response to both the global crisis and the finance company collapses gone far enough? If not, what else is needed in the way of government, industry, individual response?

13. Three policy developments that are currently under development or in the process of implementation are:²

- **Prudential regulation of ‘non-bank deposit-takers’** – to require bank-like institutions to maintain minimum prudential standards, similar to those applied to banks. Ideally a further step would be to simplify and further clarify the bank/non-bank boundary by restricting use of the term ‘deposit’ and ‘deposit-taker’ to institutions that are licensed, and supervised, as banks, with all other institutions then being described as issuers of risk investments.

² A number of the policy measures listed were initiated prior to, but have been accelerated by, the outbreak of the GFC.

- **Regulation of financial advisers** – to raise standards of professionalism, notably with respect to competence and conflicts of interest. The proposed Code of Professional Conduct, which will apply to all providers of financial advice, should see a floor being put under standards when there has been none previously. But whether standards lift to a more consistently adequate level may depend as much on the extent to which existing industry bodies take up the mantle of developing a more fully-fledged profession, say, along the lines of the accounting and legal professions.
- **Comprehensive reform existing securities law**, including to –
 - substantially revamp existing prospectus and investment statement disclosure requirements. Core proposals are that the information required to be provided to investors at the ‘point of sale’ should include (a) a risk rating, not just the information needed to enable investors themselves to make their own assessment; and (b) in the case of complex products, warnings that unsophisticated investors should not invest without taking professional advice. These proposals are well-aligned with the points made above in relation to ‘do-it-yourself’ investing and, if implemented, could make for a substantially more effective disclosure regime than hitherto.
 - consolidate the financial regulatory functions of the Securities Commission, MED and NZX into a new Financial Markets Authority, to create a single regulator focused on proactively monitoring and enforcing securities law. Reducing fragmentation of regulatory roles should make for more effective regulation. It is not clear, however, whether current proposals go as far as they could, for example, whether it would be beneficial also to incorporate the current *financial* regulatory role of the Commerce Commission under the Fair Trading Act, and the Takeovers Panel, into the FMA. In a similar vein, there is a question concerning whether the multi-layered structure for collective investment funds (fund manager, trustee, and administrator) is the most cost-effective approach. Does splitting roles and responsibilities strengthen or weaken scrutiny and accountabilities? And there is the question of cost, against the backdrop of a widely held view that the all-up costs (fees) for managed investment fund products are high relative to the value added.

14. An area of policy development that is at a more preliminary stage is macro-prudential policy. There is an emerging consensus, globally, that central banking during the last decade of two became somewhat bifurcated, with monetary policy focused on CPI inflation, and prudential supervision focused on individual institutions taken in isolation. As a result, the potential for system-wide financial booms and busts – which individual investors have very limited capacity to diversify against – was underplayed. In these respects the Reserve Bank of New Zealand, arguably, maintained a more integrated approach than most, as evident, for example, from the weight it appears to have attached to housing market developments in its monetary policy settings. But like other central

banks, it has identified a possible need for prudential policy to play a greater role in maintaining macro-financial stability. This should be a priority area for policy development going forward, and has been listed as such in the Reserve Bank's 2010 Statement of Intent.

2. Introduction

15. This report has been prepared as background for the 2010 Review of Retirement Income Policies being undertaken by the Retirement Commissioner, in accordance with the requirements of the Retirement Income Act 2001. One of the matters that the Government has asked the Commissioner to address is how the global financial crisis may affect the adequacy of retirement income provision for individuals at various life stages. In that connection, the Commissioner has sought an independent assessment covering four matters:³

- What impact has the global financial crisis had on individuals' savings and worth (considering, if possible, both the wellbeing of the current retired population and the retirement preparations of the non-retired)?
- What were the causes of the collapse of New Zealand's finance companies?
- What are the important lessons from the crisis for current and future retired populations in their management of savings and retirement income?
- Has the response to both the global crisis and the finance company collapses gone far enough? If not, what else is needed in the way of government, industry, and/or individual response?

16. The structure of this report follows the order of those questions. The first two questions are concerned mainly with the sources and impact of the crisis. The latter two are more forward looking and focus on the lessons and issues that emerge, both for the public in making and managing their investments effectively, and for policy-makers in providing a policy environment that supports the saving-investment process.

17. Two caveats should be noted at the outset. First, some of the conclusions and assessments presented, necessarily, are preliminary. While the initial impact of the crisis in global markets, and of the collapse of finance companies in New Zealand, is reasonably evident, these events have yet to run their full course. That is reflected in recent concerns about the possibility of sovereign default by some European countries, and about the possibility of a 'double dip' recession. After-shocks from sources such as these, potentially, could be quite severe. Moreover, most countries have scarcely

³ These matters also overlap significantly with another of the Commissioner's terms of reference, namely: the role of New Zealand's financial services sector in relation to retirement income provision, including what might be done to enhance markets' and consumer trust in the sector.

commenced, let alone completed, an exit from the extraordinary fiscal, monetary and financial support measures introduced to support their economies and financial systems through the immediate crisis. A full assessment of the effect of the Global Financial Crisis will not be possible until its second, and third, round effects have been worked through, and something closer to monetary and fiscal policy ‘normalcy’, has been restored, which may be some years away.

18. Second, given the nature of the questions to be covered, and the limitations of readily available and up-to-date data (including data that is disaggregated according to age cohort/retirement status), the analysis is mostly qualitative in nature. By the same token, the assessments made and conclusions reached take account of discussions with and comments from a cross-section of experienced observers of the New Zealand financial system, covering industry, regulatory, academic and consumer interests. Their input has assisted significantly, both as a source of ideas, and as a check on my own analysis, and is gratefully acknowledged. However, responsibility for the views and assessments presented rests entirely with the author.

3. What impact has the global financial crisis had on individuals’ savings and worth (considering, if possible, both the wellbeing of the current retired population and the retirement preparations of the non-retired)?

19. Since about mid 2007, and more especially since the failure of Lehman Brothers in September 2008, New Zealand has been rocked by financial stresses of a severity that have not been experienced since at least the share and property market crashes of the late 1980s, if not since much further back in New Zealand’s history.

20. Those stresses have come from both:

- the impact of the global crisis, particularly in the North Atlantic economies, on New Zealand’s financial system and investment markets. Those impacts have come through various channels, including:
 - losses of value in global equities and other financial instruments (eg, CDOs) held in New Zealand portfolios;
 - losses of value in holdings of similar, New Zealand-issued, financial instruments;
 - constraints on access by New Zealand banks to foreign funding sources; and
 - the more general impact of a sharp downturn in international trade and economic confidence on the New Zealand macro economy.⁴
- home-grown sources, in particular the failure of a large number of New Zealand finance companies.⁵

⁴ See the supplement to the Reserve Bank of New Zealand’s 2009 *Annual Report* for a chronology of the impact of the *global crisis* on New Zealand, at <http://www.rbnz.govt.nz/about/whatwedo/arfoldout2009.pdf>

⁵ A list of finance companies that have failed, commencing with National Finance 2000 Ltd in May 2006, up to May 2008, is provided in the Reserve Bank of New Zealand’s May 2008 *Financial Stability Report*,

21. While these, mostly, have been separate ‘shocks’ – it is hardly as though the finance company failures in New Zealand were *caused* by the impact of shocks from abroad – there are sufficient points of connection to take them together for the purposes of assessing their impact. Those points of connection include that both can be traced back to, inter alia, a quest for yield by investors in a relatively low interest rate environment in the early part of the decade, and weak, if not reckless, lending standards (sub-prime lending by mortgage originators in the US, speculative property lending by finance companies in New Zealand).

22. In other words, it is not as though during the period running up to the crisis New Zealand stood entirely aside from what was a period of exuberance in financial and investment markets. On the contrary, some of the same buoyancy in property and equity markets, and erosion of lending standards, as occurred in most other OECD economies also occurred here. And, in any event, with the global crisis and the collapse of our finance company sector having occurred at broadly the same time, it would be difficult if not impossible to fully isolate the effects in New Zealand of one from the other.

23. When examining the impact of the GFC on individuals’ savings and worth, it is necessary to take account of both direct and indirect effects. The direct and most obvious effects of the GFC include the impact on asset, including financial asset, values, for which quantitative estimates are reasonably available. But the less direct effects may be at least as substantial. These include sharply weaker fiscal positions, and hence larger future tax burdens, and curtailment of risk appetites which result in less private investment. Such effects can result in the economy’s future income-producing potential settling a notch or two lower than where it otherwise would have been.

3.1 The direct impact

24. An overview of the direct financial impact of the crisis on households, up until end 2009, is reflected in table 1.⁶

p 30; with a more up-to-date list available on the interest.co.nz website at <http://www.interest.co.nz/saving/deep-freeze-list>.

⁶ At the time of finalizing this report, data for 2010 was not available, but can be expected to reflect a softening in values across a range of asset classes during 2010, including most categories of real estate.

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Household financial assets										
Registered banks	40	43	47	50	55	61	70	79	90	93
Non-bank deposit-takers	5	6	7	8	10	12	12	12	9	9
Building societies	2	2	2	2	2	3	3	3	1	1
Credit unions	-	-	-	-	1	1	1	1	1	1
All other non-bank deposit-takers	3	4	4	5	7	8	8	8	7	7
Other fixed interest assets	8	8	10	12	14	14	16	19	22	26
Solicitors nominee company and contributory mortgages	1	1	1	1	1	1	1	1	1	1
Government stock	1	1	1	1	1	1	-	1	1	1
Other	6	6	8	10	12	13	15	18	21	25
Superannuation, life insurance and managed funds	56	55	49	51	54	57	65	65	56	63
Superannuation	22	21	19	19	20	21	23	24	20	25
Life insurance	9	9	8	8	9	9	9	8	7	7
Managed funds	24	25	22	24	25	28	33	33	29	31
Direct domestic equities	11	11	11	13	16	14	19	17	12	15
Direct overseas equities	6	5	4	5	5	6	8	9	5	7
Total household financial assets	125	129	129	140	153	164	188	200	195	212

Household financial liabilities	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Loans from banks and non-bank lending institutions	73	79	87	100	116	133	150	168	175	180
Loans from registered banks	69	73	80	92	105	121	136	154	163	170
Loans from non-bank lending institutions	4	5	6	8	10	11	13	14	11	9
Loans from non-bank lending institutions from RBNZ annual surveys	0	1	1	1	1	1	1	1	1	1
Life, super & managed funds loans	1	1	1	1	1	1	1	1	1	1
Solicitors' trust loans	0	0	0	0	0	0	0	0	0	0
Total household financial liabilities	74	80	88	101	117	135	151	170	176	181
Household net financial wealth	51	49	41	39	36	29	37	30	19	31
Less student loans	4	4	6	6	7	7	8	9	10	10
Plus housing value	231	247	282	370	429	506	559	614	568	603
Household net wealth	278	292	317	403	458	528	588	635	577	624

Source: RBNZ

Notes:

Totals may not add due to rounding.

- Not available

Note that these data do not include households' ownership interests in non-listed businesses, including farms, which are substantial. They are, therefore, not a comprehensive measure of household wealth. However, given that private firms and farms are relatively illiquid, and relatively infrequently traded, it is likely that data inclusive of these additional asset classes would not substantially alter the overall picture on movements in household wealth, as shown. Still, the *realizable*, as distinct from book, value of many privately-owned business will have been impacted, but some of that impact will have dissipated, in line with the recovery in business confidence in 2009, before softening during 2010..

3.1.1 *Some facts*

25. Salient points from table 1 include that:

- Household finances, in aggregate, took a moderate hit in calendar 2008, with falls in financial assets (-2 ½%), housing wealth (-7 ½%), and net worth, ie, the net of assets less borrowings (-9%).
- Within this high-level picture, superannuation, life insurance and managed fund investments (taken together), and the value of individuals' equity holdings, fell by nearly 15% and 35% respectively. These asset classes perhaps provide a better indication of the impact of the GFC on individuals' 'retirement savings'. On the other hand, some of those falls will reflect a diversion of savings, away from higher-risk asset classes and into bank deposits. The latter, which account for nearly half of all household financial assets, jumped nearly 14% in 2008.
- And most of the losses, at least in aggregate, were recouped during 2009. By end 2009, *real* household net worth and gross housing wealth were both back to close to end 2006 levels, ie, close to peak, pre-crisis, levels. Real financial assets by end 2009 were *above* pre-crisis levels, although markets since have given up some of the rebound that occurred during 2009.
- Housing remains the dominant form in which New Zealand households hold their wealth. Between 2000 and 2007, housing as a percentage of total household (gross) wealth increased from 65% to 75% and, despite a fall in house prices in 2008, a subsequent partial rebound saw the ratio still at 74% at 2009. This dominance of housing assets means that New Zealand households have a substantial exposure to the housing market. The fall in the value of housing assets in 2008, of \$46 billion, and the rebound in 2009, of \$35 billion, were multiples of the corresponding decline and rebound in financial asset holdings.
- Household borrowing has slowed considerably since 2007. In 2008 and 2009 the total stock of household borrowing increased by about \$6 billion and \$5 billion respectively, compared with increments of \$19 billion in 2007 and \$16 billion in 2006. Household borrowing has remained subdued in 2010.
- Deposits with finance companies, which grew rapidly between 2000 and 2005 (from \$3 billion to \$8 billion) have since tailed off, to \$7 billion at end 2009 (a figure that is overstated given that deposits with failed finance companies in receivership or subject to moratoria have not, in the table, been written down to their realizable value).
- There has been significant and sustained growth in households' holdings of 'corporate' bonds, from \$6 billion in 2000, to \$25 billion at the end of the decade.⁷ The trend, if

⁷ The 'Other fixed interest assets' category in table one comprises mostly corporate bonds, including bank-issued subordinated debt.

anything, kicked up in 2007 and 2008, reflecting both that during the crisis, corporates turned to the bond market as borrowing from banks become more difficult, and that fixed interest investors sought out alternative, perceived to be higher quality, securities than available from finance companies. Household investment in fixed-interest corporate bonds increased by \$7 billion in 2008-2009, to reach a level at end 2009 3½ times the aggregate of finance company deposits.

26. Overall, these data suggest that the *direct* impact of the GFC on individuals' savings and worth, in the aggregate, and taken over the whole crisis period up until end 2009, was comparatively modest.

3.1.2 *But aggregates mask disparate individual outcomes*

27. While the impact of the GFC on households, overall, has not been especially severe, this comparatively benign picture masks significant disparities in outcomes across individual households. Some households will have incurred permanent losses on a scale that will be devastating for their future well-being, a few will have augmented their wealth, whilst the majority will not have been impacted substantially, although on average will have experienced something of a set back.

28. Most prominent amongst those who have experienced losses have been investors in finance companies, and in some fixed interest managed funds.. There is no official data on those losses. However, unofficial estimates based on information collected on finance industry failures suggest that there have been more than 50 finance company failures affecting 195,000 deposits and that investors face losses of around \$3.8 billion out of around \$6.7 billion invested.⁸ The percentage losses vary widely, with some failed finance companies having returned over 90% of debenture holders' funds, and others expected to return as little as 10%.

29. Other investors will have incurred losses on equity investments, both directly held and via managed funds. Some commentators note, for example, that the loss in Telecom's market value, of about \$5½ billion since beginning 2007, is at least as great as the amount lost on finance company investments. However, the parallel can be over-drawn: an equity investment is quite different from a debt or bond investment, since with an equity investment there is also exposure to growth in value. Thus, even in 'normal times' some equities lose value, offset by some that grow in value. And unless a company fails, and is wound up, there is always some prospect that losses will be recovered. Thus far during the GFC, no major company listed on the NZX has failed.⁹

⁸ Source: Interest.co.nz website at <http://www.interest.co.nz/saving/deep-freeze-list>. Note that these data exclude deposits covered by the Government's retail deposit guarantee scheme introduced in late 2008, and that the number of deposits will be greater than the number of depositors affected to the extent that some people held deposits with more than one failed institution. On the other hand, the losses may be understated, should realizations come to less than expected, and where interest has ceased to accrue once a finance company has gone into receivership or moratoria.

⁹ This contrasts with the New Zealand experience following the share market 'crash' in 1987, when there was a spate of very large corporate collapses.

30. While the beneficiaries from the crisis will be few in number, there still will have been some. A few will have been astute enough early in, or ahead of, the crisis to have sold equities and bought prime fixed interest bonds which, with falling interest rates, will have increased in value. A few others may have benefited in ways that are more questionable. While in New Zealand ‘bankers’ bonuses’ have not been the issue they have been in North Atlantic markets, there still have been suggestions that the shareholders of some finance companies extracted dividends that, at least with the benefit of hindsight, were excessive. That is, dividends were paid even though subsequent events evidence that the company was actually facing a need for capital to be injected, not withdrawn, and as a result losses to investors have been greater than otherwise would have occurred.

3.1.3 Distribution of impact by age cohort

31. An aspect of the impact of the crisis that is of interest from a welfare-in-retirement standpoint concerns how it has been felt across different age cohorts. A particular focus is on older cohorts, ie, those in and approaching retirement, who have comparatively less scope to rebuild lost wealth by saving from future income.

32. While data are not readily available to enable a detailed analysis of the impact by age cohort, anecdotal information, and logic, suggest that the majority of the financial losses will have been incurred by older cohorts. Older cohorts generally have accumulated more than their younger counterparts, and thus, on average, carry a larger exposure to wealth-destroying events. And they tend to account for a disproportionate share of total financial asset holdings, given that a large share of the saving of younger cohorts takes the form of servicing/paying down a home mortgage. Moreover, a higher than average proportion of older cohorts’ financial assets are likely to take the form of *fixed interest* investments, given the, generally logical, tendency in retirement to shift from capital growth-generating (equity) investments to income-generating investments that provide the (stable) cash flow needed to substitute for previous wage and salary income. All these factors point to older cohorts being disproportionately represented amongst those who have suffered losses on finance company investments.

33. In this respect, it seems likely that the impact of the GFC, across age cohorts, will have differed from that following the share and property market crash in 1987. The wave of equity and commercial property investing in the run up to the 1987 crash – much of which was leveraged – seems to have been more broadly based, if not weighted toward younger to middle-aged cohorts, who will have had more time to recover from their losses before reaching their retirement years. In this sense, while the losses incurred by New Zealand investors from the GFC may be smaller than following the 1987 share market crash, the welfare impact, arguably, may be at least as great.

3.1.4 Housing wealth

34. Given that housing dominates New Zealand households’ wealth portfolios, and that the GFC emanated from – although has been far from confined to – housing markets, a focus on the impact on the New Zealand housing market is warranted.

35. In New Zealand the average price of houses fell in 2008 by 7½ per cent, but recovered by 6¼ per cent in 2009, before softening again in 2010. Overall, the impact on housing wealth, to date, has been modest. That has been a large factor in New Zealand having weathered the GFC better than a number of other advanced economies. That said, the run up in house prices earlier in the decade was as large and as prolonged in New Zealand as in other countries that since have experienced substantial corrections, raising the question whether further downward adjustment here may be in store.

36. Another factor that will have helped New Zealand avoid the sharpness of the housing market adjustment experienced by some other countries is that the banks (and the Australian parents of New Zealand's main banks), on the whole, maintained reasonably prudent home loan underwriting standards. To be sure, the banks competed aggressively to expand their residential mortgage books, but most of the take-up of mortgages was by mid- to higher-income households, with very little 'sub-prime' residential lending of the kind that was so prevalent in the US. That, in turn, can be attributed at least in part to the relative absence of securitization of residential loans in Australasia. Most of the credit risk in residential lending stayed with the mortgage originators (overwhelmingly the banks) and hence they faced incentives to maintain prudent under-writing standards. The absence of securitization can in turn be attributed to two key factors.

37. First, prior to the crisis, Australasian banks had ready access to offshore funding markets on competitive terms, largely the result of strong demand from Uridashi and EuroKiwi investors for what, by international standards, were high yielding NZD and AUD denominated investments. Hence, the banks did not face commercial incentives to securitise their own assets as a source of funding.

38. Second, the Australian and New Zealand bank supervisors maintained more prudent criteria for determining when the risk embedded in securitized mortgages could be regarded by banks as having been genuinely shed, and thus moved off the balance sheet and no longer in need of capital backing. Even if the banks had faced a need to raise funding by securitizing their home loan books, these supervisory policies will have helped contain the housing boom, at least in terms of channeling it towards higher income households.

39. Therein also lie implications for how the wealth effects of the housing boom have been distributed across different age cohorts. Older cohorts in or approaching retirement with largely debt-free homes will have benefited from elevated property prices which, so far, mostly, have been sustained. To be sure, that benefit can be realized only by 'trading down' (or borrowing against the equity in the property), but the option to do that should the need arise is itself of some value. Middle-aged cohorts that will have done much of the borrowing, by contrast, may take more debt into retirement than traditionally has been the case, with correspondingly higher debt servicing obligations. Whether or not that additional debt will be matched by corresponding additional housing wealth, of course, will depend very much on how house prices track over the next decade or so – with the possibility of downward correction being in prospect.

40. All of which goes to illustrate a more general point concerning the impact of shifts in house values on individuals' savings and worth, namely that shifts in house prices represent a redistribution of, rather than an increase or decrease in, wealth. If changing house prices reflect solely a shift in market valuations, of the same houses, in the same condition, then there is merely a transfer of value, as between current and future homeowners. Rising house prices, as in the period up until 2007, benefited existing home owners, who tend to be older, than those who do not (yet) own a house. And the dip since then will have shifted the balance back, a little, the other way. These shifts in wealth as between those who own and who do not own houses are quite different from those arising from a change in the condition of a house, say, in the cases of houses found to be 'leaky'. A lack of weather tightness in a home represents an outright loss of wealth. That loss of wealth has been estimated at about \$1½ billion, involving about 42,000 properties.¹⁰

41. A final note on housing is that averages, again, mask a diversity of individual situations. For some heavily mortgaged home owners, the market down-turn since 2007, and/or a lack of weather tightness, will have left them with little, or negative, equity in their house; and in some of those cases, such as those who lost employment income during the recession, losses will have been realized on being forced to sell, by way of mortgagee sale or otherwise. The number of mortgagee sales in 2009 was just over 3000, compared with under 500 in each of the years between 2005 and 2007.¹¹ It seems likely that most facing a forced sale will have been younger cohort households although, reportedly, there have been some from amongst older people who made leveraged residential property investments (of the kind marketed by Blue Chip) which may have resulted in forced sales.

3.2 Indirect effects

42. The indirect effects of the GFC on households are less obvious than the direct impact on the market value of their asset holdings, but potentially at least as significant.

3.2.1 On investor confidence

43. A feature of this crisis in New Zealand has been that amongst the most *prominent* investment losses incurred by the public have been those on what will have been regarded as *relatively* safe 'deposit' and 'fixed interest' investments (in finance companies and, for example, in the ANZ/ING bond (CDO) funds that collapsed in value). While losses on these kinds of 'fixed interest' investments (probably no more than about \$4 billion) have amounted to much less than the drop in equity values in 2008 (about \$9 billion alone on account of equities held directly by households), they are permanent, with virtually no prospect of recovery, whereas equity prices rebounded strongly in 2009. Even though the durability of those rebounds is now less certain than six months ago, the fact that markets recovered from their low points will have helped to put something of a floor under public confidence in the equity markets.

¹⁰ Source: Weathertightness – Estimating the Cost, a report for the Department of Building and Housing prepared by PriceWaterhouseCoopers, 29 July 2009.

¹¹ Source: <http://www.zoodle.co.nz/cms/terralink-mortgagee-sales-report>

44. A point of reference for gauging the magnitude, and consequences, of the impact of the GFC on investor confidence is the 1987 share market ‘crash’. There is a widely held view that that crisis left a generation of New Zealander’s wary of investing in equities, a contention that is consistent with the fact that the long term performance of the New Zealand equity market has languished. (The market capitalisation of the 50 largest listed companies has fallen from nearly \$43 billion at end 1986, the height of the mid-1980s equity market bubble, to a little over \$33 billion today.¹²) Investor appetite for commercial/industrial property investment also took a set-back, something that may have contributed to the subsequent appetite for property investment having strongly favoured the residential sector.

45. With the GFC having impacted prominently on retail debt investments, that is where any long term scars to investor confidence this time might be expected. However, early indications are that any such scars might be comparatively narrowly confined within segments of the financial system, that is, to finance company and more ‘exotic’ forms of fixed interest investments. There appears to have been no contagious affect on perceptions of prime corporate bonds and bank term deposits; on the contrary, as reflected in the data, there has been a significant lift in investor demand for these products.

3.2.2 *The fiscal impact*

46. While the government’s balance sheet does not represent ‘individual’ wealth, it does represent the financial position of ‘taxpayers’, and has a bearing on their financial position in so far as future taxes are a claim on their future income. And one of the largest impacts on New Zealand of the GFC has been via the public accounts. As the result, mainly, of lower tax revenues, some (automatic) increases in government social support spending, and additional discretionary spending to support the economy through the recession, the total net worth of the Government is projected (Budget 2010) to fall from nearly 58 per cent of GDP in mid 2008 to 37 per cent of GDP by mid 2013.¹³

47. This projected shift in the government’s net worth, at nearly 20 per cent of GDP, is about three times the drop in household net worth between end 2007 and end 2009. Thus, much of the impact of the GFC has been absorbed by government dis-saving; household saving, if anything, has increased, with the rate of household debt accumulation in particular having slowed quite sharply. While this rebalancing between household and government saving has significantly buffered the economy from the impact of the GFC, it also means that much of the impact has been shifted to future taxpayers, whether that will be as the result of future taxes having to be higher, or government spending having to be lower, than otherwise, or some combination of the two.

48. A specific fiscal decision that has been taken in the context of this changed fiscal position has been to suspend contributions to the New Zealand Superannuation Fund. That

¹² Source: NZX data for NZSX50 market capitalization.

¹³ Arguably some of this increase can be attributed to fiscal policy decisions taken before the outbreak, and should not be attributed to the impact, of the GFC. On the other hand, absent the easing in fiscal policy that occurred ahead of the crisis, it seems likely that there would have been a larger fiscal policy response to the crisis, and, in that sense, most of the weakening in the government’s fiscal position can be attributed to the crisis.

decision, in and of itself, has little if any effect on the Government's overall forward financial position. (If contributions had been maintained, the larger asset portfolio would have been offset by the additional borrowing the government would have needed to undertake to fund the contributions.) But given that the amount of funds specifically ear-marked for paying future superannuation benefits will now be less than previously planned, it is probably not drawing an excessively long bow to conclude that one of the impacts of the GFC will have been to reduce the level of certainty future retirees can have in the New Zealand Superannuation benefit being maintained on present terms. Meantime, however, the 'wealth' of today's 65 years and older cohort (and those within a few years of age 65), in the form of expected New Zealand Superannuation benefit payments, is being sheltered from the impact of the crisis by the Government's current commitment not to make any adjustments to superannuation entitlements.

3.2.3 *Some other buffering factors*

49. An analysis of *why* New Zealand has come through the GFC comparatively well is beyond the scope of this report, not least because any account would need to encompass Australia as well, given the nature and extent of the financial and economic connections and commonalities as between New Zealand and Australia. These include that:

- almost all of the commercial banking system, and large segments of the remainder of the New Zealand financial system, operate within the framework of corporate groups that span both countries, and under regulatory arrangements that are integrated at least to some degree.
- both New Zealand and Australia, as exporters of primary commodities, are integrated more with emerging Asia, which has been on the periphery of the GFC, than with the mature North Atlantic economies which have been at its epicenter. Moreover, Australia is the dominant external market for New Zealand's non-commodity exports.
- New Zealand and Australia both suffered severe financial sector stresses in the wake of the October 1987 share market 'crash'. That post-1987 crisis, in a number of respects, was more severe in Australasia than has been the impact of the GFC, and has had long-term effects on the financial systems of both countries. Many of those who occupy senior financial sector management and regulatory positions will have internalized lessons learned from that time, which may have helped both countries avoid the worst of the excesses in the boom years running up to the GFC.

50. Whatever the reasons, New Zealand's financial institutions – finance companies excepted – maintained credit standards in the boom period preceding the crisis that, on the whole, were reasonably prudent. Despite quite rapid expansion of banks' balance sheets and some pockets of what was lax lending, the growth in lending mostly was to middle- and higher-income households who could afford to service additional debt.¹⁴ New Zealand banks

¹⁴ The Reserve Bank of Australia has made similar observations on lending growth during the period to Australian households, see for example the RBA's March 2010 *Financial Stability Review*, pp 41-47. <http://www.rba.gov.au/publications/fsr/2010/mar/pdf/0310.pdf>

also had little involvement in financing leveraged ‘private equity’ deals, or with investing in the asset-backed securities issued out of northern hemisphere markets. Thus the core banking system remained reasonably healthy and, despite some tightening of credit standards during 2008/09, there has not been a ‘credit crunch’, and a collapse of asset prices, and of economic activity and employment, on the same scale as experienced by harder-hit economies. To be sure, the recession here was reasonably prolonged (five successive quarters of negative growth) but it was not of such severity as to cause great damage to the savings and net worth of New Zealand households.

4. What were the causes of the collapse of New Zealand’s finance companies?

51. Rarely do crises result for a single factor: a combination of contributing factors is usually involved, although some may be more critical than others. The collapse of the finance company sector in New Zealand has been no exception. The following considers what appear to have been the main causes of the failure of the finance company sector commencing mid-2006.¹⁵

4.1 High risk finance company business models

52. Finance companies vary in their business models and strategies, but broadly, can be categorized as providers of:

- (i) consumer credit;
- (ii) asset-based business equipment lending (including by way of leasing); and
- (iii) property development finance.

53. The finance companies that have failed mostly have been in category (iii), although a handful of consumer credit finance companies, mainly focused on second hand car financing, also failed. Those finance companies in the business equipment lending market segment have generally performed normally. Many of the latter are affiliates of major commercial organisations, and raise comparatively little funding from the public, instead raising most of their funding from group or other wholesale sources.

54. The failures of consumer credit finance companies can be attributed mainly to rapid growth achieved on the basis of very weak loan underwriting standards. They were also amongst the first to fail and, as things have turned out, recoveries for investors, through the receivership process, have been relatively good (75% to 90%). These outcomes stem in part from the failures having occurred early in the downturn, thus making for better outcomes on realizing/collecting on loan assets. They may also indicate that receivership is a better vehicle

¹⁵ For another account of the causes of the collapse of the New Zealand finance company sector, see the report provided to the Select Committee of Parliament by the Registrar of Companies (available as Appendix B at http://www.parliament.nz/NR/rdonlyres/16F22058-8DD8-4541-B9A9-064848076239/100892/DBSCH_SCR_4272_6521.pdf)

for collecting against personal debts, than the moratorium arrangements that have applied to most of the finance companies that mainly were financiers of property development.

55. Most, and generally the larger, of the finance companies that failed were property development financiers. A common characteristic of their lending was that no interest or principal repayments were required from the borrowers whilst the property project was under development; rather interest could be capitalized (added to the principal of the loan) and repayments deferred for, say, 3-4 years, while the development was being undertaken, with a view to sale and loan repayment on completion. This is in contrast with normal bank lending practices, where regular debt servicing payments, covering both interest and loan amortization, are the norm.¹⁶ As a result, the finance company lenders built what were in effect *growing* speculative exposures to the property market, with repayment becoming increasingly dependent on the market remaining buoyant. Absent inflation in property prices, default was always going to be a real possibility. The risk exposure was accentuated where finance companies funded developments as a 'second tier', or 'mezzanine', financier, ie, with their lending ranking in point of security after a funding tranche provided by, say, a bank.

56. Moreover, in the absence of cash flow from the loan portfolio, some finance companies will have been able to cover the full amount of their interest payments to investors only from the proceeds of further debenture securities issued to new investors, ie, by borrowing to pay interest on existing debt. As such, their operations had some of the characteristics of a 'ponzi scheme', especially if shareholders too were paid dividends in cash that was financed from the proceeds of new borrowings.

4.2 But a different picture was presented to the investing public

57. In contrast to the high risk character of the asset side of their balance sheets, many finance companies represented their liabilities to the investing public as 'deposits', or as 'secured', or as 'first ranking secured', debenture stock. These representations generally were both permissible and technically correct. The taking of 'deposits', in New Zealand, is not confined to banks; debenture-holders, typically, will have had a secured interest in the finance company's assets; and those interests typically will have ranked ahead of the company's other creditors.¹⁷

58. But the security afforded by the debenture security could be no greater than the quality of the loan assets over which that security was held, which in the cases of most finance companies were more 'speculative' than 'undoubted'. And a *first ranking* elevates the level of

¹⁶ Which is not to suggest that in the period running up to the GFC there was no 'property backed' lending by the banking sector. Indeed, the amount of such lending by banks, including by one or two overseas-based banks that were active in funding the New Zealand property sector, will have been at least as much as from finance companies. But with the banks being larger and more diversified institutions, with substantial business streams based more on the ability of the borrower to service debt from cash flow (eg, home mortgages, and business working capital facilities), ensuing losses on property related lending have not been of a magnitude to have caused significant impairment, at least not to any New Zealand-based bank.

¹⁷ Subject to any specifically noted prior charges, and preferential claims, eg, taxes and certain employee entitlements.

security only to the extent that there is other debt funding (and equity) ranking behind. Thus, a ‘first ranking debenture security’ did not provide much protection absent meaningful amounts of funding from other (unsecured) creditors or from shareholders.

59. This ability to represent the liability side of the balance sheet (the securities issued to investors) in a different light from the asset side (the loan assets on which investors were reliant for repayment) was something finance companies could take advantage of:

- through television advertising that conveyed positive images of safety and financial standing. Such advertising, because it did not explicitly refer to an offer of securities, but was confined to advertising a ‘brand’, was not subject to the provisions of the Securities Act that govern the advertising of securities.
- by way of investment statements and prospectuses that were ‘glossy’ and voluminous documents, but with key information on risks submerged beneath ‘marketing’ and/or detailed technical information. There is now a widely held view that the Investment Statement regime has failed in its objective of requiring issuers to present the terms and risk attributes of an investment offering in a simple, short-form, document that is suitable for the prudent but non-expert investor.
- by pitching offerings with moderate rates of return, say, three or four percentage points above bank deposit rates, but well under rates of return commensurate with the risk embedded in the loan asset portfolio. It seems that, with the ‘high return = high risk’ mantra having become widely understood by the investing public, finance companies ‘cottoned on’ to the possibility that offering ‘high’ rates of return would have deterred rather than attracted investors, and instead, implicitly, pitched their offerings on the basis that ‘moderate return’ must equal ‘moderate risk’. Besides enabling a positive pitch to investors, such a strategy will have left plenty of net interest margin – finance company lending rates typically were closer to 20 per cent (or more) than 10 per cent – to fund advertising campaigns, and to pay commissions to investment advisers.
- because accounting standards that permitted, and/or required, capitalized interest charged on loans to be recorded as income, thereby enabling profitable operations to be reported, albeit not on a cash basis. While the lack of cash flow from operations should have been evident from the cash flow statement required to be included in published financial statements, it appears that these did not receive the same attention from investors and advisers as did the ‘headline’ profit results. Moreover, in some cases the lack of operating cash flow may have been masked in various ways, eg, by rolling maturing loans into new loans, thereby enabling accrued interest to be realized, even though the interest payment was funded by the successor loan. Reportedly, some finance companies, similarly ‘rolled’ problem loans into new facilities, thereby avoiding the need to report problem loans in their accounts. These issues go to the adequacy of accounting standards, and/or of the auditing of compliance with them.¹⁸

¹⁸ An article by Rebecca Macfie, entitled “You are in Safe Hands”, in the April 3-April 9 2010 *New Zealand Listener* discusses these practices. See also the report to the Finance and Expenditure Committee of Parliament by the Registrar of Companies, op cit.

4.3 A liquidity or a solvency problem?

60. Following the tightening of global funding markets from about mid 2007, *banks* became more cautious lenders. One consequence was that potential end-buyers of properties under development found it more difficult to raise funding and either lost interest or walked away from potential acquisitions, leaving the developers unable to repay the finance companies which had funded the development phase. On this line of analysis, it might be argued that the impact of the GFC from abroad, on market confidence, and on banks' access to funding, was a, if not *the*, cause of New Zealand's finance company failures.

61. Thus there is a question whether provision of liquidity assistance to finance companies would have staved off the subsequent insolvencies; or whether by mid 2007 the 'die was already cast', with most if not all of the companies that failed, at that point, already destined for insolvency. The fact that by the latter part of 2007 – when perturbations in international funding markets were just beginning – at least 10 New Zealand finance companies had already failed, points to the latter interpretation.¹⁹ Subsequent events, in particular the lack of recovery in the property development sector, also points to the same conclusion. In that case, provision of last resort lending to finance companies would have breached the principle of lending only to illiquid, but not insolvent, institutions; or in other words, that the failure of the finance company sector stemmed from a solvency, not merely a liquidity, problem.

4.4 Failures in governance and/or supervision

62. There is a widespread view that standards of governance, supervision and audit of finance companies was inconsistent and, on average, low.²⁰

63. Specifically:

- There were instances of dividends having been distributed to shareholders when the circumstances might have indicated that the best interests of the company would have been served by conserving capital;
- There were instances where the requirements of the Financial Reporting Act had not been complied with, and/or prospectuses were signed off that are now the subject of proceedings being taken by the Securities Commission;
- In at least one or two instances, the previous business track records of directors and/or senior management would have raised questions about whether a 'fit and proper' test would have been satisfied (if such a test had been required to be applied);

¹⁹ See the Reserve Bank of New Zealand's November 2007 *Financial Stability Report* (page 25) for a list of the finance companies that had failed up to the time of that report.

²⁰ See Rebecca Macfie, and the Registrar of Companies, *op cit*, and Gareth Morgan, *After the panic: Surviving bad investments and bad advice*, Public Interest Publishing, 2009.

- The trust deeds for some finance companies did not take adequate account of the nature and extent of the risks inherent in the company's business model, with limited monitoring of compliance with covenants taking place.

64. These criticisms go mostly to standards of *governance*, as distinct from levels of *risk-taking*. In other words, overlaying questions about the levels of risk that were embedded in many finance companies business models are questions concerning how well those companies were governed – as companies. All companies are subject to minimum standards of governance, with higher standards expected of those that raise funds from the public, especially where the funds raised are represented as 'deposits'. It seems clear that the standards of governance – understood broadly to include the roles of directors, auditors and trustees – in the cases of some finance companies fell well short of the standards expected of bank-like institutions.

4.5 Connected lending

65. Some finance companies were significant financiers of the other business activities of their own shareholders, or parties closely related to their own shareholders. That, in and of itself, is not exceptional: many companies raise debt securities from the public by way of a related entity, eg, a subsidiary or a sister-subsiary, which on-lends the proceeds to elsewhere within the same corporate group. For example, Telecom on occasions has issued bonds to the public, using TCNZ Finance Limited as the vehicle for that purpose.

66. Where there is an issue, however, is where a company represents itself as being 'bank-like', ie, it is raising 'deposits', yet, in substance, it is a funding vehicle for its shareholders' own commercial interests. In the case of banks, or 'deposit-takers', there is an implicit representation that the assets backing the deposits are at arms length, very well spread, and 'monetary' in character, eg, amortising loans that are well secured. By contrast, where a commercial enterprise issues bonds to the public, investors typically will have a quite different perception of the nature of the investment involved. (No one will have thought an investment in TCNZ Finance Limited was other than an investment in 'Telecom'.) The problem in the case of a number of finance companies was that large amounts of the funds raised were channeled to property developments which represented both large (undiversified) and/or related exposures, when the pitch being made to the public was that the finance company was 'bank-like'.

4.6 Commission selling by financial advisers

67. There is also a widely held view that one of the factors that enabled finance companies to raise significant amounts of funds from the public, at interest rates not much above bank deposit rates, was that they paid high rates of commission to financial advisers, in order to induce favourable recommendations by advisers. How important a factor this was is difficult to gauge with any certainty. But there are reasons to believe it was material. Most finance companies had quite limited distribution networks of their own, and will have relied mostly on financial advisers, as well as newspaper 'coupon' advertisements, supported by television brand advertising, as their main distribution channels.

68. Arguably, the fact that commissions were required to be disclosed to investors (under the Securities Markets (Investment Advisers and Brokers) Regulations) should have countered any incentives advisers faced to skew advice in favour of investments paying the best commissions. But given that commission selling was mainstream, and that commission structures were not always straightforward, eg, they could include so-called trailing commissions, which could appear more like a fee for on-going service than a commission, probably resulted in investors often not being as conscious of the extent of the conflict of interest facing advisers as they might have been.

5. What are the important lessons from the crisis for current and future retired populations in their management of savings and retirement income?

69. The GFC has provided the largest stress test of financial systems, policies and practices for several decades; for New Zealand at least since the late 1980s when serious financial stresses followed the 1987 share market ‘crash’. Such episodes inevitably expose ‘fault lines’ and result in some ‘wake up’ calls. This crisis has been no exception, with considerable attention now being given to a wide range of issues, spanning financial regulation, failure resolution, financial literacy, and monetary policy management (what role for monetary policy in addressing asset price bubbles?) There are also issues and lessons relating to individuals’ own retirement saving practices, which is the focus of this section.

5.1 Background

70. In New Zealand retirement income depends mainly on:

- Government-provided New Zealand superannuation, a non-means tested, but taxable, benefit for which anyone over the age of 65, and satisfying certain residency criteria, is eligible to receive. This benefit is paid currently at a rate set at approximately 65 per cent of the average wage for a couple, and two thirds that for a single person. It is widely viewed as providing a base level of income support for retired persons, while at the same time, by, virtue of the absence of means testing, creating no disincentive for those who can and wish to continue working to an older age to do that.
- Savings accumulated by individuals over their working lives. That has been primarily a matter for individuals to organize themselves. Until recently there has been little by way of workplace-based saving structures. That, however, began to change from 2006, when the Government introduced the KiwiSaver scheme under which it makes a \$1,000 contribution on an account being opened; matches employee contributions by way of a tax credit up to \$1042 per annum; and requires employers to make matching contributions up to 2% of an employee’s salary (the latter contributions being exempt from income tax).²¹

²¹ From about 2002 tax benefits also became available for employer contributions to superannuation funds in general, under the specified superannuation contribution withholding tax (SSCWT) regime. Under this regime it became possible for at least higher income employees, on higher marginal tax rates, to substitute salary for superannuation contributions (‘salary sacrifice’) and have that income taxed at the lower SSCWT rate.

71. Thus, in effect, New Zealand has now moved closer to the three-tier structure that is typical of many countries: a state provided base pension; workplace-based saving, and individual saving with individuals' making their own arrangements. However, the New Zealand regime remains heavily based on individuals making their own investment decisions. While KiwiSaver schemes have official recognition (as to which certain criteria must be met), most aspects of membership – the choice of KiwiSaver provider, whether to take contribution holidays, whether to contribute more than the minimum, and what class of assets to invest in – are all open to individual choice. Thus, in many respects, it remains for individuals to plan their own saving for retirement.

72. The GFC has brought to the fore at least three issues that pertain to effective individual planning and saving for retirement:

- How much needs to be accumulated to maintain a desired standard of living in retirement?
- Effective management of accumulated savings in retirement.
- Effective investment management, more generally.

5.2 How much needs to be accumulated to maintain a desired standard of living in retirement?

73. How much one needs to save for retirement is determined by essentially two variables: the standard of living desired in retirement, and the rate of return that can be expected on that saving in the intervening years.²²

74. The Retirement Commission has calculators on its web site to assist people in developing their long-term saving plans. These assume a rate of return on saving of 2½% per annum, after fees, tax and inflation. That may seem a conservative rate of return, especially to an older generation that became used to double digit nominal interest rates during the 'great inflation' of the 1970s and 80s.

75. But a net real rate of return on saving of 2½% is probably in the right ballpark, possibly even a little on the high side. Theoretically, the long run real interest rate should be in the vicinity of the economy's per capita long run growth rate, which for New Zealand over the past 20 years has been 1.6% per annum. Or looking at what's realistic from another standpoint, if inflation is 2½%, the tax rate is 28%, and fees (before tax) are 2 %, the gross nominal return

²² Whether or not one owns a house, and how much if anything is owing on a mortgage, is also a major consideration. However, that is actually part of the saving choice set, given that paying down a mortgage is a form of saving, which generates a return equivalent to the rate of interest/rent which otherwise would need to be paid.

required to deliver 2.5% net real return is about 9%.²³ Few managed funds will have generated gross returns, over the longer run, as high as 9% p.a; over the past decade or two, returns averaging 6% to 7% have been more typical.²⁴

76. None of this is to suggest, or predict, that the period ahead will necessarily be characterized by similarly modest investment returns: past performance is not necessarily an indicator of future performance, and investment returns from one decade to the next can be quite volatile. There may even be reason to think that with asset prices generally now down from the elevated levels prevailing ahead of the crisis, asset *yields* going forward will be bit higher than previously, although that needs to be counterbalanced against the currently more subdued economic growth and earnings prospects (thus requiring lower asset values to maintain investment yields.). All things considered, it would seem prudent for individuals, in establishing saving targets, to allow for the possibility that rates of return on their investments will be a notch or two below what hitherto has been thought a reasonable expectation.

5.3 Effective investment management approaching and in retirement

77. The preceding analysis also carries implications for those in retirement, and looking to their investment portfolio to generate a reliable flow of investment income to substitute for previous employment income. The typical profile of those who invested in finance company debentures was someone aged 50+ years, probably with a significant, but not a large amount available for investment (say, up to a few hundred thousand dollars, rather than a million dollars plus). For these people, the additional 2%-3% p.a. return available from finance companies, compared with bank term deposits, may have appeared to provide a way to maintain a desired standard of living in retirement whilst preserving their (modest) financial capital.

78. To the extent this is an accurate account, it points to two things.

79. First, as above, there may well be a need for reassessment of the level of income that reliably and safely can be generated from an investment portfolio, in retirement as well as whilst saving for retirement. That feeds back into assessments of the amount that needs to be accumulated by retirement age.

²³ Assuming fees are 2% per annum might seem a little high, but the all-up fees incurred by investors who invest in many retail saving plans (including those charged by fund managers, trustees, custodians, and advisers, as well as any commissions that may apply) probably are closer to 2% than 1%. Indeed, information on the Retirement Commission's Sorted website on KiwiSaver fees indicates an (unweighted) average fee, across 330 separate funds, of 2.3% per annum (or 1.7% after tax assuming a 28% tax rate). See also Gareth Morgan op cit for a discussion of investment management fees.

²⁴ Gareth Morgan op. cit. (chapter 5) charts the performance of a range of (balanced) retail and employer sponsored investment/superannuation funds from 1994 to 2008. These indicate annual returns net of fees and taxes averaging about 2½ per cent (for retail funds) to 3½ percent (for a selection of employer sponsored funds), or, say, 6% to 7% before fees and taxes. By way of longer term comparison, over the 20 years since 1990 growth in the S&P 500 index of US equity prices averaged 5.9% (and over 30 years, 8.1%.)

80. Second, it may imply a need for those in retirement to be more willing to run down their capital in retirement, particularly in a low inflation/low nominal interest rate environment. Historically, high rates of inflation, and thus higher nominal interest rates than those prevailing today, will have facilitated consumption of capital in retirement. To the extent that people regard the inflation-compensation component of interest receipts as income available for consumption, they, perhaps unwittingly, run down their (real) capital. With lower inflation and lower nominal interest rates today than in earlier decades, consumption of capital in retirement requires more of the investment portfolio actually to be liquidated. Anecdotally, however, it appears that there is some aversion amongst older people to doing that, given inherent uncertainty about life expectancy, and perhaps also because the contingencies of life (poor health, etc) loom larger as we age. But the experience of the past few years suggests that if such aversion results in greater investment risk taking, in an attempt to sustain an income flow from the investment portfolio, there is a risk that will result not in preservation, or even consumption, of capital, but in its outright loss.

5.4 Effective investment management – there’s a lot more to it than meets the eye

81. New Zealanders are known as a nation of ‘do-it-yourselfers’. That is probably the case with respect to investment management at least as much as in other spheres of activity. Indeed, the regulatory regime for investment is constructed largely on the basis of such a presumption; for example, the purpose of an investment statement under the Securities Act is to “provide certain key information that is likely to assist a prudent but non-expert person to decide whether or not to subscribe for securities” (s 38D). In other words the document is pitched to the ‘do-it-yourselfer’, not to the expert professional adviser.

82. Consistent with this focus, emphasis has been given by the authorities, over a number of years, to imparting some key messages to the investing public. These have included, for example, that high return generally is associated with high risk and that diversification is a key to prudent investing. Another conventional wisdom is that there is a hierarchy of investment risks/returns, ie, cash, bonds, property and equities, in that order. And it is sometimes said that when it comes to investing, it is “time in, not timing”, that matters.

83. While there is a large measure of validity in all these principles, the GFC has made evident that if followed *naively* they can be as dangerous as they are helpful. As discussed above in relation to finance companies, it seems that the ‘high return = high risk’ mantra may have led some investors to develop the mistaken impression that moderate return, correspondingly, meant moderate, or not much, risk.

84. Similarly, some investors and advisers clearly interpreted diversification simplistically, for example, by thinking that investing, or accepting advice to invest, across a number of different finance companies would give them a well-spread investment portfolio; when what resulted was something closer to a concentrated and risky exposure to the property development sector. Moreover, the emphasis given to the benefits of diversification may have resulted in less attention being given to the *quality* of the underlying investments. A ‘junk’ bond does not become a ‘prime’ bond by virtue of being included in a portfolio of investments, least not if the portfolio comprises predominantly other ‘junk’ bonds.

85. In a similar vein, the conventional hierarchy of investment categories and returns – cash, bonds, property and equities – is no more than a broad guide, and pertains to ex ante expected returns, with no assurance that ex post actual returns, even over reasonably extended periods, will match those expectations. Indeed, risky investments at times, by definition, will disappoint, even if over the long run they may outperform safe investments. And divergences between actual investment outcomes and those that might be expected on the basis of the ‘normal’ hierarchy of returns can persist for a long time. For example, in New Zealand for most of the past 25 years short (cash) rates have been higher than long (bond) rates. Residential property also has delivered attractive returns over much of the period, taking account of tax free capital gains, whereas equity returns have tended to disappoint.²⁵

86. The more general ‘lesson’ embedded in these points is that investing in products beyond what might be called ‘vanilla’ products, such as bank term deposits and government bonds, calls for a degree of skill and experience. In a world where most aspects of life are becoming more technically complex, it is perhaps surprising that investing continues to be seen as much as it is as a do-it-yourself endeavour. It also raises a question about the realism of policy proposals to address the perceived complexity of investment offer documents by requiring them to contain simpler information for the non-expert investor, and underscores the need to raise the level of public confidence in the professionals the public looks to for financial advice. These aspects are discussed further in section 6 below.

87. Last, but not least, the GFC reminds that periods of financial instability, including crises, are a recurring feature of the economic and financial landscape. While the lessons learned, and policy changes resulting, from the GFC may make it less likely that a further episode of severe financial and economic instability will occur in the near term, it is inevitable that there will be further such episodes in the future.²⁶ Recognition that crises can and will happen carries implications for investors; notably the need to build some buffers into their borrowing and saving arrangements, buffers that provide some scope to ‘weather the storms’ that will occur from time to time.

6 Has the response to both the global crisis and the finance company collapses gone far enough? If not, what else is needed in the way of government, industry, or individual response?

88. Policy decisions already taken that address issues arising from the global crisis/finance company collapses have included:

- The introduction of a new, tripartite (Reserve Bank, Securities Commission and trustee corporation) supervisory regime for non-bank deposit takers (finance companies, building societies, credit unions and other deposit-taking mutuals). This regime has formalized a new, intermediate, class of investment product, so called ‘non-bank

²⁵ Which is not to say that broad pattern of investments returns is anyway embedded; they may be quite different in the years ahead.

²⁶ And ‘after-shocks’ from the GFC also are to be expected which, given New Zealand’s high external debt exposure, could still impact here quite strongly.

deposits'. These fall between bank deposits, with banks being prudentially supervised by the Reserve Bank, and risk investments, which are subject to the requirements of the Securities Act.

- The introduction of a regulatory regime for financial advisers.
- A decision to consolidate the Securities Commission, and most of the financial regulatory functions of the Ministry of Economic Development (MED) and of NZX, to form a new Financial Markets Authority.

89. In addition, a comprehensive review of securities law has been progressed to the point that a discussion paper proposing a range of quite fundamental reforms has been released. This discussion paper incorporates a number of responses to the recommendations of the Capital Markets Development Taskforce, which reported in late 2009.

90. Each of these areas of 'work in progress' are discussed in turn.²⁷

6.1 The introduction of a new, tripartite supervisory regime for non-bank deposit takers

91. The new supervisory arrangements for non-bank deposit takers are to be based on a set of prudential standards developed by the Reserve Bank, following along the lines of those applied to registered banks, but to be administered by trustee corporations, under the oversight of the Securities Commission. Also, each non-bank deposit taker will be required to obtain and publish a credit rating from one of the three major international credit rating agencies (Moody's, Standard and Poors, or Fitch).

92. In many respects, the root of the problems arising with finance companies was a lack of clarity in the boundary between 'deposits', which the public can take as being monetary in character, and 'investments', which can span a wide range of risk and require closer, case-by-case, analysis and evaluation. The introduction of the new regulatory regime for non-bank deposit takers addresses this problem by moving issuers primarily in the borrowing and lending business ('finance companies') much closer to being regulated as if they were banks. That should result in much less scope for 'expectations' gaps to re-emerge. But it may also leave less scope for financial intermediaries to provide asset-based business finance facilities, eg equipment leasing, funded by issuing securities to the public. While that need not be a concern from a retirement saving context, it might be from the stand-point of business being able to access some classes of funding. That suggests that the present regime might best be viewed as a transition to a simpler regulatory structure that draws a 'bright(er) line' between those institutions that are 'deposit takers', and those that are not and instead issue risk investments. The existing, so-called, non-bank deposit-taking institutions would then need to move in one direction or the other. The present regime for non-bank deposit-takers is required, by the legislation that enacted it, to be reviewed by 2013.

²⁷ Note that initial steps under some of these areas of policy development pre-dated the GFC/finance company failures. But the crisis generally has resulted in acceleration and /or extension of what already was underway.

6.2 Regulation of financial advisers

93. The new regime for regulating financial advisers is in the process of being implemented, and appears to have broad support. The need for more consistent and higher standards of professionalism amongst financial advisers, encompassing both technical capability and professional ethics, particularly regarding conflicts of interest, is widely accepted. The Code of Professional Conduct being developed under the Financial Advisers Act, and to take effect over the next twelve months, addresses both dimensions and should result, over time, in a lift in professional standards and in public confidence in the profession.

94. That said, there remain some potential issues about aspects of the regime now being implemented. One concern is that, because the regime applies to *everyone* who provides financial advice, it may result in constraints on the financial media and on public *commentary* on investment matters; which, given the smallness of the New Zealand market, already tend to lack depth. If that were to occur, it would run counter to desires to lift public understanding and awareness on investment matters, and to lift standards of financial literacy. Care will be needed to ensure that unintended consequence is avoided.

95. Which leads to a question whether it would be desirable, in time, to move to a regulatory regime more along the lines of those currently in place for the accounting and legal professions, ie, one that controls who can *represent* themselves as an ‘authorized’ or ‘chartered’ financial adviser, with front-line responsibility for maintaining professional standards resting more with the profession itself. That approach would remove concerns about having to be authorized in order to provide public commentary on investment matters. It would also be less of a ‘one size fits all’ approach, and would enable investors to continue to access advice from parties who might not qualify as ‘authorized’ financial advisers, but nonetheless are a ‘trusted’ source of investment wisdom. Such an approach probably has not been feasible initially since financial advisers currently are represented by a number of different industry bodies, making for difficulties in garnering the impetus necessary to establish a self-regulatory regime. But it should not be ruled out for the future; indeed, there are probably limits to the extent that standards can be raised by regulation alone, without the sector itself taking up the mantle of building a more fully-fledged profession.

96. Another issue concerns the continued permissibility of ‘commission selling’ of investment products, something that is (to be) banned in Australia and the UK. However, there is a broadly held view that whether legally permissible or not, commission selling of investment products is on the way out, and eventually will be banned.²⁸ Which leaves a question about how to achieve the transition from commissions to ‘fees for service’ that are charged directly to the adviser’s client. A concern is that the public may be reluctant to pay for advice which to date it has regarded as available for free. Strengthened commission disclosure requirements in the interim, that make commissions *very* explicit to clients, including as a dollar amount, and in a manner that shows how the commission is in effect the adviser’s fee,

²⁸ The Investment, Saving and Insurance Association Inc, which represents a large segment of the retail market for managed investment products, has indicated that its members plan voluntarily to phase out commission-based selling of financial products, although the timeframe for implementation of that plan has yet to be announced.

and comes out of investment returns, could assist in making the transition to fee-for-service based advice.

97. Some observers also question whether the standards of technical competence to be met by ‘authorised’ financial advisers might be set too low, to accommodate incumbents; or whether there is a risk that regulating advisers will raise public expectations of investment advisers to an unrealistic level. On the latter view, there is as much a need for a shift back towards more ‘vanilla’ investment products, as there is to lift adviser capabilities to match the complexities embedded in some modern day products. There are also some concerns that the Qualifying Financial Entity regime, which enables a firm rather than its individual employees to be the entity responsible for maintaining the requisite standards, may result in a ‘watering down’ of the standards required. That concern, however, needs to be balanced against the possible capability gains that can come from a critical mass of professional advisers operating as a team rather than as individuals. There are also some concerns that some financial advisers who, from experience, have built ability and competence, but who do not have the mandated levels of *technical* qualification, may be forced to exit the industry.

98. These considerations all point to a need for the current regulatory regime for financial advisers to be ‘bedded in’ rather than ‘set in stone’. While the regime now being implemented can be expected to give much needed impetus to lifting professional standards, further evolution of the regime may prove to be necessary. An important determinant of the direction that evolution might appropriately take will be the extent to which the current industry bodies evolve into a more fully-fledged professional body.

6.3 Establishment of a new Financial Markets Authority

99. The proposal to establish a new Financial Markets Authority (FMA) has been widely welcomed, consistent with a view that New Zealand’s regulatory arrangements have been excessively fragmented. That fragmentation has resulted in both over-laps (inefficiency) and under-laps (ineffectiveness), and has also been associated with soft accountabilities and scope for responsibility shifting.

100. The current proposal is to consolidate the financial regulatory functions of the MED and of NZX into a reformulated Securities Commission, resulting in a ‘twin peaks’ structure for financial regulation overall – that is, a single prudential supervisor (located in the Reserve Bank) and a single securities market regulator (the FMA). However, certain regulatory functions will remain outside of that framework. These include the financial regulatory functions of the Commerce Commission (under the auspices of the Fair Trading Act), the Takeovers Panel, and the remaining functions of the Companies Office within MED.²⁹ It is not obvious that there are compelling reasons for leaving these functions outside of the FMA.

²⁹ Note, for example, that both the Banking Ombudsman and the Commerce Commission have had jurisdiction, and active involvement, in addressing the problems that arose with certain ANZ/ING investment products. Another example of overlap and duplication is the regulation of payment, clearing and settlement systems – where the Reserve Bank, the Securities Commission and the Commerce Commission are all involved.

101. Another aspect concerns the location of the policy maintenance/development function in relation to securities markets. It appears that the plan may be for that role to remain within MED, following the model that policy should be split from implementation. That model has the advantage of protecting against policy ‘capture’ by frontline regulators; but also the disadvantage of policy becoming potentially distant from market developments. In that connection, there is a clear call for the new FMA to have a lead role in identifying market developments that could be inimical to public confidence, and in responding to them, pro-actively. Those responses will need to encompass all of effective enforcement of existing rules, active public communications, and provision of timely advice and recommendations to the government on any policy and law changes that are needed. To carry out these roles, the new Authority will need a mix of resources, spanning enforcement (legal), market surveillance (connectedness with the markets), media, and policy, similar to how the Reserve Bank’s prudential supervision role spans both policy and front-line supervision.

102. A related matter concerns how some financial service providers will continue to be subject to multiple layers of regulation, supervision, and scrutiny – sometimes by three or more from amongst a cadre of supervisors, regulators, trustees, auditors, and rating agencies. Non-bank deposit takers, for example, are now subject to oversight by the Reserve Bank, the Securities Commission, a trustee corporation, and a rating agency, as well, of course, by their own auditors and directors. Similarly, managed investment funds typically involve an investment manager, a custodian, a trustee, and investment advisers, with the Securities Commission having an oversight/supervisory role.³⁰ It can hardly be said that in New Zealand there have been insufficient pairs of eyes involved!

103. The decision to establish the FMA, and the review of the Securities Act now underway, provide an opportunity to take a thorough and wide-ranging look at how best to achieve *cost-effective* regulation of New Zealand’s investment markets and institutions. Quite apart from the question whether the existing fragmentation and multiple layers of supervision strengthen or weaken scrutiny and accountabilities, there is the question of cost. There is a widely held view that (all-up) fees for managed investment fund products in New Zealand is comparatively high, and absorb a significant proportion of gross returns, ie, that the costs are not matched by commensurately better investment performance. This amounts to a view that the sector is a low productivity sector, ie, input costs are high relative to the value added. How much of that is perception and how much is reality is difficult to establish objectively, given a lack of consistency and transparency in how fees and returns are disclosed.

104. Proposals are already afoot to make fees and returns more transparent, and comparable across alternative products. That initiative might also provide a basis from which the soon to be established New Zealand Productivity Commission might usefully be commissioned to investigate the productivity performance of the New Zealand retail investment services sector, which, *prima facie*, is low. Such an investigation, ideally, might be undertaken in collaboration with the Productivity Commission’s Australian counterpart. Australia provides a useful counter-factual, both in that there is less overlap in the roles of its financial regulators, and collective investment schemes there operate under a ‘single responsible entity’ model. Another

³⁰ Additionally, MED is seeking comment on whether collective investment funds should be required to have an external administrator, who would be responsible for, for example, unit pricing.

aspect is the very small size of the New Zealand savings and investment markets. With only a very small pool of investment funds across which overheads can be spread, there is a question whether further steps toward establishing a single financial market with Australia might help address some of that disadvantage.³¹

6.4 Prospectus/investment statement disclosure requirements

105. The investment statement and prospectus disclosure regimes prescribed by the Securities Act are widely regarded to have failed. It is thought that few people refer to them and, if they do, that few find them useful for informing their investment decisions. The main problems are that the most pertinent information often is submerged by ‘glossy’ marketing material and/or voluminous technical detail. It also seems that a culture may have developed to the effect that provided legal/technical disclosure requirements have been met, everything is ‘ok’. In other words, disclosure requirements potentially can shield issuers from, as well as expose them to, responsibility.

106. The Capital Markets Development Taskforce (CMDTF) has recommended that these weaknesses in the existing Securities Act disclosure regime should be addressed, inter alia, by requiring issuers to provide investors with a short-form key information summary, of not more than two pages, which sets out in *plain english* the main terms of, and risks embedded in, the investment offering.

107. The difficulty in crafting a template that will be effective in achieving that – ambitious – objective should not be underestimated. Many investments nowadays entail degrees of complexity that may defy simplification to the degree envisaged, at least without the disclosures becoming ‘simplistic’ and potentially mis-leading (just as it has turned out that some investment ‘mantras’ may have been as harmful as they have been helpful to non-expert investors). Alternatively, the envisaged short-form disclosure document may end up containing little more than ‘health warnings’, disclaimers, and cross references to the detailed information available in the detailed prospectus.

108. These considerations point to a possible need for a more fundamental re-think of what makes for an effective disclosure regime for the investing public; a shift from providing prospective investors with the information they need to evaluate risk for themselves, to actually providing them with a risk assessment.

109. The CMDTF recommendations go some way in this direction, with a proposal that the disclosure document for particularly risky or complex products must include a warning label to that effect, highlighting the need for caution and to seek independent advice. The MED Discussion Paper on a new Securities Act takes this idea a step further by countenancing that issuers be required to provide an actual risk-assessment, not just the information needed for the investor to make their own risk-assessment. That might be a self-assessment, or an assessment

³¹ Although it is sometimes noted that fees charged by investment funds in Australia also are high, possibly stemming from the fact that investment managers have a captive market owing to Australia’s compulsory saving arrangements.

provided by an independent third party.³² The disclosure document containing this information would be short (one to two pages), but detailed financial and other information would still be required to be made available to professional analysts/advisers, and investors who would like it, on a government run web site.

110. On their face, these proposals have merit. The risk assessment would be made by those best placed to make it, and might operate along the lines of a ‘traffic light’ that would be unlikely to be missed. Although there would be an obvious incentive for issuers to understate risk, that should be capable of being countered by attaching accountabilities to those who make the assessment; and because questionable risk assessments would be something of a ‘lightning rod’ for public commentary.

111. Health warnings might also have a useful role to play where products are complex. And potentially there is scope here to leverage a stronger financial advisory profession, for example, if such warnings were, prominently, to include a recommendation to seek independent advice, or possibly even to include a requirement that the investor provide evidence of having done so before investing. (While the latter may be going too far, it is instructive that banks generally will not establish a mortgage facility without evidence of the borrower having received independent legal advice.)

112. Whilst the above kinds of proposals would, in some respects, shift more responsibility onto those issuing/selling financial products, they could also result in a shift, over time, in the balance of resources utilized in the securities markets, from legal resources that are engaged to ensure technical legal compliance by issuers, to investment advisory resources, and market commentary, that supports the ‘buy’ side of the market. With both securities law reform and implementation of the law governing the giving of financial advice in train, there exists an opportunity to capture complementarities in ways that should help each to leverage the effectiveness of the other.

6.5 Remedies and sanctions

113. Where it is established that wrong-doing, negligence or mis-management by those issuing or selling investments has resulted in loss to investors, the sanctions that can be applied, and the remedies available to investors, are important strands in the fabric of arrangements that underpin public confidence in the saving and investment process. Sanctions deter actions that could be detrimental to investors’ interests, and remedies provide compensation, or part compensation, where losses have been incurred that are outside the bounds of the risks that investors could and should have managed themselves.

114. For sanctions and remedies to engender public confidence, they need to be, respectively, consistently applied and reasonably accessible. Otherwise outcomes can end up being seen as uncertain, unfair, disproportionate, and even capricious. An evaluation of how

³² One approach, at least for investments represented as a fixed interest investment, would be to require issuers to represent the risk by way of two metrics: one that states the probability of default, and the other that states possible loss given default. Simple quantitative metrics along these lines have long been used by the risk management units in banks, and have been formalized into the Basel II capital adequacy framework for banks.

well the existing set of remedies and sanctions, across the New Zealand financial system, measure up against these criteria is beyond the scope of this report; but some observations nonetheless can be made.

115. First, in New Zealand, access to remedies by investors, traditionally, has been founded on the access investors have to the courts to pursue civil claims. But in recent years, that has been extended to include industry-based dispute resolution schemes, namely the Banking Ombudsman Scheme, and the Insurance and Saving Ombudsman Scheme. And that aspect of the framework of remedies is in the process of being extended to cover all providers of financial services to the public (by the Financial Service Providers (Registration and Dispute Resolution) Act 2008).

116. In that sense, access to remedies for investors is already in the process of being extended.³³ In another sense, however, that access will remain relatively narrow. While there will be a comprehensive set of mechanisms for arbitrating on matters in (contractual) dispute, there will remain no arrangements for settling claims/losses where an institution has failed. To cover, or part cover, (credit) losses arising in that circumstance, some form of insurance or compensation scheme would be needed.

117. Australia in the past few years has introduced low-level compensation schemes covering retail deposits and insurance, and requirements for holders of a financial services licence to have adequate professional indemnity insurance (with ASIC having quite comprehensive powers to take proceedings on behalf of investors). New Zealand has little by way of comparable arrangements. That said, in the wake of the GFC, which saw government's just about everywhere, including in New Zealand, intervene to protect 'deposits', there now is probably a perception of greater (de facto) protection for bank deposits, and especially large bank deposits, than previously.

118. Against this backdrop, it would be timely to take a comprehensive look at the overall structure of and balance in the remedies that depositors and investors have in New Zealand when 'things go wrong'. Do the existing arrangements strike the right balance – between judicial and industry-based dispute resolution arrangements, between remedies and sanctions, between ambiguity and predictability, and in countering 'moral hazard', facilitating diligent risk-taking and providing a basis for the public to have confidence in the financial services sector?

6.6 Financial pro-cyclicality and systemic risk

119. One of the main policy issues to have emerged from the GFC, globally, has concerned the tendency for financial systems to swing from excessive exuberance to crises of confidence, sometimes referred to as a process of building and bursting 'bubbles'. During the past two to three decades, most parts of the world have experienced such an episode, with those in Japan, (late 1980s), Australasia (late 1980s/early 1990s), Scandinavia (early 1990s), and East Asia

³³ Even over-extended in so far as the multiplicity of parties involved with some investment products give rise to potential scope for multiple claims in respect of what is a single problem, or 'dispute resolution shopping'.

(late 1990s) having been prominent. The GFC has been the latest, and largest, of what has been a series of macro-financial booms and busts.

120. Policy-makers now widely acknowledge that bubbles can and do occur, even if the theory remains incomplete; and there has been a marked shift in thinking about the policy implications. Whereas up until the GFC the predominant view had been that the best policy stance, largely, was to stand aside and to stand ready to ‘clean up the mess’, the mainstream view has shifted toward policy having a counteracting role. The main focus has been on developing macro-prudential frameworks, within which prudential instruments would be adjusted to lean against the marked shifts in risk appetite that are associated with financial bubbles. But, so far, policy frameworks for this purpose are at no more than at a formative stage.

121. The Reserve Bank has the foundations in place for adopting such a role, with banks, and soon, non-bank deposit takers, subject to capital and liquidity/core funding requirements. The Reserve Bank has indicated a cautious view on adjusting these in a counter-cyclical manner; but with policy development in this area identified as a priority.³⁴ Meantime, the Reserve Bank appears to see the prudential requirements currently in place, in particular the core funding ratio applicable to banks, as providing something of a bulwark against any near-term recurrence of unsustainable financial expansion, given the relative shortage (and expense) of domestic retail and long-term foreign funding.

122. While there is no urgency to settle on an operational framework for macro-prudential stabilization policies, given few signs of a return to excessive exuberance any time soon, there is a risk that as time goes by, the policy focus will wane, as it did, outside of Asia, after the Asian crisis. That could see little being learned from the GFC experience.

123. Yet, the costs of unsustainable financial booms and busts of the kind experienced during the past decade or two can be large. And as has been starkly evident during the past 2 to 3 years, systemic risk is something that individuals have only limited scope to diversify against, or manage themselves through, not least in planning and saving for retirement. That points to a need for central banks to focus in the period ahead on developing a stronger policy framework within which to carry out their ‘financial stability’ function’, in much the same way as they developed a stronger framework for monetary policy following the ‘great inflation’ of the 1970s/80s.

³⁴ In its 2010/2011 Statement of Intent. See also an article by Deputy Governor Grant Spencer on the evolving macro-financial stability (MFS) function of the Reserve Bank in the June 2010 Reserve Bank Bulletin, available at http://www.rbnz.govt.nz/research/bulletin/2007_2011/2010jun73_2spencer.pdf