The Financial Crisis in New Zealand: An Inconvenient Truth

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Abstract

The financial crisis has been the topic of recent financial debate and the motivation behind initiatives to tighten the regulations governing the financial sector. In New Zealand the financial crisis reached its height in 2006. This paper traces the development of the financial sector in New Zealand from the early 1970's through to the financial collapse of 2006-2009 and the aftermath of regulatory reviews, finger-pointing and corrective measures that dominated the last three years to the present day. The paper argues that the financial crisis is the product of an inconvenient truth that has been legitimised over the past century, encouraged poor corporate governance practices, and that the knee-jerk reaction to correcting the regulatory framework is too-little too-late.

Key Words: Financial Crisis, New Zealand, Corporate governance

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Introduction

The financial crisis of 2006-2008 has become a worldwide talking point and the subject of much debate in the financial sector. New Zealand has not been any less affected by the crisis compared to its other trading partners in Europe, Asia and the Americas. The current financial crisis is not the first to occur since the great depression of the 1930s. In the last 40 years there were four of significance which affected New Zealand. These include the debt crisis of the early 1980s, the Mexican crisis of 1994, the Asian crisis of 1997 followed closely by the Brazilian crisis of 1999 (Palma, 2004). Less than a decade after the last of these is the most recent crisis which overshadows all four of these in terms of magnitude and duration. For New Zealand the height of the financial crisis was reached in 2006 with a total of more than 40 finance companies going into liquidation or receivership, closed or placed in moratorium. The impact has been widespread but with particular severity on fixed income investors and property developers.

The focus of this paper is to explore the financial environment of New Zealand and to link these to both the current financial crisis and the reaction that has been taken by both the financial sector and government regulators. The paper draws on data relating to failed financed companies in New Zealand between 2006 and 2010 and synthesises the commentary that has accompanied these failed companies. The theoretical framework is that of agency theory and is discussed further in section 2.

The paper begins by providing a review of the Asian crisis of 1997 (section 1) in order to establish the context for analysis. Section three includes a review of the New Zealand financial market from 1970 through to the current period including the motivations that influenced its development over this period. Section four discusses the reasons behind the collapse of many finance companies in New Zealand. Section five discusses the reaction to the crisis by standards setters, regulators and treasury. The last section provides a summary of the findings together with the contribution that this paper makes to the extant literature.

Section 1: The Asian Crisis

The Asian financial crisis is a forerunner for the current crisis and it provides insights as to the circumstances leading up to it. While there have been a number of these over the past 40 years, the 1997 crisis is selected for its relative magnitude compared with the 1982 debt crisis, 1994 Mexican crisis and more recent 1999 Brazilian financial crisis (Palma, 2004). The Asia crisis has also been selected as its commercial impact on New Zealand are greater compared with the other three. The wealth of literature surrounding the Asian financial crisis allows for greater analysis of its cause, impact on the financial market and therefore any potential similarities to the current one. Much of the analysis that has been carried out to date with respect the Asian crisis draws on the information and discussion surrounding those of the previous two decades. In the same manner, the analysis of the financial crisis for New Zealand will draw on the case studies of its forerunners.

The events leading up to the Asian financial crisis follow an unfortunate yet logical sequence of events. Prior to the 1997 collapse, the Thai baht was fixed to the US dollar at a rate of 25 baht to a single US dollar. This initial exchange rate made Thai exports attractive to its trading partners leading to a balance of payments surplus (Sundaram, 2004). When the US dollar fell relative to the Japanese yen, Thailand's export prosperity increased even further as the baht's value fell in line with that of the US. Confidence in the Thailand economy ballooned to such an extent that Thai companies and banks borrowed US dollars to finance their activities and growth (Feldstein, 2003; Sundaram, 2004; Wade & Veneroso, 1998). This was done on the understanding that the baht would continue to be fixed to the US dollar. This understanding was supported by the Thailand government's assurance that it would continue to support the US$ Thai-baht exchange rate (Feldstein, 2003). The economic performance of the Thai economy over this period created a false sense of security among investors and gave credibility to the government's assurances. The circumstances necessary for a financial collapse to occur were now set in place and awaiting the catalyst that would trigger the bursting of the bubble (J. B. Taylor, 2008). The vulnerability in Asia was based on an over-reliance on the fixed exchange rate between the baht and the US dollar. Revenue was typically denominated in baht while the foreign sourced debt was denominated in US dollars.

Increases in inflation in Thailand, fuelled in part by the economic prosperity of the previous two decades, lead to a fall in international competitiveness. The baht became overvalued. To compound the situation further, the US dollar was appreciating relative to the Yen. The current account deficit that increased dramatically deteriorated over the 1990s until it became 8% of the GDP in 1997 (Feldstein, 2003). The Thai government attempted to support the value of the falling baht by using its own foreign currency reserves. These attempts were not sustainable and eventually the government was forced to float the baht (Edwards, 2003). The immediate effect was a fall in the value of the baht to 50 per US dollar. At this exchange rate the US dollar denominated debt effectively doubled, marking the height of the Asian financial crisis.

Market Liberalization

The economic circumstances surrounding the Asian financial crisis have been the topic of a number of research studies. Allen and Gale (2004) suggest financial liberalization leading to expansion in credit as a forerunner of the financial collapse. As evidence, they sight escalation in asset prices in Japan, Norway, Finland and Sweden in the 1980s, which was then followed by the collapse of the 1990. The liberation of the banking sector in Mexico in the 1990s, in the form of removing the reserve requirements led to a steep increase in credit creation for private borrowers and an escalation in asset prices. The period of high asset prices was short lived as a shift in the political climate marked by the assassination of Mexican Presidential candidate Luis Donaldo Colosio in March 1994, began a chain of events that saw stock and asset prices fall and the eventual collapse of the banking sector.

Wade and Veneroso (1998) concur with this view in relation to the Asian financial crisis of 1997. They suggest that the Asian financial crisis is not one of solvency but liquidity. “Creditors have ‘run’ on the currency and domestic assets, leaving the borrowers unable to continue to finance their loans. It happens partly because of excessive financial deregulation, including, above all, allowing firms to borrow abroad without any government control or coordination” (Wade & Veneroso, 1998, p. 5).

Deregulation of the financial markets is a fundamental characteristic of the free capitalistic market itself. The capitalistic market in its purist form is consistent with few regulations allowing market forces to reach equilibrium. Soros (1999) suggests that the financial crisis is

a necessary consequence of capitalistic markets. “ International financial markets have served as more than just a passive transmission mechanism for the global contagion; they have themselves been the main cause of the economic epidemic” (p. 56). He adds that policy makers need to be aware that financial markets are inherently unstable and is more than a pendulum shifting backwards and forwards between recession and recovery, but rather a ‘wrecking ball’ that swings from country to country destroying everything in its path.

Bird and Rajan (2001) found that the banking sector and the implementation of financial liberalisation contributed to the Asian crisis by facilitating the conditions that lead to the occurrence of a currency crisis. They suggest that “a graduated and sequenced internationalisation of the domestic banking system is also a relevant part of financial sector reform aimed at raising efficiency” (p. 907). In an economy where the banking sector is not geared to identify and act on the long term implications of disparities between the current account, domestic interest rates, exchange rate regimes and international capital flows, there is little scope for relying on it to curtail the impact of a pending financial crisis.

In 1986, Hyman Minsky introduced a *Financial Instability Hypothesis* to explain the incidence of financial crises. Minsky (1986) suggests that the elements responsible for creating financial instability are inherent in the system itself. He notes that in any open economy, innovation drives investors to move beyond hedging their investment portfolios towards financial speculation. Such behaviour is endorsed and encouraged as this leads to equilibrium. With the broadening scope of financial instruments and international capital markets, speculation is the driver of both speedy economic prosperity and economic collapse (Arestis & Glickman, 2002; Morris & Parrish, 1997).

The response of investors to a pending financial crisis has been described as a self-fulfilling prophesy of the inherent in the financial market mechanism (Allen & Gale, 2004; Radelet & Sachs, 1998), The panic reaction by some investors to withdraw their money from the bank has lead to a ‘run’ on bank reserves beyond the levels they normally hold. Repeated instances of this happening have created a stabilising role for central banks and the government. This stabilizing role has taken on the form of the management of reserve to asset ratios, monetary policy, greater financial disclosure, and lender of last resort. These measures have largely eliminated the incidence of banking crises at the domestic level. However the same cannot

be said of the international financial market. Radelet and Sachs (1998) suggest that for this reason, international financial markets are more prone to panic reactions than domestic financial markets. The perceived lack of coordination and mixed political agendas at the international level promotes the ‘mob psychology’ of withdrawing from a doomed project before you are left carrying the financial burden yourself (Allen & Gale, 2004).

Emerging Economies

Financial crisis and emerging economies are generally associated, leading to a view that financial crisis is a characteristic of emerging economies (Mishkin, 2003; Palma, 2004). The association is unfortunate as the capital flows, and flow-on consequences of a financial collapse is not isolated to the emerging economies within which they are seen to occur. Greenspan (1998) describes the recent liberalisation of international trade, new technologies and financial instruments as creating a global and interdependent financial market. He writes:

> There is a clear sense that the new technologies and the financial instruments and techniques they have made possible, have strengthened interdependencies between markets and market participants, both within and across national boundaries. As a result, a disturbance in one market segment or one country is likely to be transmitted more rapidly throughout the world economy than was evident in previous eras (Greenspan, 1998, p. 244).

The financial crisis in 1997, while identified as occurring in Thailand, impacted on the currencies and economies of Indonesia, Malaysia, the Philippines, Taiwan, Hong Kong, Korea, Estonia, Russia, Brazil, Australia and New Zealand (Wade & Veneroso, 1998). Emerging economies are characterised with a desire for economic prosperity that can be expected to be greater than that of its richer trading partners. Encouragement to expand is spurred on by multinational institutions including the World Bank (WB) and International Monetary Fund (IMF) (Lim, 1998). These institutions promoted a liberal financial market without attention to the localised infrastructure to administer such accelerated economic development. Lim (1998) suggests that the emerging economies of Central and South East Asia, Latin America and East Central Europe have been used as showcases for the expansion of western free market models with little attention to the underlying culture and capacity for these economies to embrace such a model.

The desire for economic recovery and prosperity by countries classified as emerging provide an incubator for creating the circumstances that result in the financial crisis. The attraction of emerging economies to international investors is based on a number of drivers including low cost of labour, high returns, host government incentives and general enthusiasm on the part of the host country to receive foreign investment (Sundaram, 2004). Emerging economies are often characterised with relatively low labour costs. The relatively low cost of labour in emerging economies is supported by the stringent border controls on the free flow of labour from developing countries to the wealthy and developed. Multinational corporations provide a mechanism for overcoming the free flow of labour by establishing their operations in these developing countries (Eiteman, Stonehill, & Moffett, 2004). Governments of these developing countries encourage foreign investment as a means of addressing domestic unemployment and economic growth. The cooperation that multinational companies receive from host governments can take on a number of forms. These include subsidies, tax incentives, regulatory concessions and financial support. The result of this cooperation with an expected outcome that looks to benefit all involved is significant capital inflows into host country.

Capital inflows were not limited to those through multinational corporations. Emerging economies promised higher yielding investment opportunities and a less regulated financial environment compared with many OECD countries (Palma, 2004). Foreign direct investment into these emerging economies continued leading to an escalation in domestic asset prices.

The inevitable outcome of foreign investment is economic growth and fiscal surpluses that lead in turn to domestic prosperity, demand driven inflation and an increase in labour costs. This market reaction is entirely expected as it represents the well established model of demand and supply. Eventually the incentives that made foreign investment attractive begin to disappear in favour of other investment destinations. At this point, host governments will try and defend the economic stability of the country through managing foreign exchange and monetary policy (Baig & Goldfajn, 2002; Krugman, 1979). These efforts are temporal and may lead to a panic reaction on the part of investors who quickly realise the imbalance between foreign denominated debt and foreign exchange reserves. Some writers have identified these measures as a source of 'moral hazard' and 'crony capitalism' suggesting that governments exacerbate the eventual impact of a financial crisis by creating a false sense of

comfort for domestic and foreign investors (Arestis & Glickman, 2002; Krueger, 2003; Palma, 2004; Radelet & Sachs, 1998; L. Taylor, 1998; Wade & Veneroso, 1998).

Emerging economies provide good incubators for financial crises. Capital movements are relatively quick and not constrained in the same way as physical assets. Coupled with the speculative nature of the modern investment, investor confidence is important for financial stability. Managing investor confidence in an environment of instantaneous telecommunication leads to a commercial environment of volatility. A nervous reaction from investors may trigger a surge of capital flow out of the host nation with such a momentum that a credit crisis is immediately followed by a financial one. This has been the case with each of the financial crises of the last four decades. Emerging economies make good incubators for financial collapse because of the infant or weak financial infrastructure that they have when they are the target of foreign direct investment. Palma (2004) suggests that the liberalisation that many emerging economies undertake for the sake of economic growth is often so sudden that it leads to the "interaction, on one side, of international financial institutions with very little knowledge of the institutional dynamics of emerging markets and, on the other, of still inexperienced domestic financial players" (p. 121).

Radelet and Sachs (1998) suggest that emerging economies are prone to financial crisis because of their relatively low and volatile holdings of foreign reserves. The volatility of these foreign reserves, coupled with the relatively low levels that they hold, make these emerging economies illiquid following even minor shifts in capital flows. The case of Mexico in 1994, Argentina in 1995 and then Asia in 1997 are examples of how a shift in the direction of capital flows quickly escalates to speculation on the host currency which in most cases is pegged or fixed (Mishkin, 2003). The volatility in the foreign reserves held by these emerging economies is fuelled by panic reactions on the part of international investors and exchange rate management strategies by host governments using the very foreign exchange reserves that are in short supply.

Exchange Rates

Mishkin (2003) outlines a financial crisis in a emerging economy, as comprising of four stages. The first stage describes the deterioration of the balance sheet for many lenders as liberation of the financial sector is allowed to happen with the promise of financial prosperity

and economic growth. The deterioration of the balance sheet leads to the second step being currency crisis to be followed closely by financial collapse or crisis. Evidence from both the Latin American and Asian financial crises of the 1990s, show the currency crises that pre-empted the financial collapse were preceded by financial liberalisation and deteriorating balance sheets. Deteriorating balance sheets create an environment for investors to speculate on the host currency leading to panic trading on the foreign exchange market. The economic policies that characterised the growth of international trade in the 1960s and 70s were not aligned with the financial climate of the 80s and 90s for speculators to place quick speculative bets on the financial market and thereby turn the fortunes of corporations and individuals around over night. Mishkin (2003)writes:

> In today's world, financial innovation has produced new markets and instruments that make it easy for financial institutions and their employees to make huge bets quickly. In this new environment, an institution that is quite healthy at a particular point in time can be driven into insolvency extremely rapidly from trading losses as has been forcefully demonstrated by the failure of Barings in 1995, which although initially well capitalised, was brought down by a rogue trader in a matter of months (p. 108).

Edwards (2003) suggests that foreign exchange rate regimes contribute to the build up of circumstances pre-empting a financial crisis. He writes:

> The currency crises of the 1990s have led economists to rethink their views on exchange rate policies in emerging countries. Specifically, these crises have many economists to question the merits of pegged-but-adjustable exchange rates, both in the short run – that is, during a stabilisation program – and in the longer run (p. 33).

Edwards (2003) advocates that emerging economies should adopt a credible exchange rate regime that is not prone to volatility sparked by rumours of the currency being over-valued. He suggests that a floating exchange rate regime would prevent the occurrence of a crisis by allowing the exchange rate to correct for speculative capital in-flows driving up asset prices and subsequent capital outflows leading to financial collapse.

Pegged and fixed exchange rate regimes in the late 1960s and early 1970s have been a popular way of providing a stable trading platform for companies involved in international

trade. These exchange rate policies, it would appear, were suitable for an international market primarily focused on managing the capital flows that tracked the path of international trade, but not the instantaneous transfers and capital movements that characterise the current electronic era.

The International Monetary Fund (IMF)

The International Monetary Fund (IMF) was originally set up as a multilateral institution to manage the foreign exchange arrangements between trading nations (Krueger, 2003). The objectives of the IMF include encouraging free trade and assisting nations in the management of their foreign exchange which is assumed to be fixed but adjustable if there is a fundamental disequilibrium. The growth of international trade is encouraged by the IMF with mechanism such as the General Agreement on Tariffs and Trade (GATT) that sought to remove barriers to trade. However when a country experiences balance of payments deficits, quantitative restrictions are permitted and used to stabilize the deficit although the cost of these measures is often more detrimental to the host country as in the case of Turkey in 1958.

In the last thirty years, the IMF has been involved in the rescue attempt for many financial crises, particularly those involving emerging economies (Krueger, 2003). In the case of Korea, the IMF stabilization program is broadly divided into three stages. The three stages included the restoring of conditions that would return investor confidence, restructuring of the financial sector but foreclosing those banks that are identified as weak and lastly through management of the current account and the exchange rate. Restoring investor confidence did not only involve blacklisting those banks that were identified as weak but injecting more than $100 billion into the Asia as financial bailouts (Sachs, 1998).

The IMF recognises the complexity of each case that it has been involved with and the potential for criticism should the programmes that it has been involved with prove to be counterproductive. In particular the different stages of lending up to a financial crisis require different stabilization programmes. The different stages of a financial crisis have been described by some writers as a twin crisis. A current account crisis leads to a credit crisis, which is then followed by a currency crisis and lastly a financial crisis. Krueger (2003) notes that the IMF's efforts to address a current account deficit entails an exchange rate change together with a tightening of monetary and fiscal policy to curb inflation. A financial crisis

however requires the opposite in order to stimulate growth and stop the outflow of capital. Krueger concludes that "to a significant degree, in the presence of twin crises, whatever is done to address one will, in the short term, make the other worse" (p. 313). From this seemingly 'no-win' situation it may have been better for the IMF to not intervene at all and in so doing remove the presence of 'moral hazard' that some lenders have incorporated into their decision making on the assumption that the central bank or in this case the IMF will always come to their rescue (Mishkin, 2003).

Criticisms of the IMF's attempts at stabilizing financial crises have been widespread (Feldstein, 1998; Goldstein, 2003; Radelet & Sachs, 1998; Sachs, 1998). Sachs (1998) describes the impact of the IMF's efforts at stabilization as achieving the opposite and actually fuelling both the speed and the extent of the Asian financial crisis. He writes:

> The IMF deepened the sense of panic not only because of its dire public pronouncements but also because of its proposed medicine – high interest rates, budget cuts, and immediate bank closures – convinced the market that Asia indeed was about to enter a severe contraction (as had happened earlier in Argentina, Bulgaria, and Mexico). Instead of dousing the fire, the IMF in effect screamed fire in the theatre. The scene was repeated in Indonesia in November and Korea in December. By then, the panic had spread to virtually all of East Asia (Sachs, 1998, p. 17).

The stabilization programmes of the IMF, while good intentioned, are out of date, out of sync, and do not employ the existing political and economic infrastructure within each country in order to gain national acceptance. The 'superhero' image described by Sachs (1998) under minds local authorities who cooperate through a sense of desperation and fear rather than genuine trust. It is unclear whether in fact the IMF with their stabilization programmes add to the severity of a financial crisis or not. One thing that is sure however, is that they remove the opportunity for these economies to learn from the experience.

The actions of the IMF mimic those of central banks and governments in trying to stabilize a domestic banking crisis. Evidence suggests that this has benefited the banking sector in the past. At the global level however, becoming lender of last resort creates a degree of moral hazard that encourages the risky speculative investment behaviour that prompt the chain reaction leading to financial collapse.

Monetary Reforms and Regulations

The Asian crisis, as with those of Eastern Europe and Latin America, have provided a database and platform for financial reforms and changes to regulations in a global market that exists and operates in an instantaneous and electronic context. The suggested remedies for financial crises are varied and reflect the multiple perspectives of politics, economics, accounting and finance. The current study draws on the suggested remedies of Mishkin (2003) as a means of evaluating the occurrence and aftermath of the current financial crisis (2006-2009) for New Zealand. The choice to use the remedies of Mishkin is based in its coverage of many of the ideas proposed by earlier writers and because many of these ideas have been used in one way or another as an attempted means of managing financial crises. His breakdown of recommendations into twelve areas covers the complex and multi-discipline nature of financial crises. A summary of his recommendations are noted below.

Mishkin (2003) suggests as a way forward

1. Prudential supervision
2. Accounting and disclosure requirements
3. Legal and Judicial system
4. Market based discipline
5. Entry of foreign banks
6. Capital controls
7. Reduction of the role of state-owned financial institutions
8. Restriction of foreign denominated debt
9. Elimination of too-big-to-fail policies in the corporate sector
10. Sequencing financial liberalization
11. Monetary policy and price stability
12. Exchange rate regimes and foreign exchange reserves

Section 2: Agency Theory and Corporate Governance

Agency theory and corporate governance provide the appropriate explanations for the current global financial failures. The introduction of limited liability, allowing the general public to own shares in companies, has impacted the way companies are controlled. Shareholders (as

owners and also principals of listed companies) delegate the day to day decision making of the company to company directors (as shareholders' agents, and company management). This leads to a separation of ownership and control which in turn leads to the "agency problem" that company directors do not necessarily make decisions in the best interest of the shareholders, and that the goals of the principal and agent conflict. The objective of the shareholders as a company is wealth maximization. However, in practice this is not necessarily the case as there may be a tendency for some company managers to pursue their own personal objectives. This "agency problem" presents shareholders with a need to control company management (Solomon, 2004).

Corporate governance, a mechanism of accountability is a strategy used by shareholders and other stakeholders in order to control company management (Dellaportas et al., 2005; Solomon, 2004). Corporate governance is defined as "the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activities" (Solomon, 2004, p. 14). Solomon (2004) and Dellaportas et al (2005) observe that one reason 'good' corporate governance is linked significantly to good corporate financial performance is its link with management quality. They indicate that better managers instigate better corporate governance, pay more attention to their stakeholders, manage companies more effectively and produce higher financial returns. However, corporate governance systems are vulnerable to abuse and may not prevent unethical activity by top management, yet they are a means of detecting such activity before it is too late. This view is also expressed in the Higgs Report (2003). The role of independent non-executive directors in monitoring company management; the role of institutional investors as majority shareholders in influencing company management and taking an active interest in their investment, rather than remain passive observers; essential corporate disclosures especially financial accounting information; internal controls; the role of the audit function are examples of important elements of 'good corporate governance'.

Corporate governance failures have been blamed as the fundamental cause of the global financial crisis. For example: Inadequate corporate mechanisms, including transparency had accelerated economic deterioration in the key crisis countries (Suto, 2003); "a fundamental failure of the risk control systems at large financial firms which failed to pierce through the

lack of transparency in the complex structures financial instruments that generated excessive concentration of risk in the mortgage market" (p. 314) had led to the financial crisis of August 2007 (Lang & Jagtiani, 2010); the board of directors not performing the oversight role was found in the crux of the collapse of the global financial company, Lehman Brothers (Weitzner & Darroch, 2009) and the 2008 US financial crisis (Sharfman, Toll, & Szydlowski, 2009); executives of major banks greedily focused primarily on maintaining their bonuses while the US economy was collapsing around them (Clarke, 2010; Lloyd, 2009) ; corporate governance not taken seriously (Rouse, 2009); minority shareholders having very limited influence over family dominated shareholding, and board of directors not independent of top management and not accountable to minority shareholders have all contributed to the 1997 Thai financial crisis (Persons, 2006; White, 2004) . The list goes on and is not exhaustive.

Section 3: Financial Regulatory Reforms in New Zealand

The regulatory framework governing the financial market in New Zealand has developed in response to largely economic forces and the need to create an environment of confidence. In 1969 finance companies and other financial institutions are required to hold a given ratio of Government securities. This is done to ensure finance companies hold a prudent level of liquidity and secondly as a mechanism for implementing government monetary policy. The required holding of government securities for finance companies is set at 5% in 1970 and steadily increased to 25% by 1980 (Deane, Nicholl, & Smith, 1983). By 1972, controls have been introduced to regulate the interest rate being charged and received by finance companies (Carew, 1987). In 1973 the New Zealand Government introduces the reserve asset ratio (RAR), requiring trading banks to hold a set proportion of their deposit in reserve. These reserves are held in the form of time liabilities in government securities. During this period, banks and other financial institutions (including finance companies) operate under an environment of interest rate restrictions. Variations in interest rates could therefore not be used to compete for deposits. The impact of this regulatory system is greater liquidity being held by the finance companies and banks. The reserve asset ratio also serves as a vehicle for implementing the government's monetary policy and controlling private-sector lending (Singleton, Grimes, Hawke, & Holmes, 2006; The Reserve Bank of New Zealand staff, 1981b, 1981c).

By the mid 1970s, the impacts of the oil shocks on the New Zealand economy are beginning to be felt. The focus of the then National led government is on economic growth and increasing exports to counter the escalating current account deficit. An era of deregulation follows in an effort to stimulate economic growth. In March 1976, interest rate controls are removed, allowing trading banks to compete for time deposits by offering more competitive interest rates (Carew, 1987). The Interest on Deposits Regulation which controlled deposit rates at NBDTs since 1972 is also revoked ((The Reserve Bank of New Zealand staff, 1981a).

In an attempt to curb uncontrolled credit create through consumer borrowing to finance capital purchases, the government sought to directly control hire purchase contract by legislating a minimum deposit of 60% and a repayment term of no more than 12 months (The Reserve Bank of New Zealand staff, 1981a). Furthermore, penal borrowing system was altered forcing banks that had breached the cash reserve requirement to borrow from the central bank (Reserve Bank of New Zealand) at penal rates of interest.

Through to 1984, New Zealand has been operating a fixed exchange rate regime. Deteriorating balance of payments through increases in the international price of oil results in a series of devaluations of the New Zealand dollar but not to the extent that is needed. Foreign reserves have been depleted to such an extent that by the 1984 general election, the choice to float the dollar was inevitable. Coupled with the floating of the exchange rate, other financial regulations are lifted. In particular, interest rate controls, the reserve asset ratio (RAR) and other foreign exchange controls were removed in 1984. Lifting these controls moved New Zealand's financial markets to a more deregulated position than in any other country. New Zealand appears to have been the first country to remove all monetary policy (reserve) ratio controls on banks in the post-war period (Evans, Grimes, Wilkinson, & Teece, 1996). In 1986 the Reserve Bank Act was amended allowing a greater number of banks to operate in New Zealand. The amendment also provided the Reserve Bank of New Zealand with a supervisory framework.

The wave of deregulation continued in 1987 with the lifting of many regulations governing financial institutions. Financial markets are deregulated and financial institutions are allowed to borrow from overseas. Banks are now allowed to compete on a more equal footing with other classes of financial institutions. Once financial markets are deregulated, the banks

expanded into lines of business in which their participation has previously been restricted and as a consequence a number of other classes of financial institutions are squeezed out of the market. Some of the larger building societies converted to bank status and operated in the same line of business as the traditional trading banks (Tripe, 2009). The deregulation of the financial markets led to a significant increase in the numbers of financial companies leading to increased competition and the need to diversify. Other financial players including non-banks deposit takers (NBDTs) (who were not registered as banks) are free to provide whatever banking services they wished, provided they do not call themselves banks. The implication of the deregulated financial market is increased competition and greater option for customers to choose their financial provider. The seeds for financial innovation are now sowed and the new market framework would be an incubator for financial innovation and for trading in financial instruments.

The negative consequences of a deregulated market followed soon after with the New Zealand stock market crash of October 1987. Many New Zealand companies collapsed including DFC, a major financial institution specialising in mortgage lending. During the same period many banks were pushed to the edge with confidence in the banking sector being brought into question. The New Zealand government responded to the collapse of JBL, Cornish, Circuit and Securitibank and Public Service Investment Society (PSIS) by introducing the Securities Act 1978. The Act required New Zealand finance companies to make greater disclosures to depositors and other investors (Singleton et al., 2006). The drive for greater financial disclosure continued and in 1993 the Reserve Bank of New Zealand also proposed to expand the amount of publicly available information about the quality of bank portfolios (The Reserve of Bank of New Zealand Staff, 1993). In 1996 private monitoring of banks by supervisors was replaced by a reporting system that required a defined set of financials to the public. The aim of the disclosure reforms was the protection of the financial sector as a whole while trying to reduce the cost of compliance. The revised system of reporting also has the objective of reducing moral hazard and promoting market discipline. The overall outcome of the reforms would be to alleviate the risk to taxpayers of bearing the cost of a bank crisis (Brash, 1995). The 1996 disclosure regime comprises of (1) the Key Information Summary for the bank and (2) the General Disclosure Statement which gives details on corporate information, financial statements, capital adequacy and risk exposures.

This regime required bank directors to take on the full responsibility for providing investors and other stakeholders with true and fair disclosures.

The growth and development of the financial sector in New Zealand that followed was largely promoted by economic forces to grow international trade and encourage domestic economic activity. The National government of the early 1970s followed a tight regulatory stance and legislated for the control of inflation, interest rates and exchange rates. This is unsustainable and both the economy and foreign exchange reserves declined to an all time low. The new Labour government elected in 1984 immediately implemented a series of reforms to deregulate the financial sector and established Closure Economic Relations (CER) with Australia. The reforms mirror many of those observed in emerging economies in South America, Asia and Eastern Europe. The wave of deregulation was interrupted by the stock market crash of 1987 which prompted a tightening of regulations through greater financial disclosure. New Zealand adopted a philosophy of 'let the buyer beware' (caveat emptor) rather than regulating interest rates, exchange rates and inflation.

Section 4: The Current Global Financial Crisis

The current financial crisis is global and the impact continues to spread to all countries who participate in the international financial market. The trigger from the crisis has been traced back to the Sub-Prime Mortgage Crisis in the United States. In particular the housing boom that characterised the beginning of the millennium saw many consumers borrow for real estate and major consumer purchases secured by the high property prices. When real estate values then contracted, lenders, many of which were financial institutions faced imminent collapse.

The circumstances surrounding the financial crisis were different to those observed in Asia, Latin America and Eastern Europe. The most obvious is the absence of a developing economy. Previous financial crises were characterised with an emerging economy, initially experiencing significant capital inflows based on the expectation of high returns. When the debt servicing obligations of these foreign borrowers fell into question, investors began to withdraw. The outflow of capital away from these emerging economies required an alternative investment destination. The domestic real estate market appears a more secure

option and so the chain of events leading to the housing boom of the early part of the new millennium is set in motion.

The real estate boom is not limited to the United States and in many parts of the world, including New Zealand, property prices increased significantly during this period as did domestic credit. Furthermore, financial institutions are interlinked and the activities of borrowing and lending to one another frequently occur across national borders. The inevitable outcome of these links is the domino sequence of collapses that then followed and continue to unfold through to the present day.

The event that then followed with the Sub-Prime market crisis in 2008 could hardly be blamed on poor economic management by the governments of developing economies as had been the high-handed commentary from the West and the International Monetary Fund (IMF). With the benefit of hindsight, the current financial crisis is a reminder that the fundamentals of risk and return apply to all countries and industry sectors.

The size of the current global financial crisis, while significant, is difficult to measure and is still unfolding. The collapse, or at the very least, the financial restructuring of major finance companies is a sign of the magnitude of the crisis. The $85 billion dollar credit facility extended to the American International Group (AIG) by the US Federal Reserve to prevent its otherwise certain collapse is also an indication of the severity of the crisis.

The Financial Crisis in New Zealand

The financial crisis in New Zealand is not a product of its own making. As with many countries participating in the global market, New Zealand experienced the flow-on effect of the financial collapse of large international finance companies including Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch and AIG. Furthermore the nervous reaction of investors in the wake of these larger collapses has created further tension and a lowering of overall confidence in the market. As at May 2010, approximately 50 finance companies in New Zealand were marked as failed (see Appendix B).

Poor corporate governance has been identified as a contributing factor to the impact that the financial crisis has had in New Zealand. The investment drive of the early part of the new millennium was skewed towards property and the financial sector in Zealand reacted in much

the same way as they had done overseas. In particular, steps to disclose and management portfolio risk is often overshadowed by the promised high returns.

A significant number of investors in New Zealand are elderly individuals or couples saving for their retirement. Many elderly investors are not in a position to fully comprehend the magnitude of the risk they are getting involved with. Furthermore, as demonstrated later in this article, managers of these failed finance companies did not fully disclose to these investors, the extent to which they are exposed to risk following their initial investment. Some investors are unaware that the fund management practices which followed after their initial investment with the company are inconsistent to what they were originally led to believe.

The length of time that many finance companies were in operation is inconsistent with the timeframe that investors expected. The timeframe for individuals' saving for their retirement is medium to long term. The average lifespan for the fifty failed finance companies included in this study (see appendix A) is ten years. This average has been skewed by 5 finance companies with a lifespan exceeding 20 years. With a median of only 6.8 years and a standard deviation of 10 years, the lifespan of these failed finance companies suggests that the market response to those needing to save for their retirement has been a series of incompetent providers regulated by a cavalier institutional structure and framework incapable of delivering the desired result.

The collapse of so many finance companies over a relatively short period of time cannot be fully attributable to an unfortunate set of circumstances beyond their control. To observe so many fail, suggests two possibilities. The first is that the international financial crisis wave is of such a magnitude that any company, big or small, diligent or unwise would have suffered inevitable collapse. The second is that the international financial wave is only moderate but that the financial companies in its path are vulnerable and prone to collapse. The analysis that follows explores these two possibilities and the reaction of financial institutions and financial regulators during this period.

Why so Many Finance companies had failed

The failure of finance companies in New Zealand is not a new phenomenon as was seen in the collapse of DFC, JBL, Cornish, Circuit and Securitibank, and PSIS in the 1970s and 1980s. The distinguishing characteristic with the current financial crisis is the high number of finance companies that are unable to weather the global financial storm that started with the US Sub-Prime market crash. There is little argument over the size of the current financial crisis and it is possible that finance companies that operated on the margin and therefore vulnerable to such financial shocks were prone to fail. However, the large number of collapses suggests that the financial climate was such that prudence together with a robust regulatory framework was absent when the financial crises reached New Zealand.

The Registrar of Companies Neville Harris issued a report on his insights concerning the collapse of the finance companies between 2006 and 2008 (Commerce Committee, 2008). The report covered observations on the elements of the supervisory framework which were inadequate or "where it failed to address the risks inherent in the business model adopted by the failed companies" (p. 8).

Corporate Governance and Poor Fund Management Practices

Corporate Governance:

Poor corporate governance has been identified as a leading cause of the collapse of many finance companies. In particular, a number of the failed finance companies were dominated by a chief executive who was the main architect of the company's method of operation. The boards tended to lack the breadth of experience and skills required to oversee the scale, complexity and characteristics of financing operations that were undertaken. Too often directors were not adequately informed, misled or failed to take sufficient interest in the affairs of the company.

The financial track record of many company CEOs and directors supported the notion of poor governance being the cause company failure. Some CEOs and Company directors have been associated with previous company failures within the financial sector. Bridgecorp founder Rod Petricevic was involved in the $250 million failure of Euro National in the late 1980's; Michael Reeves of Lombard Finance and Investments Limited had a troubled history with

contributory mortgage schemes and pleaded guilty in 2006 to a breach of the Securities Act 1978; Roger (Kenneth) Moses of Nathans Finance NZ Limited was involved in the failed contributory mortgage broking firm Reeves Moses Hudig. The fact that these individuals were allowed to continue operating, be it under a different company name, is indicative of the passive and ineffective nature of the financial regulation surrounding the industry.

Treatment of non-performing loans:

The treatment of non-performing loans is an exercise on financial prudence and ensuring the true financial position of the company is reflected. Without regulation to restrict or guide the treatment of these loans, most companies engaged in the practice of rolling-up a non-performing loan into a new loan, that included the original principal and the arrears in interest. This resulted in the true performance of the loan portfolio being masked to avoid the classification of these loans as being in default. The disclosure documents of several companies effectively misled investors as to the quality of the company's lending practices and performance because they reported low or nil defaults (Harrison J commented on such practices in paragraphs 12 and 13 of his judgment in the matter of the receivership of Capital & Merchant Finance Limited).[1]

Lending practices:

Lending to related parties has been used as a means of financing risky related party ventures. They have also been used to affect a personal benefit to any one or more of the directors. A number of the finance companies engaged in excessive lending of investors funds to related-parties, often in circumstances where conventional funding sources could not be secured for the particular venture. In some cases, the Registrar of Companies observed that the only objective for entering into one of these transactions was to benefit one of the directors (or interests associated with the directors). In other cases related party loans has been used to prop up a poor performing investment. For example: prior to receivership, Nathans Finance NZ Limited (in Receivership) provided $171 million of debt to related company VTL Group

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[1] Judgment of Harrison J in the High Court of New Zealand, Auckland Registry, between CAPITAL+MERCHANT FINANCE LTD And Anor V FORTRESS CREDIT CORPORATION And Ors, CIV 2007-404-007298 [29 November 2007].

Limited, parties associated with it and various VTL franchisees from a loan pool of only $176 million. Nathans Finance NZ Limited has only six loans to unrelated third parties totalling $5.3 million. The receivers of Nathan Finance NZ Limited have confirmed that the loans to VTL and its subsidiaries are unlikely to be recovered. The receivers of Capital + Merchant Finance Limited (in Receivership) reported that there were six (6) related party loans recorded in the company's loan book totalling $37.6 million at the date of their appointment. The borrowing companies were controlled by Tallentire, Douglas or Nicholls individually, who were also on the board of directors for Capital + Merchant Finance Limited. Two of the related debtor companies are currently in the process of being wound up by the court. During the course of their investigations, the receivers identified a number of other loans totalling $41 million which contained "related party elements". Of the total $41 million outstanding, only $1.75 million has been recovered with the balance expected to be written off.

Concentration of loan risk:

The concentration of investment portfolios within a particular industry paid little regard for diversification and exposed investors to higher levels of risk. Some of the larger finance companies relied significantly on the success of a single industry and/or a very small group of borrowers. For example the loan books of Bridgecorp and Lombard Finance Limited were heavily weighted to the speculative end of the property market. These finance companies had no choice but to continually roll over poor performing loans until the borrower's development project could be completed. Bridgecorp's single largest loan exposure was $50 million invested in the yet to be completed Momi Resort project in Fiji. The Brooklyn Rise apartment development in Wellington accounted for almost 30% of Lombard Finance's loan book. The significantly impaired $42 million Brooklyn Rise loan was part of a loan book of which 80% was lent to just five borrowers.

Repayment:

Faced with imminent default on their interest obligations, some finance companies continued to lure potential investors with promises of high returns through to the time they were declared insolvent. The Registrar of Companies noted that a number of the failed finance companies were in the end acting in a similar manner to ponzi schemes. In many cases, funds received for investment from new investors were used to repay the maturing loans of existing

investors. In these circumstances the companies continued taking in funds many months after their position was irreversible, thus exposing investors to immediate losses.

Trustee supervisory model

The trustee supervisory model is an important part of the corporate governance and operating mechanism for companies in the financial sector. In New Zealand, there are effectively five trustee companies, of which Perpetual Trust Limited (Perpetual) and Covenant Trustee Company Limited (Covenant) were the appointed trustees of at least 25 of the failed finance companies (see Appendix C and D). This degree of involvement raises issues as to the quality of due diligence at the time of their acceptance of the assignment, and in particular the extent to which they accepted a position of relatively weak authority as afforded to them by what were potentially ineffective trust deeds. The Registrar of Companies noted that Covenant and Perpetual were slow to detect adverse financial issues as they developed and were too casual and timid in their response to circumstances where investors' interests were being put in jeopardy. The staff at Covenant and Perpetual did not appear to be sufficiently experienced, nor did they have an adequate understanding of the risk profile of finance company lending, to deal effectively with what turned out to be widespread failure within their finance company client list.

The trust deeds outlining the roles, responsibilities and authority of the parties involved did not capture the arrangements necessary to protect the beneficiaries or investors. Given the risks the trustee companies were assuming and the activities they were engaged in, it seemed that the covenants in the Trust Deeds agreed between the trustees and some of the finance companies were too weak. In many cases, the Trust Deeds lacked a description of "enforcement events". This left the trustees with insufficient powers to take action and a limited ability to intervene when solvency issues arose.

Trustees were found to be in breach of their obligation to report on breaches or potential breaches of the deed. In accordance with section 11 of the Corporations (Investigation and Management) Act 1989, trustees are required to notify the Registrar of Companies (the Registrar) if a company has breached, or is likely to be in breach of the terms of a Trust Deed. In relation to the most recent series of finance company collapses, the Registrar of Companies maintains that notification (section 11 notifications) was frequently received on

or about the date of the appointment of a receiver. By then, the company was already past the point of no return financially, and little could be done in response.

In recent years ownership of trustee companies have changed significantly and now bears little resemblance to the "institutional strength" the public perceive them to have. For example, Perpetual is wholly owned by NZX-listed Pyne Gould Corporation Limited, while Covenant is largely owned by a single shareholder, Graham Miller. Trustees Executors Limited is owned by US-based investment firm Sterling Grace Corporation.

The accountability relationship between the trustees and those they appoint in an agency capacity is weak and in cases compromises the independence of the agent. In relation to the recent financial company failures, receivers are appointed by the trustees. Thus, it is unlikely that any shortcomings in the performance of a trustee company would be uncovered or pursued by receivers who look to trustees for further assignments. The Registrar understands that receivers are uncertain as to their standing to consider such issues. The outcome of this muddied relationship is that investors are left with no real avenue for examining the performance of trustee or to pursue redress for negligence in the performance of their duties.

The role of auditors

In the event of a company failure, the audit profession is among those that are brought into question. This is not unexpected as auditors are an important feature of the securities market supervisory framework. The association between audit firms and failed finance companies reveals a pattern that suggests the larger Audit firms were either not invited to become auditor for these failed finance companies or they refused to be associated with them. Based on Appendix C and D, it is clear that the 'Big Four' accountancy firms (Deloitte, Ernst and Young, Price Waterhouse Coopers and KPMG) were not extensively involved in the audit of the recently failed finance companies in New Zealand. KPMG was the only one of the 'Big Four' to act as auditor for more than one of the failed finance companies. The other three firms only appeared once in the above list. The significant concentration of audit appointments was within second-tier accounting firms including BDO Spicers, Staples Rodway and Hayes Knight.

The engagement of second-tier accountancy firms raises the question of professional audit competence. In particular, the allegations were that some audit firms did not have sufficient capability and experience to conduct the initial due diligence for the assignment and to audit such complex and elaborate company and business structures. This concern is illustrated by the action taken against the auditors of National Finance Limited, O'Halloran & Co, for failure to exercise due care and diligence and failure to comply with the Institute of Chartered Accountants' technical audit standards. The auditors pleaded guilty to a breach of the Institute's Code of Ethics and were ordered to pay over $130,000 for the costs of the hearing. The New Zealand Institute of Chartered Accountants is now looking at the audits of all failed finance companies.

As a general observation, the audits of many of these finance companies lacked the rigour and analytical depth one would expect for entities managing substantial public investments. There is a view among receivers that if they had been rigorously audited, it is unlikely many of the failed finance companies would have continued in business for as long as they did Feedback from receivers suggested sub-standard audits were a component in the delay and demise of some finance companies. If auditors have issued qualified rather than unqualified opinions there would have been a stronger imperative for the trustees to step in earlier (Vaughan, 2009). Evidence of the weaknesses in the governance and supervision of the recently failed finance companies is the judgement of Harrison J in the Capital and Merchant Finance case (refer paragraphs 55, 56 and 58).

Weaknesses in Financial Regulations

Financial regulations in New Zealand have not been able to adequately capture the poor management behaviour that has resulted in the recent financial company collapses. In relation to financial disclosure, unlisted companies are not subjected to the continuous disclosure regimes required of those who are listed. The current practice for many unlisted companies is the filing of a prospectus (and any subsequent renewals) on a twice yearly basis. Where funds have been raised from the public, there is a view that some form of continuous disclosure model be required of issuing entities.

The regulatory framework failed to capture the specific structure of organisations operating within the finance sector. In particular, the Securities Act 1978 required the presentation of a

prospectus for investment schemes defined under the Act. The Blue Chip property investment products were structured in a form to avoid being captured by the requirements of the Act to prepare a prospectus. Many investors were effectively locked into property linked to their investment despite the misleading and fraudulent promotional information that suggested to the contrary. These property and investment products were of a form that warranted a prospectus or equivalent regime. The Securities Act 1978 needed the scope to potentially include all forms of schemes that were in substance similar to those that were envisaged in the late 1970s and 1980s and not just those that fell within its strict definition criteria. There may be merit in allowing the Securities Commission to "call in" schemes, which on the face are exempt, and impose compliance with the Act.

The moratorium pathway presents an unregulated and often ineffective step in settling investors' claims on failing finance companies. Nine companies included in Appendix A are in a status of moratorium. The Registrar understood that investors in these nine finance companies have approved a restructure and or moratorium on repayments from maturing loans for a period of up to five years. However, there is no regulatory oversight of these moratoria arrangements and the management and monitoring of these restructuring plans is left with the companies, their trustees and affected investors. There is an emerging trend of a number of moratorium proposals failing to meet the forecast expectations offered to investors.

The various moratorium proposals have been the subject of some criticism. In particular, the option to delay repayments in the hope that the proposed restructuring plan will stave off the possibility that investors will be otherwise left with nothing at all, appears a desperate attempt to moderate a situation that should have been addressed earlier. Furthermore, investors are left with little choice than to accept the compromised position of a moratorium, than leave with no money at all. In the case of Hanover Finance, the moratorium also acted to mitigate the possibility of litigation against the directors. The outcome is avoidance of accountability and inquiry that directors would otherwise face in a receivership or liquidation situation.

Section 5: New Zealand's Reaction to the Financial Crisis

New Zealand's reaction to the financial crisis has been a mixture of traditional economic management and free market low intervention policies. The focus of the New Zealand

government, through the Reserve Bank of New Zealand, has been to mitigate the impact of the global financial crisis on the economy and the current account deficit. The governor of the Reserve Bank of New Zealand, Alan Bollard, suggests the impact of the financial crisis has been comparatively less for New Zealand because of its primary sector export base and position on the supply chain for consumer goods that have been at the forefront of the economic downturn. He however acknowledges that our vulnerability is through foreign borrowing due largely to an insufficient domestic savings base (Bollard, 2009). Bollard argues that New Zealand's recovery from the current global financial crisis and shielding from future crises will be enhanced by increasing the domestic savings base and thereby reducing New Zealand dependence on foreign sourced capital.

New Zealand has not promoted the strengthening of regulations as the primary means of addressing the consequences of financial crises. The current regulatory framework governing the financial sector is the responsibility of the Reserve Bank of New Zealand. The idea that the Reserve Bank be the sole regulator of the financial system was agreed to by the government as early as 2005. Two years later in June 2007 the Minister of Finance finally made the announcement that this would be the case although it was not until September 2008 that it would be made official with the passing of the Reserve Bank Amendment Bill (no.3).

The implementation of the new regulations echoed the hands-off stance that the government had taken up to that point. In particular the additional requirements focused on further disclosures in the form of credit rating and documented policies on risk and liquidity management. The capital reserve requirement was set at 8% and 10% for credit rated and non-credit NBDT respectively.

The reserve requirement for Banks is determined by a more complex formula taking into account the risk profile of the banks portfolio. This model follows the three pillar approach developed by the Basel Committee in 1974. The three pillar approach includes minimum capital requirements (pillar 1), a supervisory review process (pillar 2) and market discipline (pillar 3). The regulatory approach adopted by New Zealand focuses on the first of these and less so on the latter two. The current financial crisis however has brought to the forefront weaknesses in both the supervisory review process and market discipline for banks and NBDTs (Hoskin & Irvine, 2009).

Regulating the financial sector has targeted banks rather than the diverse group of operators that make up the financial sector. To a large extent the regulations imposed on the banking sector have worked well. However the same cannot be said of other non-bank finance companies, many of which have faced financial collapse through their own vulnerability to market shifts brought about by the global financial crisis and poor corporate governance practices.

New Zealand's management of foreign exchange has been one of riding the financial tide. A review of the balance sheet management strategies of the Reserve Bank of New Zealand prior to the current financial crisis saw a shift towards a low intervention management strategy including that allowed a greater degree of alignment with the market and reporting disclosures to match. In particular, the Reserve Bank allowed for a proportion of its reserves to be un-hedged. Furthermore, the recent adoption of IFRS (International Financial Reporting Standards) in 2005 introduced a shift towards marking the value of financial instruments to market (Eckhold, 2010).

The New Zealand government is not inclined to provide a bailout to finance companies suffering the brunt of the financial crisis in the same manner as the US in relation to $US 85 billion credit facility extended to AIG by the Federal Reserve. However in October 2008, the Minister of Finance, Michael Cullen announced that the New Zealand government would be introducing an opt-in retail deposit guarantee scheme in an attempt to encourage investor confidence in the New Zealand financial sector. The folly of this scheme was brought to the forefront less than two years later with the collapse of South Canterbury Finance (SCF) in August 2010. The cost to the New Zealand tax payer was a $NZ 1.6 billion payout to SCF's 30,000 depositors. This was however, not a bail-out in the manner of that between the US Federal Reserve and AIG, but one where the New Zealand government had little choice but to honour its commitment as the guarantor.

New Zealand's management of financial crises since the 1970s has been one of education and disclosure rather than regulation. Mayes and Wood (2007) write:

> New Zealand is one of few countries that has reacted differently and argued that the solution to improving the prudent behaviour of banks lies not in regulating and supervising them ever more closely but making sure that the

> stakeholders in these banks are aware of and are exposed to the risks they are running. (Mayes & Wood, 2007, p. 3)

This comment is consistent with New Zealand's current policy stance although certainly not absolute. Greater financial disclosure has been encouraged through the adoption of IFRS and the introduction of greater levels of reporting for banks and registered NBDTs. Regulations have been introduced although this has been targeted at banks rather than the wider financial sector. Regulation governing the financial sector has been and continues to be poised between the push for growth through reduced compliance costs and encouraging consumer and investor confidence. The outcome is a financial sector that continues to be only lightly regulated, an economy that is bent on foreign trade partnerships and a monetary and fiscal policy stance that is equally aligned with New Zealand need to be internationally competitive.

How does New Zealand Measure up?

The summary of recommendations outlined by Mishkin (2003) have been used here as a yardstick to assess New Zealand's response to the current financial. Against the recommendation of prudent supervision (1), New Zealand has performed with respect to banks although the same cannot be said of NBDTs and other operators in the financial sector.

Against the criteria of accounting and disclosure requirements (2), New Zealand continues to rank highly. The push for greater disclosures and the adoption of IFRS are examples of this. Furthermore, the greater level of disclosure is consistent with New Zealand's approach of placing the onus on the investor to beware. The third and fourth categories address the issues of the legal and judicial system (3) and market based discipline (4). This has been weak in the case of New Zealand on two fronts. First, the market based discipline is inadequate to deal with financial operators who operate outside the boundaries of financial prudence and expose their investors to high risk. Second, the legal channels for enforcing the regulations that are in place are inadequate and slow.

Mishkin's fifth recommendation regarding entry of foreign banks is a redundant issue in New Zealand as new entrants have been few due to the relatively stringent regulatory environment for banks and small size of the New Zealand market to accommodate an additional banker.

Capital controls in New Zealand are a strong point. However this strength is skewed towards banks and registered NBDTs. Other finance companies in the financial sector operate outside these capital controls. The consequences of allowing such a large number to operating outside these capital controls is the high number of finance companies that have failed during the current financial crisis.

State owned financial institutions are few in New Zealand and the entry of Kiwibank within the last ten years is a rare example of the government pushing for a domestically owned banker as an alternative to the current number, many of whom are foreign owned. Mishkin's recommendation to limit the number of state-owned banks is based on the creation of a moral hazard where the state will not allow such a financial institution to fail. In the case of New Zealand, this is unlikely as the government's management of these banks through the Reserve Bank of New Zealand is sufficiently stringent to detect financial difficulty before it becomes too late. Unfortunately for other finance companies, this stringent monitoring was non-existent and failure came often without warning to many investors.

Restrictions on foreign denominated debt have not been an issue for the New Zealand financial sector. Unlike many developing countries discussed earlier in this paper, New Zealand has not been a target of significant capital inflows. The difficulty in the case of New Zealand has been the relatively small domestic funding base that it can draw on. Banks and other financial operators are often forced to seek capital off-shore as the domestic pool is insufficient. This has created a vulnerability to foreign market fluctuations as evidenced by the Asian financial crisis of 1997 and the current global crisis. The Reserve Bank of New Zealand, as part of its economic stabilisation policy has encouraged domestic savings to ease the need to seek foreign capital (Bollard, 2009). This is however a long term measure and is unlikely to address the short to medium term domestic capital shortage.

The elimination of too-big-to-fail policies in the corporate sector is Mishkin's ninth recommendation and is aimed at eliminating the maverick behaviour of large corporations operating under the pretence they will not be allowed to fail. This has not been the case for New Zealand although the depositor guarantee scheme provided an example of the potential cost to tax payers of policies that introduced moral hazard into the financial sector.

Financial liberalisation has been the theme of economic policy since the late 1970s and early 1980s. The floating of the exchange rate in 1984 and relaxing of capital controls through the elimination of the reserve asset ratio are examples of this liberalisation. Financial liberalisation has been largely staggered in the case of New Zealand and coupled with greater levels of financial disclosure. However, this staggered liberalisation has not been uniform throughout the financial sector. Many non-registered financial operators were quick to take advantage of the relatively liberal market of the 1980s leading to the formation of many finance companies during this period (refer Appendix A). The moment for these new entrant firms has dissipated with the impact of the current financial crisis.

Monetary policy and price stability (Mishkin's 11th recommendation) has been and continued to be the focus of the New Zealand government and Reserve Bank. Such has been the importance of managing the inflation rate that it is included as one of the key performance indicators for the Reserve Bank. Monetary policy has been of recent loose with systematic reductions in the official cash rate (OCR) over the past 5 years. The relative shield that New Zealand has experienced throughout the current financial crisis has in part been attributed to the conservative and appropriate management of the money supply and inflation.

The exchange rate for New Zealand Exchange was floated in 1984. Since that time the rate against the US dollar has range between 0.39US$/1NZ$ and 0.72US$/1NZ$. The Reserve Bank of New Zealand has maintained a hands-off approach to foreign exchange. This allows the market to determine the equilibrium rate without bulk purchasing or selling of the domestic currency so as to influence the rate as has been the case for many Asian countries during the 1997 Asian financial crisis.

Conclusion and Summary

The Financial Crisis in New Zealand has been a topic of much debate and controversy. Although the current financial crisis originated in markets outside New Zealand, the blame for the collapse of so many finance companies over a relatively short period of time cannot be entirely attributed to those foreign markets. New Zealand is merely one of many countries who participate in the global financial market and therefore vulnerable to the consequences of market shocks. The current financial crisis has however raised the question of whether or not

New Zealand's financial infrastructure is suitably placed to weather the storm of financial crises as and when they occur.

This paper suggests that New Zealand financial infrastructure has been the product of a relatively small economy trying to survive in an international commercial environment. Economic policies aimed at growth and free trade has overshadowed the need to develop a financial infrastructure to suit the growing financial sector. New Zealand's approach to management of the financial sector has been passive relying more on encouraging the investor to beware rather than imposing regulations. Much of the regulatory attention has been directed at banks, and to a lesser degree, registered NBDTs. Many other players in this sector operated outside the narrow parameters of the regulatory framework. The large numbers of finance companies that have collapsed are the result of a weak regulatory framework governing non-bank financial operators.

The relatively weak regulatory framework in the financial sector has allowed for poor corporate governance practices and therefore increasing the vulnerability of many finance companies to failure. The recommendations suggested by Mishkin (2003) have been used in this study to assess New Zealand reaction to the current financial crisis. The outcome of this assessment places New Zealand (at least in total) in a relatively strong position compared to other countries. However, significant weaknesses are evident in relation to the financial sector and in particular non-bank operators. The current financial crisis in New Zealand is more associated with finance company collapses than with unemployment and economic growth. While the economy as a whole appears to be successfully managing the current crisis, the attention to finance company failure is not unwarranted.

There continues to the present day a segment of the financial sector that operates in an unchecked and vulnerable manner. It is a breeding ground for poor corporate governance practices, a trap for unsuspecting investors and a legacy of the free market model. Regulators have not been quick to stamp them out as they represent the purest form of the capitalistic philosophy upon which western capital markets have been based. The inconvenient truth is that this same capitalistic philosophy is the cause of the current financial crisis and the reason why regulations are introduced in a manner which is too-little-too-late.

Appendix A - Failed companies Lifespan

Name of Finance Company	Date Failed	Incorporation Date	Status in May-10	Lifespan Years	Lifespan of Co. Incorp post '80
National Finance 2000	1-May-06	6-Sep-99	Receivership	6.7	6.7
Provincial Finance Ltd	Jun-06	11-Feb-89	Receivership	17.3	17.3
Western Bay Finance	Jun-06	2-May-88	Receivership	18.1	18.1
Bridgecorp Capital Ltd	Jul-07	6-Aug-04	Receivership	2.9	2.9
Nathan Finance	Aug-07	7-Feb-86	Receivership	21.5	21.5
Chancery Finance	Aug-07	8-Jul-02	liquidation	5.1	5.1
Property Finance Securities	Aug-07	1-May-01	in & out	6.3	6.3
Five Star Consumer Finance	Aug-07	2-Oct-98	Receivership	8.8	8.8
Antares	Aug-07	23-Nov-05	liquidation	1.7	1.7
LDC Finance	Sep-07	5-Feb-04	Receivership	3.6	3.6
Finance & Investments	Sep-07	8-Jul-76	Receivership	31.2	
Clegg & Co	Oct-07	4-Apr-02	Receivership	5.5	5.5
Beneficial Finance	Oct-07	28-Sep-72	moratorium	35.0	
Geneva Finance	Oct-07	19-Aug-02	moratorium	5.1	5.1
Capital + Merchant	Nov-07	18-Jan-02	liquidation	5.8	5.8
C+M Investments (ex Blue Chip Finance)	Nov-07	3-Jun-05	Receivership	2.4	2.4
Numeria Finance	Dec-07	9-Sep-02	Receivership	5.2	5.2
OPI Pacific Finance Ltd	Mar-08	13-Sep-99	liquidation	8.5	8.5
Boston Finance	Mar-08	25-Mar-04	Receivership	3.9	3.9
ING Funds x2	Mar-08	28-Feb-02	suspended	6.0	6.0
Lombard Finance	Apr-08	11-Oct-02	Receivership	5.5	5.5
Kiwi Finance	Apr-08	13-Dec-05	Receivership	2.3	2.3
Tower Mortgage Fund	Apr-08	12-Feb-02	closed	6.1	6.1
Cymbis NZ	May-08		Receivership		
Belgrave Finance	May-08	1-Sep-00	Receivership	7.7	7.7
IMP Diversified Fund	Jun-08	10-Mar-00	moratorium	8.2	8.2
Dominion Finance	Jun-08	4-Feb-54	Receivership	54.4	
North South Finance	Jun-08	3-Nov-99	moratorium	8.6	8.6
St Laurence	Jun-08	14-Aug-03	Receivership	4.8	4.8
Dorchester	Jun-08	9-Oct-91	moratorium	16.7	16.7
Canterbury Mortgage Trust	Jul-08	4-Sep-97	closed	10.8	10.8
Hanover Finance	Jul-08	21-Sep-84	moratorium	23.8	23.8
Hanover Capital	Jul-08	4-Aug-05	moratorium	2.9	2.9
United Finance	Jul-08	20-Feb-01	moratorium	7.4	7.4
Guardian Mortgage Fund	Jul-08	13-May-99	closed	9.1	9.1
Totara Mortgage Fund	Jul-08		closed		
AMP NZ Property Fund	Aug-08	26-May-99	suspended	9.2	9.2
AXA Mortgage Bonds	Aug-08	2-Jun-05	closed	3.2	3.2
Strategic Finance	Aug-08	20-Apr-99	Receivership	9.3	9.3
St Kilda (All Purpose)	Aug-08		Receivership		
Compass Capital	Aug-08	10-May-06	suspended	2.2	2.2
AXA 3x Mortgage Funds	Oct-08	2-Jun-05	suspended	3.3	3.3
Guardian Mortgage Units	Nov-08	13-May-99	suspended	9.5	9.5
Orange Finance	Dec-08	3-Jul-03	moratorium	5.4	5.4
Mascot Finance	Mar-09	9-Apr-84	Receivership	24.9	24.9
Compass Capital	Mar-09	10-May-06	Receivership	2.8	2.8
Strata Finance	Apr-09	11-May-01	default	7.9	7.9
Structured Finance	May-09	15-Feb-94	suspended	15.2	15.2
Vision Securities	Apr-10	18-Jul-01	Receivership	8.7	8.7
Rockforte Finance	May-10	10-Jun-03	Receivership	6.9	6.9
Viaduct Capital	May-10	8-Jul-04	Receivership	5.8	5.8
Average Lifespan				10.1	8.1
Standard deviation				9.9	5.7
Median				6.8	6.3

Appendix B - Failed Companies		
Company Name:	**Date Failed**	**Status**
National Finance 2000	1-May-06	Receivership
Provincial Finance Ltd	Jun-06	Receivership
Western Bay Finance	Jun-06	Receivership
Bridgecorp Capital Ltd	Jul-07	Receivership
Nathan Finance	Aug-07	Receivership
Chancery Finance	Aug-07	liquidation
Property Finance Securities	Aug-07	in & out
Five Star Consumer Finance	Aug-07	Receivership
Antares	Aug-07	liquidation
LDC Finance	Sep-07	Receivership
Finance & Investments	Sep-07	Receivership
Clegg & Co	Oct-07	Receivership
Beneficial Finance	Oct-07	moratorium
Geneva Finance	Oct-07	moratorium
Capital + Merchant	Nov-07	liquidation
C+M Investments (ex Blue Chip Finance)	Nov-07	Receivership
Numeria Finance	Dec-07	Receivership
OPI Pacific Finance Ltd	Mar-08	liquidation
Boston Finance	Mar-08	Receivership
ING Funds x2	Mar-08	suspended
Lombard Finance	Apr-08	Receivership
Kiwi Finance	Apr-08	Receivership
Tower Mortgage Fund	Apr-08	closed
Cymbis NZ	May-08	Receivership
Belgrave Finance	May-08	Receivership
IMP Diversified Fund	Jun-08	moratorium
Dominion Finance	Jun-08	Receivership
North South Finance	Jun-08	moratorium
St Laurence	Jun-08	Receivership
Dorchester	Jun-08	moratorium
Canterbury Mortgage Trust	Jul-08	closed
Hanover Finance	Jul-08	moratorium
Hanover Capital	Jul-08	moratorium
United Finance	Jul-08	moratorium
Guardian Mortgage Fund	Jul-08	closed
Totara Mortgage Fund	Jul-08	closed
AMP NZ Property Fund	Aug-08	suspended
AXA Mortgage Bonds	Aug-08	closed
Strategic Finance	Aug-08	Receivership
St Kilda (All Purpose)	Aug-08	Receivership
Compass Capital	Aug-08	suspended
AXA 3x Mortgage Funds	Oct-08	suspended
Guardian Mortgage Units	Nov-08	suspended
Orange Finance	Dec-08	moratorium
Mascot Finance	Mar-09	Receivership
Compass Capital	Mar-09	Receivership
Strata Finance	Apr-09	default
Structured Finance	May-09	suspended
Vision Securities	Apr-10	Receivership
Rockforte Finance	May-10	Receivership
Viaduct Capital	May-10	Receivership

Appendix C – Companies in Receivership with Accompanying Trustee and Auditors

In Receivership	Trustee	Auditors
National Finance 2000 Ltd May 2006 (and in liquidation)	Covenant Trustee Company Limited	O'Halloran & Co, Chartered Accountants
Provincial Finance Ltd Jun-06	Perpetual Trust Limited	Ernst & Young, Chartered Accountants
Western Bay Finance Ltd Aug-06	Covenant Trustee Company Limited	Ingham Mora, Chartered Accountants
Bridgecorp Ltd July 2007 (and in Liquidation)	Covenant Trustee Company Limited	PKF Chartered Accountants & Business Advisors
Nathans Finance Ltd Aug-07	Perpetual Trust Limited	Staples Rodway
Five Star Consumer Finance Ltd Aug-07	Covenant Trustee Company Limited	BDO Spicers, Chartered Accountants & Advisors
Five Star Finance Ltd September 2007 (and in Liquidation)	*NO PROSPECTUS	
LDC Finance Ltd Sep-07	Perpetual Trust Limited	Sherwin Chan & Walshe
Finance and Investments (Partnership) Sep-07	* NO PROSPECTUS	
Clegg & Co Finance Ltd Oct-07	Covenant Trustee Company Limited	Hayes Knight Audit, Chartered Accountants & Business Advisors
Capital + Merchant Investments Ltd Capital + Merchant Finance Limited Nov-07	Perpetual Trust Limited	BDO Spicers Chartered Accountants & Advisors
Numeria Finance Ltd Dec-07	Perpetual Trust Limited	BDO Spicers, Chartered Accountants & Advisors
Lombard Finance and Investments Ltd Apr-08	Perpetual Trust Limited	KPMG, Chartered Accountants
Kiwi Finance Ltd April 2008 (and in Voluntary Administration)	Perpetual Trust Limited	Silks, Chartered Accountants
Fairview NZ Ltd (formerly Cymbis) May-08	Perpetual Trust Limited	BDO Spicers Chartered Accountants & Advisors
Belgrave Finance Ltd May-08	Covenant Trustee Company Limited	Hayes Knight Audit, Chartered Accountants & Business Advisors
Dominion Finance Group Ltd Sep-08	Perpetual Trust Limited	BDO Spicers, Chartered Accountants & Advisors
All Purpose Finance Limited Nov-08	Trustees Executors Limited	PricewaterhouseCoopers

Appendix D: Companies in Liquidation/Moratorium/Frozen Repayments, their Trustee and Auditors

In Liquidation	**Trustee**	**Auditors**
Five Star Debenture Nominee Limited Nov-07	* NO PROSPECTUS	
In Moratorium/Frozen repayments	**Trustee**	**Auditors**
Beneficial Finance Limited	Covenant Trustee Company Limited	BDO Spicers, Chartered Accountants & Advisors
Geneva Finance Limited	Covenant Trustee Company Limited	Staples Rodway
OPI Pacific Finance Ltd	Perpetual Trust Limited	Sherwin Chan & Walshe
MFS Boston Limited	Perpetual Trust Limited	Markhams MRI Auckland
St Laurence Limited	Perpetual Trust Limited	KPMG Chartered Accountants
Hanover Finance Ltd	Perpetual Trust Limited	KPMG
North South Finance Ltd	Covenant Trustee Company Limited	BDO Spicers Chartered Accountants & Advisors
Dorchester Finance Ltd	Perpetual Trust Limited	Staples Rodway
Strategic Finance Limited	Perpetual Trust Limited	BDO Spicers Chartered, Accountants & Advisors
Orange Finance Ltd	Covenant Trustee Company Limited	Grant Thornton
Blue Chip		
Northern Crest Investments Ltd		BDO Spicers, Chartered Accountants & Advisors

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