



ViewPoint

(July 2009)

What's Wrong With The Banking Sector?

A circle of complaints, reprimands and inaction has developed around behaviour of the banking sector since the dramatic drop in the Official Cash Rate (OCR) over the past year. Customers are complaining that interest rates are too high, costs are increasing, credit is getting less accessible and the banks are using any change in facility to seek additional guarantees. Some politicians are demanding that banks take on 'their share' of the crisis driven problems and drop their interest rates closer to the OCR. However, they have now resiled from commissioning a Select Committee inquiry on the basis that inquiries don't change things. The banks are largely ignoring all the talk from politicians, regulators and customers, claiming that difficulties accessing credit and larger reserve ratios needed to deal with their own toxic loans justify their actions.

Interest rates on business loans have been a particular source of conflict as firms need credit to push through waning sales, restructure and ultimately to grow our economy. Conversely the banks see increased risks associated with firms in the real economy in recessionary conditions.

In a survey carried out by the New Zealand Manufacturers and Exporters Association (NZMEA), 86 percent of respondents supported an inquiry into competition in our banking sector, the role of Kiwibank, the factors that negatively impact the real economy and the volatility of our currency. Since the start of the credit crisis 63 percent of respondents said that their bank had increased the margins they pay on credit facilities, 55 percent reported that their bank had increased charges associated with changing credit facilities and 41 percent said they were thinking about changing banks.

The fact that banks and their customers are at loggerheads is no surprise as their goals of maximising their own returns are particularly at odds in a recessionary environment. It is up to politicians and regulators to create a framework whereby these actors improve the economy as well as pursuing their own self interest.

The Problems:

- Demand for Credit
The tax havens status of land and buildings can cause higher interest rates. High interest rates are not such a problem when an asset is gaining value free of any tax burden. This increases the demand for credit and therefore the price of credit for every activity, including those that pay tax.
- Access to Credit
Higher interest rates mean that banks are able to offer higher returns to offshore investors. This drives foreign funds into New Zealand, fuelling inflation, and pushing our exchange rate up, which damages our jobs and exports. The cycle repeats itself as higher inflation causes higher interest rates and more foreign funded debt.

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These problems are further compounded by a lack of competition in the banking sector. All of the Australian owned banks already have a comfortable market share and therefore none of these banks offer any noticeable point of difference. Also, many customers find the logistics of changing banks difficult, making competition for market share a very slow moving process.

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The obvious solution to this problem is for the Government to increase the state backing of Kiwibank so that it can increase its market share. Kiwibank also gives the Government a vehicle with which it can look to increase competitiveness in the retail banking sector.

Balancing the tax take is part of the solution to the excessive demand for credit. If capital gains are taxed along with all other forms of income then it will become less attractive for investors to borrow in order to invest in that asset class assets. This will also have the added advantage of freeing up more credit for the real economy, which helps to grow real wealth and spread that wealth around through more and better employment.

The Reserve Bank needs an additional tool to restrict access to credit. This tool would limit credit volumes in addition to controlling the price of credit as the OCR does currently. Several methods of volume control have been suggested including a Variable Excise Tax, a variable savings scheme and a variable GST rate. These options all have the same effect of reducing the volume of money when inflation is high and increasing the volume when inflationary pressures subside.

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An additional option is for the Reserve Bank to vary the reserve ratios it requires banks to carry according to the economic circumstances. This would mean that higher reserve ratios would be carried over ‘boom’ years and these would be lowered in times of limited credit.

Restricting the volume of credit would also help the tradeable economy. Exporters find it difficult to forecast returns because foreign investors buy New Zealand dollars in order to cash in on our high interest rates. This can lead to rapid changes in the exchange rate which immediately damage profitability and medium term investment in the tradeable economy. These volume control measures would in fact make it easier to attain credit in tough economic times, allowing a recovery to occur far more quickly.

Prevailing conditions make it clear that there are issues around how much credit is allowed into New Zealand, who has access to that credit and at what price credit can be obtained. The issue is far more complex than simply looking at the gap between the OCR and retail interest rates. It is important that an inquiry does take place looking at the interaction of policy and the financial sector as a whole rather than just at bank margins.

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Opposition to an inquiry is difficult to understand given the obvious impact credit problems have had on the economy. As Bill English has mentioned, the tradeable sector of the economy has been in recession for five years. Monetary policy issues and broader policy incentives are at the heart of this problem.