CLOSER FINANCIAL INTEGRATION BETWEEN AUSTRALIA AND NEW ZEALAND?

Lessons from the European Union

DAVID G MAYES SF Fin, Professor of Banking and Financial Institutions, University of Auckland

This paper considers possible lessons for Australia and New Zealand from the approach to financial integration taken by the European Union in relation to the banking industry, capital markets and more generally.1

An obvious lesson from the global financial crisis is that domestic financial institutions are more vulnerable to external shocks than was anticipated and, when large and multinational financial companies get into difficulty, the domestic regulatory authorities struggle to resolve these problems because of financial complexity and interconnectedness.

The European Union (EU) has responded to this issue by undertaking a major shift towards integrated regulation, supervision and resolution within the banking industry in what has been labelled ‘banking union’.2

While New Zealand and Australia have taken the same approach to regulation and supervision as the US and UK, they seem to have adopted the opposite view with regard to resolution, i.e. separation, with each country coping independently with the problems within its own jurisdiction. This is a pragmatic approach which has a good chance of success. It is, however, rather surprising that the authorities did not see the crisis as an opportunity to take a leap forward in terms of closer integration along the lines of the EU, as ‘closer economic relations’ are part of the agenda for both countries. In any case, pragmatism does not necessarily address the question of what structures minimise the losses, either for those directly involved or for the wider economy. Nor does it address the equity of the allocation of the losses.

The US and the UK have taken a different joint approach, arguing that the best way forward is to ensure that the home country of these large multinationals can resolve the problems of the financial group as a whole, without needing to get embroiled in all the difficulties of coordinating the resolution among the various countries in which the group operates (Federal Deposit Insurance Corporation and Bank of England 2012). They have left issues of regulation and supervision to the ongoing discussions taking place through the Financial Stability Board (FSB) and the Basel Committee.

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This paper examines whether there are aspects of the EU approach which could inform a longer-term view of how financial integration in Australasia might progress. Given that the recent Financial System Inquiry (2014) in Australia focused on improved resolution as one of the areas where further policy action is needed, perhaps this offers an opportunity to look more closely at the linkages with Australia’s closest partner.

Although ‘banking union’ is only one aspect of financial integration within the EU, the EU has issued a Green Paper on a capital markets union (European Commission 2015). In some respects, this is an overly grand term for what is planned, but it does beg the question of why there is not an equivalent concept under discussion between Australia and New Zealand given that in many ways the two countries are more integrated than most of their European counterparts.

One feature which confuses the discussion is the distinction between a monetary union and various aspects of financial union. Banking union is proceeding in the EU among countries with different currencies (and independent central banks and, hence, lenders of last resort). If the EU’s approach is transferable, there is no prior requirement for a discussion of a currency union between New Zealand and Australia, even though the subject has been mentioned again following the momentary parity between the two currencies (Hawkesby 2015).

Pursuing financial union in the EU has involved the creation of new institutions and the adaptation of others. However, the way this has been undertaken reflects the political difficulties of getting agreement within the EU. Many changes that might make most sense from a practical point of view have been precluded because they would involve a change in the EU treaties. Not only would such a change take a long time but it would give the member states the opportunity to open up a whole range of difficult issues on other topics, quite possibly resulting in rejection of the package, as was the case with the Constitutional Treaty in 2004. In particular, the European Central Bank (ECB) has been given the role of overseeing supervision because that was permitted under article 127(6) of the existing Treaty on the Functioning of the European Union.3 This leads to some confusion because although the ECB is an EU institution covering all member states it only runs monetary policy for the euro area and only euro area countries are represented on its ultimate decision-making body, the Governing Council. Monetary union is not a prerequisite for close financial union.

Banking union

There are three closely related facets of banking union in the EU — harmonised regulation, a single supervisory mechanism (SSM) and a single resolution mechanism (SRM). Much of the need for a common regulatory framework stems from the perceived need to improve capital adequacy and reduce the fragility of banks, mainly within the Basel III framework. However, it also reflects worries about regulatory arbitrage which do not apply so readily in Australia and New Zealand. Branches of a bank registered in one member state can be opened in another but are subject to prudential regulation by the home country not the host. Hence, if home countries do not apply the same prudential rules, customers can shop for the regime they find most attractive and banks themselves will do the same to the extent that they can rearrange their structure.

Given that the four main banks are the same in Australia and New Zealand there would be many advantages from having the same prudential regulatory framework. If nothing else, there should be lower compliance costs. Ironically, the main difference would be felt outside the main four, principally because of the different treatment of non-bank depository institutions. However, even a fully harmonised system would need to be implemented within the context of the different legal systems. The existence of EU law means that a common scheme could be issued in the form of a regulation which applies in all countries. In the Australian and New Zealand prudential regulatory framework such a document would look more like a directive whereby a given set of rules would need to be transposed into national law. Such regulation is thus not likely to be identical in detail. Indeed, banking handbooks are large and very detailed documents and the EU has not got to the point of harmonising them, although the European Banking Authority (EBA) is working through a long list of detailed requirements for harmonisation in what is being called a ‘single rulebook’ (EBA 2015). Indeed the role of the EBA points to the need for some sort of joint institution. Perhaps, for Australia and New Zealand, this could be spawned from the Trans-Tasman Banking Council.
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There are also easy simple objections to harmonisation: it may not be needed at a detailed level; and some element of competition among regulatory regions may be helpful in developing the system. Such competition not only provides evidence of how other systems might work but it enables the banks themselves to indicate the different merits of alternative approaches through exercising regime shopping.

However, it is the supervisory and resolution areas where the gains are likely to be largest. It is generally seen as important for any agency that might have to bear a cost from the resolution of a failed bank to have a hand in the supervision of that bank although, in a national framework, the resolution agency sometimes relies on another agency to undertake the supervision, as is the case in Canada. A joint supervision framework would therefore seem to be necessary if Australia and New Zealand were to have joint resolution. Whereas, in the EU, a new institution has been required to run the supervisory mechanism (the ECB), the need for extra institutions is more limited in the case of Australia and New Zealand simply because it largely relates to the same four banks. Simply making APRA responsible for the New Zealand subsidiaries would ease APRA’s task in supervising each bank as a whole. APRA would almost certainly wish to delegate the supervision of the smaller New Zealand institutions as it would be inefficient to try to run that from Sydney and considerable local knowledge would be required.

A problem would arise, however, if the Reserve Bank of New Zealand, as the New Zealand supervisor, were to disagree with APRA. In the EU, they have an elaborate means of resolving these differences but much of that complexity occurs simply because non-euro members are not represented on the Governing Council of the ECB and hence have no say in the decisions (Castañeda et al. 2015, ch. 3). An equivalent arrangement would have a Supervisory Board, composed of officials from the two agencies. The problem in the Australasian framework is simply that one country is so much larger than the other. Any supervisory arrangement that even vaguely represented the size of the two jurisdictions would mean that New Zealand could always be outvoted, whereas equal representation would be disproportionate to the problems. There would only need to be a board such as this relating to cross-border issues, as the bulk of Australian issues could be undertaken nationally, as it is now. A decision on any such board is thus going to be very difficult politically, even though the practicalities of trying to arrange coordinated supervision are much more straightforward.

Clearly, there is also a complication at the level of macroprudential regulation and not just at the microprudential regulative stage just discussed. Here, however, the European framework would be fairly easy to emulate. The European Systemic Risk Board, which contains representatives from each member state but is chaired by the President of the ECB, does not have executive powers. It is simply a watchdog searching for problems at the European level. It can offer recommendations and impose sanctions, naming and shaming those who do not follow the recommendation but, ultimately, the responsibility for action remains national. Such a framework, run jointly by the two Australasian central banks, could operate with very little bureaucratic burden but permit the exchange of information in a more formal way than at present. The question remaining is whether there are macroprudential issues at a regional level which are not necessarily covered by the countries acting independently.
Resolution is the main issue not simply because New Zealand has chosen to go its own way with Open Bank Resolution (OBR) but because this issue has not been firmly addressed in Australia despite this being one of the main recommendations of the recent Financial System Inquiry (FSI 2014, Rec. 5). The accepted paths to resolution that are likely to work well in the eyes of the Financial Stability Board (FSB 2014a) are the polar extremes of: resolving the banking group as a whole through the home country (single point of entry, SPE); and carving up the group’s systemically important parts into separate entities that can be resolved by each country where they are located separately (multiple point of entry, MPE). However, MPE is usually necessary when the banking group is complex and a large portion is in other countries. In the case of Australia and New Zealand neither is true. The New Zealand operations are straightforward and the large majority of activity is in Australia. Other things being equal, this would imply that SPE is likely to be the better way to go and that this would minimise both the cost to the creditors and the knock-on cost to the wider economy in both countries.

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The main outstanding issue would be fairness both in burden-sharing and in decision-making. Clearly, the creditors are different under the two models. The exact distribution would depend on how the loss absorbing capacity is organised. The non-deposit funding of the New Zealand subsidiaries has a strong Australian element, 100 per cent for the equity, although losses there would ultimately be borne by the Australian parent and its shareholders who are more international. The main beneficiaries of SPE would be the New Zealand depositors, except in the case where it is only the New Zealand subsidiary that is in difficulty. Under OBR, New Zealand depositors have neither preference nor insurance and hence as junior unsecured creditors are quite likely to be bailed-in should OBR be triggered (Hoskin and Woolford 2011). Under SPE, neither the New Zealand nor Australian depositors are likely to be much affected, the former because it is the parent that is being bailed-in and the latter because of priority. In the Australian case, even if guaranteed depositors are bailed-in, it would be the taxpayer who bears the interim loss until the guarantee scheme is paid back by more junior creditors under the resolution.

Here the EU has little new to offer. Mutualisation of deposit insurance is not planned. The difficult governance arrangement, whereby the Single Resolution Board (SRB) proposes a form of resolution (normally following a request from the ECB that such action is needed), and the Commission and then the Council has the opportunity to object, is again a function of the Treaty arrangements. Under the Meroni doctrine, the Commission cannot delegate the decision to the SRB, it needs to approve it itself (Chamon 2014). And, if the technical decision is rejected then the Council of Ministers will need to be involved. Such an objection is not very plausible in the SRM as there would then be insufficient time for the resolution to be completed before markets can reopen, thereby generating a default (Castañeda et al. 2015, ch. 3). In the Australasian case, a problem would arise if New Zealand felt that the resolution arrangement was in some sense unfair and that their portion of the costs was too high.

It is not practical to handle such an objection while the resolution is being put in place and trying to provide any restitution once the losses have been allocated would be very difficult to achieve and cannot realistically involve the creditors/shareholders. It would be a political matter for the two governments to sort out, as it was in the case of Fortis (Wiggins et al. 2015).
One area where there is less of a problem is lender of last resort. Assuming each central bank follows the normal Bagehotian precepts and is prepared to lend in unlimited amounts to solvent institutions against good collateral (at above market rates to prevent it becoming lender of first resort) then each can address the stability issues in their own country. The difficulty emerges in the grey area of emergency liquidity assistance where solvency may also be in question — Charles Goodhart argues that this will normally be in question (Goodhart and Schoenmaker 2014). But, otherwise, lending would be undertaken in the domestic currency of the market where there was a liquidity problem. A coordination issue would arise if the banks were raising liquidity in one market in order to resolve a problem in the other market.

**Capital markets union**

The Commission has now issued a Green Paper on 'capital markets union' (European Commission 2015). In part, this is a reaction to the limited development of capital markets in some member states and the consequential over-reliance on bank lending — something which resonates in New Zealand. But it also reflects a wish to develop cross-border markets and assist both savers and investors, thereby contributing to improving the prospects for economic growth and increasing efficiency. The issues that it raises, relating to unnecessary differences in tax provisions (especially withholding tax), regulations, the nature of instruments etc., are readily applicable in the Australia-New Zealand context. An interesting question in the comments on the Green Paper is the extent to which harmonisation should be viewed from the perspective of the investor or from that of the borrower.

**Other aspects of financial integration**

From a regulatory perspective, the EU divides the financial sector into three segments: banking; securities markets; and insurance and occupational pensions. The last of these has received little attention in the follow-up to the global financial crisis but issues relating to the portability of pension entitlements and other benefits have featured highly in the attempt to have a more integrated system. In many respects, this is even more pertinent in the case of Australia and New Zealand, with the New Zealand population in particular being more mobile than most of its European counterparts. While some action has been taken on aspects of superannuation, allowing funds accumulated in Australia to be transferred to New Zealand, in some respects the rules have moved in the other direction. For example, KiwiSavers are no longer able to use their funds to buy a first home in Australia; it is now restricted to New Zealand. Even if we ignore many of the opportunities for learning from each other’s experiences, prima facie this looks to be an area where there could be considerable benefits from even closer integration. The EU has imposed a whole raft of problems on itself through Economic and Monetary Union (EMU) which entered its third phase at the start of 1999 when the euro was launched. By not having a fiscal union or a political union with a full federal level it has encountered a set of difficulties that would tend to discourage other countries that do not closely meet the Optimum Currency Area criteria from forming a union of their own. Given the lopsided nature of the relationship between Australia and New Zealand this would be entirely a problem for New Zealand, which would not only give up its own monetary policy but would have to undertake real adjustment if monetary conditions in Australia were inappropriate.

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In particular, New Zealand has been more inflation prone than Australia and has run higher interest rates as a result. Thus, if nothing changed, it would run exactly the risks of relative inflation that have bedevilled Greece, Ireland et al.

It is difficult to see why closer financial integration should not appeal to Australia as it would imply very little in the way of change and the possibility of worthwhile gains from reduced costs and better coordination. The attractiveness for New Zealand is less obvious, as the changes would be greater, although gains are normally also greater for the smaller country accessing the larger market.

Having a system dominated by another ‘country’ sounds unappealing but this is exactly what the smaller EU countries have been prepared to sign up to, even the EEA members (Iceland, Liechtenstein and Norway), who do not even have a seat at the table in the discussion of new regulations. Of course, membership of the EEA/EU is a total package of which financial integration is a small part. However, on this occasion much of banking union is different. While the regulatory harmonisation and the resolution directive are EEA/EU-wide, the SSM and SRM are voluntary for all countries outside the euro area (although it is not clear that the EEA countries can join). The UK and Sweden have made it very clear that they are not interested in joining and, as important home countries, that is understandable. Host countries such as Bulgaria and Romania have expressed an interest. If several others also decide to join — without joining the euro — this will be an interesting indicator for New Zealand.

Notes
1. I am grateful for the help of Giannoula Karamichailidou in preparing this paper. The research was supported financially by the European Union through a grant on the topic ‘The Outlook for Monetary and Financial Integration in the EU’. The views expressed are those of the author.
2. See Castañeda et al. (2015) for an exposition and critique.
5. This is one of the reasons for what may seem an odd dichotomy of structure where the SSM is run by the ECB in Frankfurt yet the SRB as the resolution agency is an offshoot of the Commission and is in Brussels.
6. Further details on this are provided in Office of the Minister of Consumer Affairs 2015, Opportunity to clarify KiwiSaver first home withdrawal.
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