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Is there market discipline for New Zealand non-bank financial institutions?

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Abstract

This paper studies effects of market discipline on the pricing of term deposit type investment products issued by New Zealand Non-Bank Financial Institutions (NBFIs) and how risk disclosure by NBFIs affects this relationship. While we find that more risky NBFIs indeed have to offer higher interest premiums, it is remarkable that investors do not appear to reward NBFIs for disclosure by accepting lower interest rates for better transparency. We attribute this unexpected result to possible limitations of a purely prospectus based disclosure quality index developed for this study or the inherent opaqueness of financial firms which cannot be overcome by even the best of disclosure [as argued by Morgan D.P., 2002. Rating banks: risk and uncertainty in an opaque industry. The American Economic Review 92 (4), 874–888].

JEL classification: G20; G21; G28

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1. Introduction

The concept of market discipline is a topic much has been written about in recent times, both in the form of academic research and in the financial press. One could define it as the power of markets to exercise a disciplinary force on the risk-taking behaviour of firms and in the context of this paper of financial institutions in particular. Not surprisingly, such support is welcome to market supervisors as they are engaged in continuously adapting their regulatory

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framework to unrelenting product and service innovations in the financial industry. A consequence is that the new Basel Capital Accord now explicitly includes the notion of fostering market discipline, mainly through better disclosure, as one of its three supervisory pillars (BCBS, 2004).

In New Zealand, market discipline as a major component of the supervisory regime of the banking system is nothing new. Quite to the contrary, as early as 1989 the Reserve Bank of New Zealand (RBNZ) as the prudential banking supervisor was given a "caveat emptor" market discipline based charter limiting intrusive powers under normal circumstances with the current extensive regime of quarterly disclosure coming into force in 1995. The New Zealand model is in fact often cited as an example in current discussions on a market discipline supported regulatory framework, for instance in Mayes (2000) and Gup (2000).

Another very unique feature of the New Zealand banking system, however, has not been noted by international researchers so far. This relates to the large number of bank-like financial institutions, locally called "Non-Bank Financial Institutions" (NBFIs), which are subject to neither RBNZ supervision nor comparable disclosure requirements as registered banks. In a practical sense, these firms have no restrictions on engaging in any type of banking activities but they are not authorized to carry the term "bank" in their name. Over the past few years a very diverse the NBFI sector has emerged which now accounts for approximately 10% of total domestically-sourced credit provision, provides half of consumer credit and over 15% of commercial property lending, with the share of development lending significantly higher (RBNZ, 2005, p. 22).

This study looks at effects of market discipline for a particular group of 62 NBFIs which finance their lending activities through an ongoing issue of investment products like term deposits, debentures, etc. Note that disclosure requirements for this group are the same as for any other company that issues securities to the public and are defined by provisions of the New Zealand securities legislation. These rules are, however, considerably less stringent than the bank disclosure regime and over the past few years concerns about inadequate risk disclosure have been growing. Accordingly, both the New Zealand Securities Commission and the New Zealand government have initiated appraisals into aspects of the NBFI regulatory regime.

Despite such revived attention, empirical research into the effects of market discipline on New Zealand NBFIs appears to be missing at this point. This is all the more surprising as the NBFI sector actually provides an almost perfect "lab case" to study effects of mandated disclosure as a regulatory tool to enhance market discipline, much more suitable than most banking systems around the world where moral hazard problems such as "too big to fail", implicit support or deposit insurance cloud the disciplinary effects of good risk disclosure. Empirical studies in the US or Europe typically do not directly test impacts on deposit rates but rather on spreads of subordinated debt instruments where investors are actually aware of their investment risk (e.g. Flannery and Sorescu, 1996; Sironi, 2003).

With this in mind, this study first tests how the riskiness of NBFIs as measured by a number of risk proxies affects term deposit rates offered by the NBFIs, respectively demanded by the investors. We in fact find strong evidence of market discipline with higher interest spreads paid by more risky NBFIs. More remarkable, however, is our second result where we develop a broad index assessing the quality and quantity of prospectus information provided by NBFIs but cannot find any evidence that investors reward good disclosure by accepting lower interest premiums. The paper finally explores and partially confirms some predictions of the Cordella and Yeyati (1998) banking competition model which postulates that with better disclosure, financial firms will shift to quality competition, i.e. opt for lower risk strategies whereas non-transparent markets foster pure price competition at the expense quality of individual financial firms.