Study Guide

Core Knowledge

Economic Environment

31857 v1

New Zealand Certificate in Financial Services v2
Level 5
NZQA credits 10

Professional IQ College

Your pathway to professional development
professionaliq.co.nz

CONTENTS

Level 5 - Programme Information

Welcome to this unit of the NZQA Level 5 New Zealand Certificate in Financial Services course for financial services professionals.

Please note that all students are expected to **read the contents of this study guide**, which is also available on the Professional IQ College website under your on-line dashboard at: https://professionaliq.co.nz/Login/6586/

This module relates to the New Zealand Certificate in Financial Services Level 5 - Core Knowledge module and is compulsory for completion of the New Zealand Certificate in Financial Services. It is expected that participants will need to devote at least 10 hours per week of study to complete the prescribed learning in this workbook. Students will be required to supplement each week of learning with some additional hours of their own work. This additional time is required to ensure participants read, think and reflect on the learning being covered.

Professional IQ College is a Private Training Establishment (PTE) registered with NZQA and accredited by The Skills Organisation to deliver training and assessment for financial services qualifications.

The New Zealand Certificate in Financial Services Level 5 is registered on the New Zealand Qualification Framework (NZQF). It has a compulsory Core Knowledge module, and students choose one or more strands from the following:

- Investment
- Life, Disability and Health Insurance
- General Insurance
- Residential Property Lending

Professional IQ College programmes cover each of the strands either as online modules or through Recognition of Prior Learning (RPL) or Recognition of Current Competency (RCC).

Programme Outcomes

To be awarded the New Zealand Certificate in Financial Services Level 5, you need to complete this module – Core Knowledge and one other elective module from the programme. This study guide is one of four, which provides all the study material you will need to learn and complete assessment of the Core Knowledge module of the certificate. There are four NZQA unit standards that make up the Core Knowledge strand of the qualification.

Programme Content

The unit standards covered in the Core Knowledge are:

Unit Standard 31855v1, Level 5, worth 10 credits
Demonstrate and apply knowledge of financial services legislation, good conduct, professionalism, and Six Step Process

Unit Standard 31856 v1, Level 5, worth 8 credits
Demonstrate and apply knowledge of the financial services sector to provide financial advice solutions

Unit standard 31857 v1, Level 5, worth 7 credits
Demonstrate and apply knowledge of key factors in the economic environment to provide financial advice solutions

Unit Standard 31858 v1, Level 5, worth 10 credits
Interpret and explain provisions in the regulatory framework in a financial advice services context.

This module of study is intended for people working, or intending to work, in roles in the financial services industry. It is an appropriate qualification for those seeking to advance to specialist roles and/or enhance their skills and knowledge within retail and personal services areas of the financial services industry.

People credited with these unit standard are able to demonstrate, in a financial services context how to:

- Apply good conduct obligations in client interactions, including the advice process and the key elements of legal, ethical, and professional obligations.
- Provide a range of financial advice solutions to clients using knowledge of key financial institutions, systems, markets, and products/services.
- Provide a range of financial advice solutions using knowledge of key factors in the economic environment that impact participants in the financial services sector.
- Interpret applicable provisions in the regulatory framework to use when providing Financial Advice and Financial Advice Services.

Study Guides

At the time of producing the study guides they contained the most up to date information regarding levies/rates, legislation and regulations and company names. Students will not be penalised for using the published levies/rates, legislation or regulations specified in this study guide where they have subsequently changed before the study guide has been updated.

Each module has one or more study guides and assessment documents which should be read in conjunction with each other.

It is recommended that you read the study material and complete the assessments as you go. The assessments are broken up into tasks and you are required to demonstrate competency in each outcome, by answering the questions in the assessment documents or providing workplace evidence where specified in the assessment pack.

On completion of the assessment, you will be awarded the credits applicable.

The unit standards which make up the New Zealand Certificate in Financial Services can be downloaded from the NZQA website: www.nzqa.govt.nz.

This study material covers the fundamental knowledge required for employment in the financial services industry.

For more information on the Assessment Requirements, Process and Appeals Process, please see the Student Handbook which is available on your on-line dashboard.

Student Support

The Professional IQ Website

Students can access their online details by logging into their Dashboard on the Professional IQ website – www.professionaliq.co.nz.

Each student's on-line dashboard contains full course details on the student's study pathway.

Each student is allocated a Student Liaison person who is available for questions and queries.

Telephone and Email Support

Students can contact the College at any time during working hours by phoning 09-306 1731 or by emailing info@professionaliq.co.nz. A member of the Student Liaison team will be in contact with you on a regular basis to check on your progress.

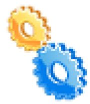
Icons used

The following icons are used throughout the courses offered by Professional IQ College:

 Key concept

 Case study

 Example

 Resources and links

 Test yourself

Study Guide

Core Knowledge

Economic Environment

Overview

The financial services industry affects our everyday life. It involves huge flows of funds (billions of dollars) throughout our economy, which in turn affect business profits and the production of goods and services. We use financial services in our everyday lives and our clients rely on us to provide them with quality financial advice and protect their best interests for insurance, investment and lending. We are the professional experts in our fields and so need to be held to a higher standard than others. The NZCFS and the Core Knowledge strand are the first steps in formally turning our industry into a profession, set minimum standards of knowledge and behaviour towards clients and gain greater confidence from our clients.

Every aspect of the Core Knowledge modules can be related to the work you do:

- Economics, business cycles, monetary policy, regulation and tax affect the way we give advice and often the type of advice our customers need.
- We interact with a number of different sectors in the industry, from providers of insurance, underwriters, bank and non-bank lenders, investments, fund managers, lawyers and accountants, so it is important we understand the role we all play.
- The advice process is the foundation of what we do with clients and so it is always good to step back and review this, to ensure we have a process that allows us to provide solutions that are appropriate and fit for purpose, and keep records to demonstrate this.
- Taxation affects everyone. As we know the only two certainties in life are death and taxes, two very pertinent topics in our industry.
- Estate planning can be peripheral to what we do day to day, and it is our professional duty to at least understand the structures of estate planning to help clients understand the importance of having this in place.

In this study guide we will be looking to understand the wider economic market and financial systems, your role in the market and how they fit together.

Course material structure

To ensure you move through the course material logically and progressively, all sections have headings and sub-headings which refer to the outcomes, evidence requirements and ranges as set out in the standard.

It is recommended that you apply your knowledge and understanding of what you have learned at your workplace. It is more beneficial for you to work with your mentor or supervisor, so that you develop a better understanding of how these newly learned skills fit into your work.

Economic environmental factors that impact financial markets participants

New Zealand Monetary Policy

The Reserve Bank uses monetary policy to control inflation and keep it within a specific target band. Monetary policy is encountered by ordinary New Zealanders in several ways. New Zealanders directly encounter the main instrument of monetary policy, the Official Cash Rate (OCR), when they borrow money at retail interest rates through mortgages, credit cards or personal loans, or when they save money in bank accounts that earn interest. Retail rates of interest are directly related to the OCR set by the Reserve Bank.

Other ways that New Zealanders encounter monetary policy are through its effect on inflation and economic activity. Since the late 1980s, monetary policy has contained inflation within narrow limits – so effectively, in fact, that we forget that just a generation ago it was thought normal to have annual price rises of 16 or more percent. Monetary policy also helps prevent large swings in economic growth and employment.[1]

Official Cash Rate (OCR) and Other Interest Rates

Since March 1999, the Reserve Bank has implemented monetary policy with an instrument known as the OCR. This is an interest rate set by the Reserve Bank to ensure the New Zealand economy remains within the agreed inflation band. The OCR is reviewed eight times a year by the Reserve Bank. Unscheduled adjustments to the OCR may occur at other times in response to unexpected developments; this occurred following the 11 September 2001 attacks on the World Trade Centre in New York.

Under this approach the Reserve Bank has significant influence over short-term interest rates, and hence can affect credit creation in the economy. The OCR is the interest rate that banks can borrow money overnight from the Reserve Bank should they run short of settlement cash, and the interest rate they will earn on settlement cash balances overnight. The OCR also affects the 90-day bill rate and other longer-term interest rates in the economy. Thus, a change in the OCR, and corresponding interest rates such as lending and savings interest rates, can be expected to produce a broadly corresponding change in the entire interest rate structure of the economy, which impacts on savings, spending, investment and borrowing decisions, and, ultimately, inflation.

For example, if interest rates are increased, this discourages consumers and firms from borrowing, because they will have to pay more interest on their loan, and

[1] https://www.rbnz.govt.nz/monetary-policy/about-monetary-policy

encourages them to save more, because their savings get a higher rate of interest. When consumers and firms borrow less and save more, they spend less money on consumption and investment goods. This reduces activity in the economy. Conversely, a fall in interest rates increases demand for consumption and investment goods. Therefore, a change in interest rates (whether up or down) will impact on mortgage advisers, and the demand for mortgage and lending products through bank and non-bank lenders.

An increase in the OCR usually results in an increase in the variable (floating) rate that registered banks (and often non-banks as well, because it will affect their lines of funding) offer to consumers. This reduces repayment affordability, and perhaps can lead to a decrease in demand for housing loans. This increased interest rate flows on to other credit products such as personal loans, credit cards and car loans.

An increase in the OCR is usually good news for savers and investors though. When the OCR is increased, then usually the interest rate offered on savings accounts, call accounts and term deposits is also likely to increase. It may also mean less of a demand for investments that are less predictable in their returns (such as shares), as investors and savers will have a higher return on their investment, with less risk. When the OCR is reduced, it reduces the rate available on savings, call accounts and term deposits – so investors are more likely to look at other forms of investment to try and get better returns on their savings – such as shares and property investments.

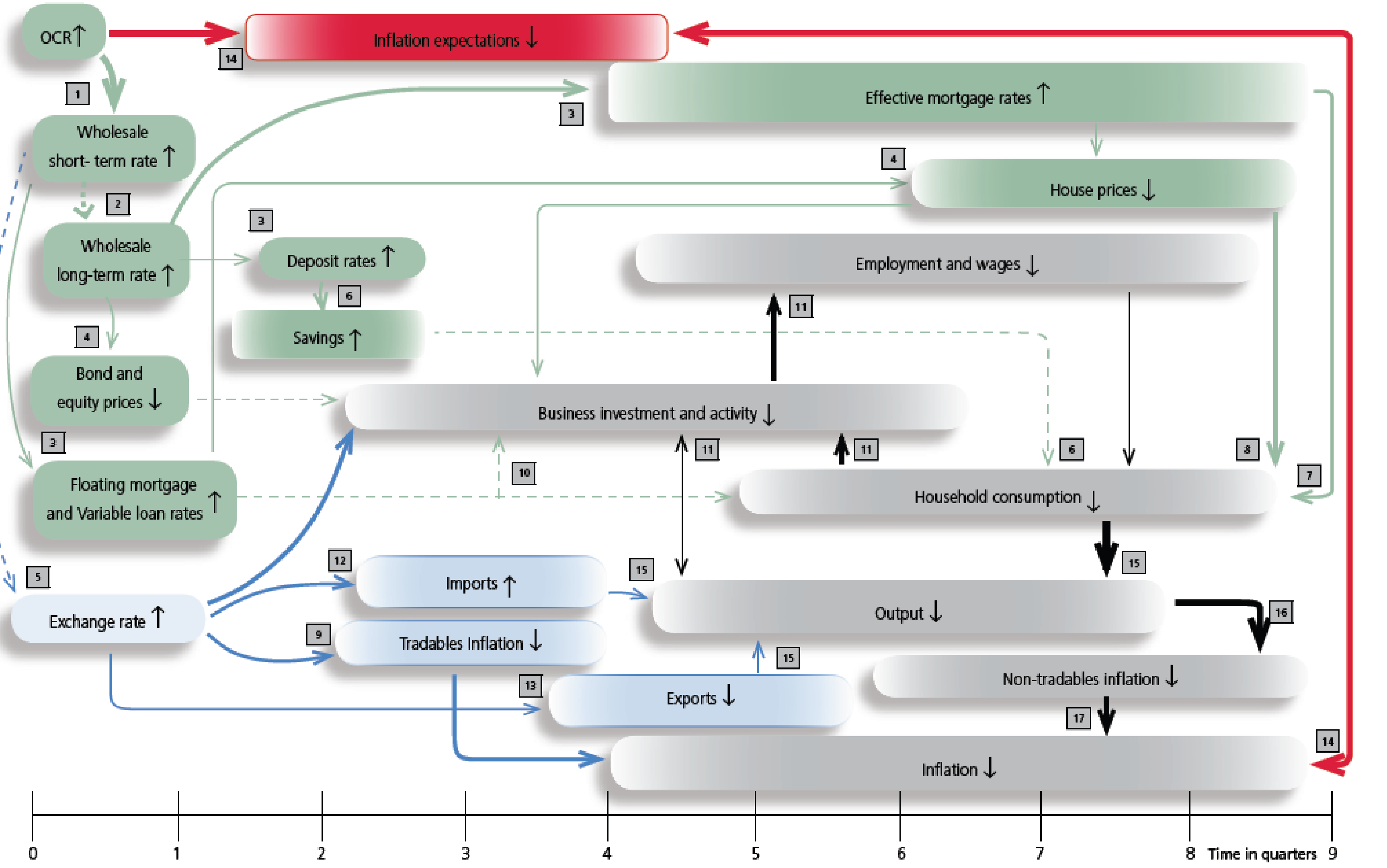
In summary: when the OCR is increased, other interest rates also increase. The effect of an increased interest rate is to slow down spending activity in the economy (as high activity is linked to higher inflation) – so there will be less borrowing and more saving or investing.

The reverse is true – when the OCR is decreased, it is to try and stimulate the economy with more spending and demand for finance (loans) to fund that spending.

The RBNZ's flowchart, 'Transmission mechanism of New Zealand monetary policy', written by Aaron Drew and Rishab Seth, provides a useful flow chart on the effect of increasing the OCR on the economy. This flow chart and corresponding notes are provided below to help explain this concept further:

Figure 1

The transmission mechanism of New Zealand monetary policy



Explanation of the movements in the OCR and corresponding reactions by the economy

Number from Figure 1 above	Explanation
1.	Increase in OCR increases the wholesale short term interest rates
2.	Increase in wholesale short term rate then raises the wholesale long term rates
3.	Higher wholesale rates feed into higher interest rates for deposits such as term deposits and mortgage rates which are on floating.
4.	Increased cost of borrowing reduces the demand for houses which decreases house prices. Unfortunately, higher interest rates reduce bond prices due to the inverse relationship between bond prices and market interest rates (interest rates rise, value of bonds falls and vice versa). Due to increased borrowing costs to companies, share prices fall as profits reduce.
5.	Higher interest rates attract more overseas investors because they can earn a larger return for a similar level of risk, even after allowing for the exchange rate.
6.	When deposit rates increase, so too does savings.
7 and 8, 10, 11.	With higher interest rates, greater mortgage costs, better returns for savings, household consumption decreases. This fall in demand for goods means business earn less revenue so have fewer funds to pay higher wages or expand. They reduce output and cut back on employees and other resources. This in turn provides less income to households who cut back on spending.
9, 12, 13, 15, 16	When the exchange rate increases, it costs less to import goods so that increases, but exporters selling overseas receive a lower amount for their goods, so that decreases. The net effect is tradeable and non-tradeable inflation falling. Exporters produce less as they have lower revenues.
17	The overall effect of an increase in the OCR is a reduction in inflation.

1. Test yourself

Name two market participants that would be MOST impacted by an increase to the OCR?

Inflation Rate

The Reserve Bank uses monetary policy to maintain price stability. At present price stability is defined as keeping inflation "on average over the medium term" between one and three percent in an agreement set out between the Minister of Finance and the Reserve Bank Governor, called the Policy Targets Agreement (PTA)[2].

Inflation is the term used to describe a rise of average prices through the economy. It means that money is losing its value. 'The underlying cause is usually that too much money is available to purchase too few goods and services, or that demand in the economy is outpacing supply. In general, this situation occurs when an economy is so buoyant that there are widespread shortages of labour and materials. People can charge higher prices for the same goods or services'[3].

Inflation can be very damaging for a number of reasons. First, people may be left worse off if prices rise faster than their incomes. Second, inflation can reduce the value of an investment if the returns prove insufficient to compensate them for inflation. Third, since bouts of inflation often go hand in hand with an overheated economy, they can accentuate boom-bust cycles in the economy.

Sustained inflation also has longer-term effects. If money is losing its value, businesses and investors are less likely to make long-term contracts. This discourages long-term investment in the nation's productive capacity.

The flipside of inflation is deflation. This occurs when average prices are falling and can also result in various economic effects. For example, people will put off spending if they expect prices to fall. Sustained deflation can cause a rapid economic slow-down.

There are various ways of measuring inflation. The one used in the Policy Targets Agreement is the CPI published by Statistics New Zealand. This records the change in the price of a weighted 'basket' of goods and services purchased by an 'average' New Zealand household. Statistics New Zealand weights and indexes the various items in the basket and forms the 'all-groups' index. The percentage change of this index is typically referred to as 'CPI inflation' and is usually expressed over both a quarterly and annual period.

The contents of the basket are defined by Statistics New Zealand, which periodically reviews and re-weights them, using data obtained from their annual Household Economic Survey. This is necessary because the basket

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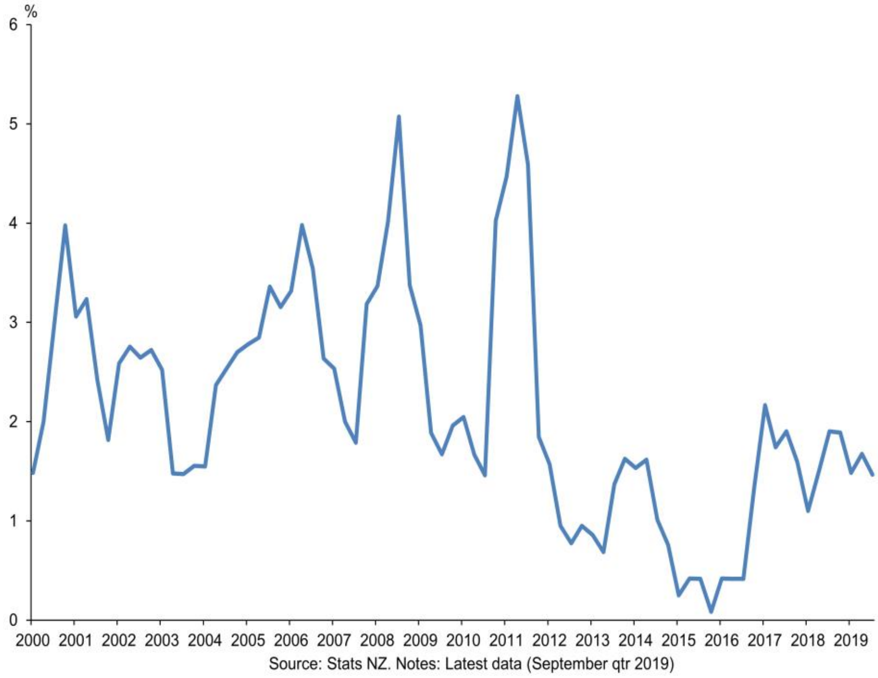
[2] https://www.rbnz.govt.nz/challenge/team-resources/monetary-policy-and-inflation

[3] https://www.rbnz.govt.nz/research-and-publications/fact-sheets-and-guides/factsheet-what-is-inflation

of goods and services purchased by the average household will change over time. The basket includes everyday items such as milk, cheese, eggs, as well as items of clothing, healthcare costs, petrol and transport costs and communication.

Changes to CPI inflation in New Zealand in the last twenty years:[4]



You will see there are four maximum points on this graph. They correspond to:

2001 – The Twin Towers attack in the USA. As a major trading partner, the impacts on the US economy had an impact in NZ
2006 – The Global Financial Crisis (GFC) – and increased interest rates for finance
2008-2009 –The economy was bouncing back after the GFC (increased spending generally leads to higher inflation rates)
2011 – The big Christchurch Earthquake

This article from 'Stuff' also discusses some other influences in the economy over the 2000-2019 period – including an increase in GST during that time: http://www.stuff.co.nz/dominion-post/4898716/Inflation-soars-to-4-5-per-cent

[4] https://www.rbnz.govt.nz/monetary-policy/inflation

Inflation in action:

In the mid 1990's you could buy a jelly tip for $1.00. According to the RBNZ[5]'s calculator, $1.00 in Q4 of 1995 would now be $1.69. However, the price of a jelly tip now sits around $2.40. The cost of all the ingredients that go into the jelly tip have increased, along with the costs of staff.

If you had invested that $1.00 (at an annualised rate of return of 2.1%, using the 90-day bill rate returns over that period), you'd have approximately $1.62 – making a gain, but after inflation as seen in the Jelly Tip example, actually losing the purchasing power of your money.
That's why, in periods of high inflation, consumers like to invest in things that hold their value, or increase as high as, or greater than, the rate of inflation. These are assets such as property and shares, or other tangible assets – such as gold. Investments into cash and bonds may not keep up with inflation, especially after tax is deducted from the return.

[5] https://www.rbnz.govt.nz/monetary-policy/inflation-calculator

Inflation particularly affects **savers and fund managers**, and therefore investment advisers. It has a wider impact on all market participants, because inflation can affect the disposable income consumers have. For example, if the cost of buying groceries increases, then consumers have less money to pay their mortgage or insurance covers, which impacts on financial advisers, and also the product providers, in this case being **insurance companies and lenders**.

It is likely that there will be impacts on lenders (bank and non-banks), insurance companies, and advisers who have clients that may be struggling to meet all their commitments and may need a review of their financial products.

Life and health insurance advisers may consider it appropriate to ensure clients have CPI cover in their insurance policies – to ensure that the future lump sum, or regular sum payment, is still sufficient for the client's needs, in the event of a future claim.

For example

You complete a needs analysis with a client which indicates they would need a lump sum of $400,000, being $250,000 to pay off the mortgage, and $150,000 to replace $30,000 lost income for five years (the client needs a lower level of replacement income because there is now no mortgage payment. So, $30,000 covers their annual living costs, and gives them a bit left over for a holiday. If inflation is running at 3% (the upper level of the bank agreed between Government and the Reserve Bank), then technically, the $30,000 is losing 3% of purchasing power each year (because the associated costs have gone up).

According to the RBNZ's inflation calculator, a basket of goods that cost $30,000 at the end of Q1 in 2010, would have cost $35,003.03 at the end of Q4 in 2019. This shows how the loss of purchasing power, could mean that the family would need to cut back on expenditure, and maybe have to make choices about spending priorities. Including the CPI adjustment on a policy can give your clients peace of mind.

In addition, it is important that fire and general advisers' complete annual reviews; the cost to replace a house is likely to increase from year to year, and it is important that the level of cover insured reflects the actual cost to repair or replace.

2. Test yourself

a) What is the current agreed inflation band in New Zealand?

b) Identify two ways an insurance company could be affected by a higher inflation rate?

Exchange Rates

Key concept

Foreign exchange rates are influenced by a multitude of factors. Exchange rates capture the supply and demand of a currency in an easy to quantify metric. Demand is driven by people's perception of a currency's value, and this perception is informed by economics, politics and the media. The discussion below only focusses on exchange rates as a stand-alone concept – but it is important to remember that, as with any economic concept, other factors influence the actual outcomes.

The exchange rate is literally the value of one currency compared to another.

"The exchange rate influences the foreign currency prices of our exports. If the exchange rate is high, then the foreign currency prices of our exports will also be high, which reduces demand for our exports. In addition, a high exchange rate reduces the New Zealand dollar price of imports, increasing demand for imports and reducing demand for domestically produced goods. Therefore, a higher exchange rate will also reduce economic activity."[6]

However, as a cautionary note – many of our export markets will use the USD as the 'pegged' currency – so changes in the NZD exchange rate are more likely to affect the exporter, rather than the purchaser. If one sheep for example is worth $50USD, then no matter what the NZD is doing, the purchaser will only pay the $50USD. It is the exporter who will either gain or lose (of course, both exporters and importers use tools to fix the exchange rate for a certain period of time, to help manage fluctuations with more certainty).

[6] http://www.rbnz.govt.nz/monetary_policy/about_monetary_policy/

Key concept

Dividend payments by domestic firms to overseas shareholders are supplied to the market in NZD and withdrawn in the relevant foreign currency (e.g. AUD); the transaction increases the supply of NZD in the foreign exchange market. Australian firms investing in New Zealand industry pay AUD into the market and these must be converted to NZD; that is, NZD are demanded from the market. Private sector borrowing abroad and government monetary aid, say to Iraq for post-war humanitarian assistance, is treated in the same way. All money flows through the capital and current account affect the demand and supply of NZD and **thus play a part in determining the exchange rate.**

Why should we care about the currency? If there has been one lesson from the Global Financial Crisis it is that a small imbalance left unchecked can snowball into something far more sinister. For a small, export-reliant economy like New Zealand, currency plays a critical role in either mitigating or exacerbating financial imbalances.[7]

NZD currency high and lows over the 5-year period from June 2014-June 2019[8]

[7] https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10837924

[8] https://www.travelmoney.co.nz/blog/nzd-forecasting

	NZD/USD	Exchanging 2k in NZD	Difference
High	0.99670 (4/2015)	$1,993.40	$235.52
Low	0.87894 (6/2015)	$1,757.88	(or 95 hotdogs)
	NZD/GBP	Exchanging 2k in NZD	Difference
High	0.59503 (11/2016)	$1,190.06	$374.04
Low	0.40801 (9/2015)	$816.02	(or 50 Bangers & Mash)
	NZD/EUR	Exchanging 2k in NZD	Difference
High	0.71410 (4/2015)	$1,428.20	$314.06
Low	0.55707 (9/2015)	$1,114.14	(or 158 Gelatos)
	NZD/AUD	Exchanging 2k in NZD	Difference
High	0.99670 (4/2015)	$1,993.40	$235.52
Low	0.87894 (7/2015)	$1,757.88	(or 66 packets of Tim Tams)

Prices valid as of 17/06/2019

Effect of changes in the exchange rate:

- The returns on managed funds will be affected. Most managed funds will have investments in both New Zealand and overseas. If the NZD decreases, then investors will receive more money in returns. If the NZD increases, the investor receives less money.

Example

Let's look at a $50USD return (when converting to NZD):

- When the NZD-USD rate is .6000 – the $50US becomes $83.33NZ (approximately)
- When the NZD-USD exchange rate is .8000 – the $50USD is now only $62.50NZ

- Therefore, exchange rates are likely to influence what countries fund managers invest into, or where they sell investments when necessary. (Of course, there are a lot more factors than just the exchange rate!)
- Insurance companies are affected where they have reinsurance arrangements. There are no reinsurers based in New Zealand, and therefore New Zealand based insurance companies may have changes to the cost of reinsurance premiums (they will pay more NZD the lower our currency goes) and also the level of cover they will receive and possibly also the level of cover they will end up receiving, depending on whether the rate has gone up or down.
- Banks and non-banks may be affected if they have borrowed money offshore. Their repayments (including interest payments) will

be affected by changes in the exchange rate, as it may cost more (or less) to meet the same repayment.

- Low exchange rates (depreciating) are good for exporters, as they get more money for their sale (they will usually quote the cost in the purchasers' currency – or perhaps will be quoted in US dollars)
- However, low exchange rates mean the cost of imported goods are higher, and it is also more expensive for New Zealanders when they travel overseas. This may mean an increase in the demand for credit to finance these overseas trips.
- High exchange rates (appreciating) are therefore good for importers and New Zealanders travelling overseas. They are not so good for exporters, or those in the tourism industry. When the NZD is high, overseas visitors get less money for their own currency – which reduces their spending power and also contributes to the perception "New Zealand is expensive." This affects our tourism industry, and may then affect the insurance needs (levels of cover) of those companies – so affecting insurance advisers and companies.

Example of the impact of the exchange rate change to a British tourist

Let's say a coffee and a scone at a café in New Zealand costs $10.00 NZ

At an exchange rate of .3500 GBP = 3.50 GBP

At an exchange rate of .5250 GBP = 5.25 GBP

Of course, there are a number of other factors that make up the cost and whether it is comparable to a tourist's home country – however, a favourable exchange rate can certainly reduce any actual cost differences – and vice versa.

Devaluation / depreciation

Winners	Losers
• Exporters • Domestic tourist industry • Workers gaining jobs in export industry • Economic growth might increase • Current account deficit should improve	• Consumers who buy imports • Residents who holiday abroad • Firms who buy imported raw materials • Those on fixed incomes/wages who see inflation rise faster • Foreign exporters/tourist industry

www.economicshelp.org

[9]

3. Test yourself

If the New Zealand dollar is appreciating (increasing in value compared to other countries), identify two market participants that would be impacted in a positive way (i.e. it is better for them).

[9] https://www.economicshelp.org/blog/749/economics/understanding-exchange-rate/

National Political and Economic Events

Changes of government will have an impact on the environment within which the financial services industry operates. Trust and confidence in the government and their policies helps enable a positive economic climate. Changes to Government overseas has an impact on New Zealand's economy - we have free trade agreements with a number of other countries, and a change of Government or other political events will have an impact on our exports and therefore economy.

The policies of each government affect the way consumers spend money, manufacturers produce goods, borrowers adopt debt, investors buy or amend portfolios and the world invests with New Zealand and trades with us. For example, positive tax rules for overseas investors encourage more money into the country. This provides greater resources to NZ businesses, tax revenue to the NZ government and available funds for borrowers. Alternatively, onerous legislation on NZ and overseas businesses, reduce production, increase unemployment and lead to a weaker economy.

Governments have their own priorities. For example, a focus on cheaper housing will allow more first home buyers into the market and will also generate growth with more services and facilities needed to build those houses. New subdivisions sometimes come with new schools and supermarkets, boosting local employment. An increase in demand for housing, is likely to result in an increase in business for mortgage advisers and lending products.

A Government that is more focused on quicker access to healthcare may channel more money into Pharmac and more staff into hospitals, which may reduce spending in other parts of the economy. However, having sick or injured residents be able to get back to work quicker may reduce the financial strain on both ACC and Work and Income. This could affect the perceived need for health insurance, thereby impacting on **life and health advisers**, and companies that provide private health insurance products.

Even Government policies such as cycleways (more or fewer), roading, immigration policies and trade agreements all influence the New Zealand economy, and the savings and spending habits of all consumers. The political decision to impose GST obligations on overseas sellers to New Zealand purchasers, can be seen as a 'levelling of the playing field' for New Zealand based businesses, whose products may have been more expensive than an overseas competitor, due to the 15% GST difference.

Economic events such as hosting the Rugby World Cup or the America's Cup can have a positive effect on the New Zealand economy. Fans travelling to watch "their team" spend money on food, transport, accommodation and tourist type activities. It has been reported that the

2005 Lions tour of New Zealand resulted in a financial boost of approximately $120 million to the New Zealand economy[10].

When tourism is high and we have a lot of overseas tourists coming into New Zealand and spending their money, **general insurance advisers** are likely to see an increase in business, as tourist industry businesses need to review their types and levels of cover to ensure they are up to date with their current turnover and activities.

Marsh's head of risk consulting, Pacific, Costa Zakis is quoted:

"*In comparison to the rest of the world, New Zealand is very politically stable. It's a very predictable economy; it, by and large, knows its government policies, so any geopolitical risk of doing business in New Zealand is fairly small. While there is a potential for government policy to present some problems for businesses, good business practice says you just need to be nicely diversified in what you're doing in terms of markets and products.*[11]"

When the Government introduces policies to make it easier (or more cost-efficient) to do business in New Zealand, more businesses will start up, or base their operations here. This results in more consumer confidence, and generally more people will take on debt to pay for overseas holidays and buy their first home (or an investment property). When people have certainty over income, and more disposable income, they are also more likely to have funds to pay for broader insurance covers and investment more into either managed funds, or direct investment options.

The New Zealand Screen Production grant is an economic incentive that the Government has introduced to encourage the production of more major films in New Zealand (produced by overseas companies).

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10 https://www.stuff.co.nz/business/80314948/wellingtons-28m-week-capital-prepares-to-feast-on-british--irish-lions-tour?rm=m

11 https://www.insurancebusinessmag.com/nz/news/breaking-news/the-risks-and-advantages-of-doing-business-in-new-zealand-160917.aspx

Key concept

The **New Zealand Screen Production Grant** is a government initiative to grow the sustainability and economic benefits of our screen sector in a dynamic global environment.

The grant was established in 2014, the New Zealand Screen Production Grant (NZSPG) supports the screen sector by encouraging international and domestic production activity.

It provides the following rebates on specified goods and services purchased in New Zealand:

- 20% for international productions (25% in certain circumstances)
- 40% for domestic productions.

Benefits from international productions

Attracting international screen productions to New Zealand produces a range of direct and indirect economic benefits. These include on-the-ground production expenditure and spill-over benefits to other areas of economic activity.

In addition, international screen productions can:

- help promote tourism
- facilitate know-how and technology transfer to other industries
- generate international recognition of the New Zealand brand.
- large film and television productions
- create jobs
- accelerate the growth of talent and skills in our local film industry
- provide spill-over benefits to the wider economy, including digital technology sectors.

4. Test yourself

If the Government increased the weekly benefit payment to Job Seekers, what two market participants would be MOST likely to be affected?

International Political and Economic Events

The New Zealand economy is also susceptible to changes in worldwide economies. This is primarily because we do not have an economy in isolation. We have a number of trade agreements with other countries, so economic events in those countries will have an impact on our exports and imports, and therefore, our economy.

For example, China is one of our major trading partners, and any changes to their economy will have effects here – in addition to flow on effects to other economies that may also impact on our domestic economy. The RBNZ states:

"China is now one of New Zealand's largest trading partners. But New Zealand's most significant economic linkage to China may be through China's impact on the terms of trade – the global prices of the things we buy and sell – rather than through the direct trade channel itself. "

We saw through the GFC that our economy, due to being a global trading partner, is susceptible to economic changes with our trading partners, however, not always to the same degree that our economies suffer. It has been said that when the US sneezes, the world gets a cold. This is a play on the original quote by Metternich, who referred to France and Europe originally. Of course, the fact it has been reworded somewhat is another indication of the changing power of different global partners, as alliances and trade agreements change – often dependent on the viewpoint of the incumbent country leader at any given time.

More recently, with the growth of the Chinese economy, it could be when China sneezes – the rest of the world gets a cold.

In addition to the impact that changing global economies have on our own economy, political changes and events also have an impact.

Some of the more current influences include:

- The change of the US president
- Brexit (this could open more trading opportunities, or it may lead to a change in the terms of existing agreements)
- Climate change (as a political agenda)
- Our contribution to defence systems and how we support our allies (for example, NZ's work with the US in Iraq and the Middle East)
- New Zealand's close relationship with Australia (as part of closer economic relations and in the Asia-Pacific region). Australia has a much wider and stronger political influence than New Zealand, having a bigger economy and population
- Technology enabling access to additional, emerging markets
- Change of political leaders in any of our current or potential trading partners.

- The implementation, or removal, or trade tariffs (which either free up markets or increases barriers to enter new markets and grow existing markets)
- Changes to the amount of money Chinese citizens are allowed to take out of the country, impacting demand for housing in New Zealand
- Pandemics, such as COVID-19 and its global impact.

The impacts due to changes in any of these factors have similar influences as the national political and economic events, although on a bigger scale. For example, if the US decided not to trade with us anymore, it would have a huge impact on our export economy and may cause business failures and redundancies. This flows on to a reduced demand for lending and credit services, and less funds available to invest. It may also reduce the demand for insurance services, as premiums may not be manageable when income has stopped or reduced.

5. Test yourself

What types of impact could Brexit have on fund managers?

Legislative and Regulatory Changes

Regulation does not just affect financial markets and the financial advice sector; it impacts on the clients of those sectors in many ways and then in an indirect way could impact on the demand for financial services, and the way financial services are provided. For example, the introduction of obligations around carbon credits, greenhouse gas emissions and clean waterways will affect not just new business owners/farmers in the agricultural and horticultural spaces, but also influence the costs of doing business (the higher the costs of doing business, the higher the cost to the consumer) in those sectors, and the needs of those businesses.

Example

Changes to the Health and Safety Act may change the general insurance needs of building companies.

In financial services, The Financial Advisers Act,(and soon the Financial Services Legislation Amendment Act) and the soon to be implemented changes to the Financial Markets Conduct Act, for example, have changed how easy it is for a new adviser to enter the industry. Increased regulatory oversight and costs of meeting competence requirements mean the cost of just being a financial adviser is higher. Increased costs can result in financial advisers needing to charge for their services (or charge more if they already work on a fee model) or may change the types of clients they provide advice to.

Example

A general insurance adviser currently earns a net commission (after all their associated costs have been deducted) for providing insurance advice to domestic clients (house, contents and motor) of $50.

Regulatory changes, which require additional costs for education, paperwork and record keeping may mean that the adviser no longer makes a profit from these clients.

Commercial decisions need to be made on how, and to who the adviser will provide financial advice services to in the future.

Commercial decisions also need to be made as a result of the implementation of the licensing regime in New Zealand financial markets. Financial advisers (FA) need to make decisions about whether they will obtain their own financial advice provider (FAP) licence, or whether the (estimated) potential costs mean it will be more cost-effective to work under a larger FAP licence. Economies of scale achievable in a large FAP mean the increased costs of obtaining and maintaining a licence can be spread amongst many advisers.

The new licensing regime also impacts the decisions of providers. Recently at least two major insurance companies advised they would only pay insurance commissions to the entity that holds a FAP licence. For advisers who currently receive commissions themselves, this could be the deciding factor in operating their own licence, rather than being an FA under another entity's licence.

However, for other adviser segments, where commission payments are already made to an aggregator group, this change may not be an influence on how they decide to operate.

Legislative and regulatory changes also have a major impact on financial services product providers, such as banks and non-bank lenders, life and health insurers, managed fund (including KiwiSaver providers) and general insurance companies.

Banks, non-bank deposit takers and insurance companies who are licenced (a different licence than that required by the Financial Markets Conduct Act) by the Reserve Bank for example, are subject to prudential supervision and capital reserve requirements. Until COVID-19 started to impact in New Zealand, the Reserve Bank had mandated that banks were to increase their minimum capital reserves.

Key concept

The purpose of the capital reserve is to prepare the company for any unforeseen events like inflation, instability, or need to expand the business, or to get into a new and urgent project.

Amy Adams has this to say about the impacts of the increased capital reserve requirements:

"Everything I'm seeing is that it's going to both push up lending costs and restrict lending availability for some borrowers, and those borrowers are highly likely to be in the rural and SME [small and medium sized businesses] sectors, at a time when both of those sectors are under pressure in any event," Adams

said on Friday, warning of a "potentially pretty significant" impact on the economy[12].

The Council of Financial Regulators is responsible for much of the legislative and regulatory change in New Zealand. While legislation is approved by Parliament, the Council either recommends and writes submissions for changes, or they are tasked with enforcing legislation that the incumbent Government wishes to introduce. In November 2019, the Council issued the following work priorities:

- **Climate change** (led by Reserve Bank of New Zealand) – to facilitate a smooth transition to a low-carbon and climate-resilient economy, while supporting the soundness and efficiency of the financial system.
- **Financial Inclusion and Consumer Engagement** (led by Commerce Commission) – to coordinate the work of the Council of Financial Regulators (CoFR) members to improve consumers' access to, and understanding of, financial services, particularly in hard-to-reach communities.
- **Conduct and governance** (led by FMA) – to develop coordination and joint action on governance and conduct issues, and to ensure that banks and insurers maintain progress in these areas.
- **FinTech** (led by FMA) – to ensure the regulatory system facilitates innovation that improves outcomes for customers and financial system participants.
- **Residential Property insurance** (led by the Treasury) – to support resilience, affordability and consumer information in the residential insurance market, while managing costs and risks to the Government.
- **Credit unions** (led by Reserve Bank) – to work together on the health and sustainability of the credit union sector.
- **Review of the Regulatory System Charter** (led by MBIE) – to promote active stewardship of the financial markets regulatory system, taking into account proposed changes to the responsibilities of the different CoFR agencies.[13]

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (https://financialservices.royalcommission.gov.au/Pages/default.aspx), identified significant misconduct and poor culture issues in a number of prominent Australian financial institutions, many of which are 'parent' companies to New Zealand financial services companies.

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[12] https://www.stuff.co.nz/business/112832162/reserve-bank--plan-has-significant-negative-consequences-for-our-country-banks?rm=m
[13] https://www.rbnz.govt.nz/news/2019/11/council-of-financial-regulators-sets-work-priorities-for-2020

In New Zealand, an FMA/RBNZ enquiry into the conduct and culture of Banks and Insurance companies also identified a number of issues, particularly around incentives linked to sales targets. As a result, the New Zealand Government introduced the 'Conduct of Financial Institutions' (CoFI) regulatory review. The main aims of this new regime are to improve conduct and client outcomes, primarily by increasing regulatory oversight, and prohibiting remuneration based on sales incentives. The proposed new regime will require product providers to have more oversight of intermediaries (financial advisers) and also remove volume-based incentives (such as overseas trips, primarily offered by insurance companies to reward insurance advisers who write a high level of annual premium with them).

A key requirement of the proposed new regime is that licensed entities (all financial advice providers, including Banks and insurance companies) will be required to meet a "fair treatment" standard, with effective policies, processes, systems and controls needing to be put in place to meet that standard.[14]

Currently in New Zealand (April 2020), we have the following financial services regulation[15] progressing through various implementation stages:

- Financial Services Legislation Amendment Act
- Regulations that support the above Act including:
  - Disclosure requirements
  - Licensing fees
  - Registration Requirements
- Code of Professional Conduct for Financial Advice Services
- Insurance Contract Law Review
- Conduct of Financial Institutions Review
- Review of KiwiSaver default providers
- International Market reforms

Regulatory change is inevitable in financial services. The Financial Advisers Act was introduced in 2010, and less than ten years later, more changes were proposed under the Financial Services Legislation Amendment Act. These changes affect the financial services regulators (RBNZ. FMA and MBIE) as well as the financial services markets participants - from providers to advisers.

6 Test yourself

Select TWO market participants and briefly explain how the Financial Services Legislation Amendment Act could impact on them?

[14] https://www.dentons.co.nz/en/insights/alerts/2019/october/4/financial-law-insight-it-is-cofi-time

[15] https://www.mbie.govt.nz/business-and-employment/business/financial-markets-regulation/regulation-of-financial-advice/

Answers Test Yourself

Question 1. Name two market participants that would be MOST impacted by an increase to the OCR?

Answer:

- Bank and non-bank lenders, as they will need to increase their lending rates, and savings rates, accordingly.
- Fund managers – as an increase in the OCR will result in an increase in savings account rates – which could mean less people wish to invest in managed funds, or the fund managers may need to move where some funds are invested to take advantage of a higher available rate.

Question 2.

a. What is the current agreed inflation band in New Zealand?
b. Identify two ways an insurance company could be affected by a higher inflation rate?

Answer:

a. 1-3%

b. Identify two ways an insurance company could be affected by a higher inflation rate.

    - Claim costs would increase (particularly for general insurance and health insurance claims)
    - Insured people may have less affordability for premium payments.

Question 3. If the New Zealand dollar is appreciating (increasing in value compared to other countries), identify two market participants that would be impacted in a positive way (i.e. it is better for them)?

Answer:

- Lenders, as it will cost them less in NZD to repay any overseas debt
- Fund managers, as it will cost them less in NZD to purchase shares and bonds in overseas companies
- Insurance companies, as it will cost them less to pay their reinsurance premiums
- Importers and New Zealanders travelling overseas – which may increase the demand for travel insurance and foreign exchanges services through banks and FOREX dealers

Question 4. If the Government increased the weekly benefit payment to Job Seekers, what two market participants would be MOST likely to be affected?

Answer:

- Banks and non-bank lenders as increased income will provide greater loan affordability, and borrowers may be more likely to meet lenders criteria to purchase a first home
- RBNZ – more money in the economy could lead to increase inflation, which will trigger the RBNZ to make a change to the OCR.

Question 5. What types of impact could Brexit have on fund managers?

Answer:

- More volatility in portfolios
- Need to look at the implications of UK firms continuing to trade across the EU – whether increased regulatory costs will lead to lower dividend payments
- Change in tax treatment of UK and EU investments may change the projected returns in a portfolio

Question 6. Select TWO market participants and briefly explain how the Financial Services Legislation Amendment Act could impact on them?

Answer: Not an exhaustive list, but guidelines only:

- Financial advisers – increased costs, lower commissions/income
- Banks – higher capital reserves, more regulatory reporting – increased costs, lower returns to shareholders
- Life and Health Insurance companies – changes to the remuneration model, more oversight of intermediaries, which will mean more internal resource and higher costs of intermediated distribution
- RBNZ – greater regulatory and oversight required, lack of growth in financial services could lead to low inflation, which will require a change to monetary policy
- Non-bank lenders (who are not subject to capital reserves) may have increased growth due to more borrowers who don't meet stricter main bank lending guidelines

References

- Code of Professional Conduct for Financial Advice Services;
- Financial Markets Authority Act 2011;
- Financial Markets Conduct Act 2013;
- Financial Service Providers (Registration and Dispute Resolution) Act 2008;
- Financial Services Legislation Amendment Act 2019;
- Reserve Bank of New Zealand Act 1989;

  and all subsequent amendments and replacements.

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