FMOA

FINANCIAL MARKETS OPERATIONS ASSOCIATION

IN THIS ISSUE

NZ FMOA Chairperson's Report

May 2004

Welcome to another issue of the semi annual FMOA Newsletter. I hope you all find the newsletter informative and interesting, and I encourage you to forward a copy onto your staff. If there is any topic you would like covered, or if you have any feedback on the newsletter please give us some feedback to maria@fmoa.org.nz. That way we can ensure that we are "hitting the mark" with this publication and adding value to our membership base.

Now to some news, the FMOA Committee has some new faces as a result of the AGM last year. I'm pleased to welcome the following members to the committee:

- Barbara Baker, NZX
- Robert Poulter, National Nominees
- Mark Lawrence, ANZ Nominees
- John Timmony, Citibank Nominees

In particular a warm welcome to John, who is the first "non resident" of the FMOA, and will I'm sure bring a nice trans-tasman balance to the committee!!!

We also have the semi annual FMOA conference coming up in Auckland on the 14th May, with an action packed agenda starting with Lester Levy from the New Zealand Leadership Institute right through to Deutsche Bank's Chief Economist, Ulf Schoefisch. We will also hear from the Sydney Futures Exchange in terms of the Austraclear replacement project (EXIGO) running in Australia, and the RBNZ will update everyone on the status of the Austraclear New Zealand system upgrade as part of their user group meeting. Full details of the agenda are detailed later in this newsletter, and I would encourage you all to attend what I'm sure will be another great day. For all you Auckland members, please remember to invite your staff along to the post match drinks, which are always good for networking with market colleagues, or just enjoying a quiet drink after a tough week!

In terms of the wider marketplace, there are some significant political & regulatory changes in the winds, which could have an impact on our industry. Firstly we have the political debate with Don Brash and his National Party starting to challenge Labour's dominance of New Zealand politics, and regardless of the outcome this is likely to result in ongoing volatility in the New Zealand Financial Markets. Secondly, the amendments to the Reserve Bank Act passed into legislation last year will have significant implications for systemically important banks and may foreshadow changes to the manner in which these banks currently structure their operations in New Zealand. As most of you will know some of these banks moved operations infrastructure (business and systems support) to Australia and / or further afield in the 1990s.

The outcome of the ANZ / NBNZ amalgamation may give us some inkling of what we can expect the future banking (operations) landscape to look like in New Zealand. In addition to this merger, it is great to see that the main New Zealand banks will staff their CLS Operations on shore when CLS goes live later this year rather than look to move this function to the Australian time zone. Whilst this means banks will need staff in their back offices up until as late as 10.30pm, it keeps jobs and opportunities in New Zealand.

All in all these changes are very positive for the New Zealand Financial Markets as a whole, and I wonder if we are seeing the "wheel turn full circle" in terms of centralization and in particular centralization into Australia. Financial Institutions are increasingly recognising the value of local operating and customer support models, which potentially bodes well for the New Zealand Markets and economy.

Hope you enjoy the newsletter and the upcoming conference, and we'll see you in Auckland on the 14th May

Kind regards,

Peter Thomas
Chairperson

AGENDA

FMOA CONFERENCE and AUSTRACLEAR USER GROUP MEETING

Friday, 14 May 2004

BNZ Tower, Level 3
125 Queen Street, Auckland

10.00am - 10.15am	**Registration/Morning Tea**
10.15am – 11.00am	"Leadership" *Lester Levy* *NZ Leadership Institute*
11.15am – 12.00pm	"Overseas Investment Commission" *Steve Dawe* *Reserve Bank of New Zealand*
12.15 – 1.30pm	**Lunch**
1.30pm – 3.00pm	Austraclear Users Group Meeting
3.00pm – 3.15pm	**Afternoon Tea**
3.15pm – 4.15pm	NZX and Sydney Futures Exchange
4.15pm – 5.00pm	"The New Zealand Economy - will the landing be soft?" *Ulf Schoefisch* *Chief Economist* *Deutsche Bank*
5.15pm – 7.00pm	**Drinks and Nibbles for Austraclear/FMOA members, operations and settlement staff at the same venue**

FINANCIAL MARKETS OPERATIONS ASSOCIATION

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A LITTLE BIT OF HISTORY REPEATING

By Razor Blade

It should be mandatory for anyone in the investment community to have to reel off a few bars of the Shirley Bassey[1] classic "History Repeating" as part of their training. What frustrates your humble correspondent is the common refrain: "this time is going to be different". But it never seems to be.

For the mouse on the exercise wheel things tend to look pretty similar, and for good reason – they are. And it's the same for investment cycles: they tend to be pretty similar because history repeats.

Whether it was Tulipmania of the 1600s, the Mississippi bubble of the 1700s, the closely connected South Sea Bubble, the big Penny-farthing cycle of the 1800s, the Florida real estate boom of the 1920s, the investment market boom of 1928-29, the sonic boom of 1947, or the 1990s IT bubble, the result was always the same. Investment or business value comes back to assets, revenue, cash-flow, and earnings. Relying on the 'bigger fool' to take an asset off you at an even more over-inflated value than you paid is not a sustainable strategy. Although this conclusion is debatable given the continuing popularity of 'Nigerian email scams' and the amount of fools the associated greed tends to create.

"New Zealand has seen big booms in housing, the currency, and migration in the past and each time they have unwound."

But I digress. In fact I don't digress because I haven't even got to the point. There have been a few elements emerging in the past year where a big cycle has appeared influencing us here in New Zealand: namely migration, the currency, housing, and United States Treasuries. The associated experts in each case managed to put the case that this time would be different and the bubbles get even bigger.

New Zealand has seen big booms in housing, the currency, and migration in the past and each time they have unwound. This time will be no different.

Migration has been a monster driver of New Zealand economic (and housing) growth of the past couple of years. It has added around 1% to population growth each year. And the migrants have not been Mexicans swimming the Rio Grande with only a peso or two in their pockets. These have been returning Kiwis with pounds or USDs to spend, or cashed up Asians and the like. However, migration is on the turn. At present it's due to fewer foreigners (tightened language criteria, fewer English language students) but next year will be the Kiwi exodus. In the past, whenever there has been a big exodus of Kiwis (e.g., 1989, 2000/01) there has been a big return flow in three years. That's what we're in the middle of now. Next year the backlog of 20-somethings will be looking to expand their horizons and work in a pub in Trafalgar Square and get a case of the Common Clapham. The migration flow is on its ebb.

The housing market is the main area where self-delusion is to the fore. Almost everything that was driving the market is on the turn: currency, interest rates, primary sector incomes, migration, rental yield, and housing supply. The market is overvalued, as is clearly evident from the proliferation of property seminars and books. The housing market has all the hallmarks of the 1987 sharemarket boom/bust.

Back then everyone you spoke to were talking about their Rainbow, Chase and Equiticorp shares. Now everyone is talking about their second and third investment properties. About the sole justification now given that prices have further to rise is that they are cheap relative to Sydney – the bigger bigger fool theory. Well they're also cheap relative to New York, London and Monaco. But so what?

Newsflash: our house prices are a whole lot more expensive than anywhere in virtually all of South and Central America, Asia and Africa. The reality is, we tend to have a major house price cycle every eight years with prices rising strongly for 3 years and stagnating for around 4.

The US bond market was extremely expensive last year, with 10 year yields dropping to 3.13%. But to justify rates that low, one had to be talking deflation or economic Armageddon. On three occasions in the past 15 years, bond market undershoots in the United States have been followed by 200bp sell-offs in close to a year. In spooky symmetry it is happening again, which will tend to push New Zealand long-term interest rates up as well.

For some, history tends to repeat a little quicker. New Zealand's central bank is on a calendar year interest rate cycle (up one year, down the next). In five years, interest rates have been sent in five different directions. In the same time, the Fed, BoE, and ECB have had two directions and RBA three. And we have the busiest central bank in the world, moving the OCR on 45% of the occasions available to them. I can't think of any other central bank which would be increasing interest rates when they are forecasting growth to slow to 1.75% in a year's time.

The RBNZ's about-turns appear decidedly leisurely compared to the current Labour Government. The hospital waiting lists were extended with the whiplash generated by the speed of their u-turn on school closures and the foreshore policy. If I were a Labour Party member of parliament the words I'd least like to hear from Helen Clark would be "I have complete confidence in Razor Blade". It's a Kavorkian kiss of death. You'd know you would be outskied within two days akin to Dover Samuels' and Lianne Dalziel's experience. But again I digress, and history repeats even within the short space of this article.

The exchange rate has hit USD0.71 on two previous occasions since its float. On each occasion its time at the peak was fairly fleeting and for good reason: we're a small economy heavily reliant on trade and cannot weather an overvalued currency for long. One local 'expert' who said, when the Kiwi was at 40c it would go to 30c, timed it beautifully and said, when it was at 70c, it was going to 80c. And there was no reason given: it was just because. If it did go to 80c, you might as well turn out the lights on the economy.

The last two times (1988 and 1996) the Kiwi got to USD0.70, the economy was in recession within two years. However, the first coincided with international recession in 1990 and Ruth Richardson's "Mother of all Budgets" and the second aligned with the Asia crisis and a Reserve Bank mistake pushing short-term interest rates above 10% - killing the housing market. This time round we have a government in spending mode trying to buy the next election, the first synchronised global upswing in two decades, and what should be a very muted interest rate cycle. So rest assured, this time is going to be different.

[1] *Investment themes obviously run strongly through Bassey's work with titles including Big Spender, Goldfinger, Diamonds Are Forever, Never Never Never, I (Who Have Nothing), and What Kind Of Fool Am I.*

Settlement Guidelines

The FMOA would like to see the introduction of Best Practice Settlement Guidelines into the New Zealand market. The guidelines would affect the way that market participants arranged the settlement of fixed interest trades.

The guidelines would put into practice a settlement regime, which attempted to ensure that counterparties matched trades one day prior to the actual settlement date. This would allow sufficient time for participants to rectify errors and should assist in preventing Loops that occur in the Fixed Interest market. The outline of the proposal is as follows:

(S-1) Settlement Date - 1

11am - NZ Time All outright trades to be entered into Austraclear. Host-to-Host users to ensure all trades pre-matched outside Austraclear
11am - 12pm - NZ Time Problem Resolution Time. Buyers responsibility to chase up unmatched deals.
12pm - NZ Time All outright trades to be “Matched” in Austraclear.
By ensuring all outright deals are “Matched” in Austraclear on S-1, the time currently spent on these deals on Settlement Date can be better utilised on Repo transactions and Loop resolution. It will also lead to earlier settlement of these outright deals on Settlement Date (Seller Stock Holdings permitting).

(S) Settlement Date

12pm - NZ Time All same day transactions input and Matched in Austraclear.
Buyers responsibility to chase up unmatched deals.
12pm - NZ Time Custodians to have all deals input and “Matched” in Austraclear.
12pm – 3pm - NZ Time Loop Resolution Time.
The need to have all Repo transactions input and “Matched” by 12pm is to allow more time to be devoted to Loop Resolution, and also to allow this resolution to begin earlier in the day.

The proposed guidelines were distributed to all FMOA members in February 2004 for comment and the response received was less than expected.

The main issues raised by the respondents were:

- Custodians would have difficulty in meeting the deadlines due to late instructions from clients.
- Inability to meet deadlines due to same day trades.
- The times were deemed to early for Australian counterparties.
- Would only FMOA members adopt the guidelines?
- Why should it be the sole responsibility of the buyer to ensure adherence
- Who would police the system and what, if any, fines would be imposed

The general consensus from the respondents was that settlement guidelines were a good suggestion and that all market participants should adopt them. It is the FMOA’s view that once agreed the guidelines should be presented to the Reserve Bank of New Zealand for implementation within the Austraclear settlement system and therefore binding all market participants, not just FMOA members

It was also generally noted that a softer approach be taken with the policing of the system, where persistent offenders were reprimanded rather than fined, this would reduce the costs associated with monitoring the system. This leniency would also avoid Custodians, Australian counterparties and those undertaking same day trades, being punished for instructions arriving late from their respective clients. The seller of securities has to also take responsibility for ensuring that their trades are matched, not leaving this solely to the buyer who may not be aware that the trade has occurred.

It has also been suggested the FMOA committee be responsible for the monitoring, reporting and reprimanding the offending participants

Your feedback into this proposal is important as if this is to be implemented it will affect all market participants. Please contact Robert Poulter at National Nominees Limited via email on robert_poulter@bnz.co.nz