

The Treasury

Reserve Bank Act Review Phase 2 Submission Information Release

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Safeguarding the future of our financial system.

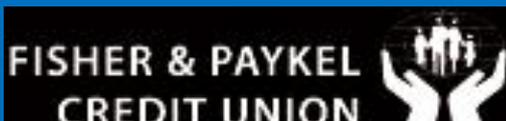
Submissions by certain Non-bank Deposit Takers on:

- Consultation Document 2A
- Consultation Document 2B

Building societies



Credit unions



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PHASE 2 OF THE RESERVE BANK ACT REVIEW (“PHASE 2 REVIEW”)

1. This submission follows on from an earlier submission made by Wairarapa Building Society (“**WBS**”) and Nelson Building Society (“**NBS**”) on the Phase 2 Review. A number of credit unions (listed in Schedule 1) and Heretaunga Building Society now also wish to join in making this submission with WBS and NBS (collectively called the “**Submitters**” or “**we**”). Accordingly this submission represents the interests of a substantial portion of the non-bank deposit taker (“**NBDT**”) sector, by size and number.
2. In this submission we comment on three “in principle” decisions outlined in the Ministerial Forward to Consultation Document 2A *“In principle decisions and follow up questions on: the role of the Reserve Bank and how it should be governed”* (“**Consultation 2A**”).
3. In particular we comment on the in principle decisions to:
 - (a) replace the “soundness and efficiency” objectives with a single overarching “financial stability” objective;
 - (b) combine the separate regulatory regime for banks and NBDTs into a single licence deposit taker perimeter; and
 - (c) develop a formal deposit protection scheme that will protect depositors’ savings up to an insured limit, currently proposed within a range of \$30,000-50,000.
4. In the context of responding to these issues and, in particular, in relation to the regulatory perimeter we will also comment on a number of the issues raised in Consultation Document 2B *“The Reserve Bank’s role in financial policy: tools, powers, and approach”* (“**Consultation 2B**”) (Consultation 2A and Consultation 2B collectively referred to as the “**Consultation Papers**”). We comment specifically on:
 - regulatory tools and powers;
 - how the Reserve Bank of New Zealand (“**Reserve Bank**”) should supervise and enforce prudential regulation;
 - features of New Zealand’s crisis management regime; and
 - how the Reserve Bank should be funded and resourced,as well as highlighting some areas where there are significant differences between how banks and NBDTs are regulated that will need to be addressed *if* changes are made to the regulatory perimeter.
5. Given the impact on their businesses, the Submitters are keen to be involved in the next phase of the process. Please refer to Schedule 2 for the relevant contact information for each of the Submitters.

KEY SUBMISSION – THE DECISION ON THE PERIMETER IS PREMATURE

6. While WBS and NBS noted in their initial submission that there may be value in consolidating the NBDTs in banking regimes and, in doing so, bring New Zealand's framework into line with similar models in Australia and UK, they also stated that "significant further consultation would be required before any decision is made on whether the two regimes are consolidated into one".¹
7. It is disappointing that an "in principle" decision has been made by the Minister without any targeted consultation with NBDTs. While the Submitters accept there may be value in consolidating the regimes, there will be significant complexity in endeavouring to consolidate the NBDT and banking regimes. We will highlight some of the complexity in this submission. The complexities of consolidating means there is a material risk of unintended consequences and the alternative of a better aligned but parallel regime should probably be considered.
8. Even the Consultation Papers acknowledge that little thinking has yet gone into how the regime will be consolidated. Indeed, the Consultation Papers seem to indicate that bank registration could still be governed largely by whether an entity chooses to use the word "bank" or not. This seems to suggest that in fact there will be two separate regimes or at least two categories under one regime.

OVERVIEW OF NBDT SECTOR

9. There are currently 20 registered NBDTs in New Zealand ranging in size from less than \$10 million in assets to approximately \$850 million in assets.²
10. In real terms, the total assets in the NBDT sector is probably less than \$2.5 billion compared with the total assets for the entire banking sector being \$527 billion.³
11. Much of the NBDT sector is comprised of mutuals, including three building societies (with approximately \$1 billion of assets) and nine credit unions (with approximately \$1.1 billion of assets - most of which is concentrated in two credit unions, namely Credit Union Baywide and First Credit Union).
12. The NBDT sector therefore comprises of only a tiny part of the financial system.⁴ However, this small sector plays a fundamental role in New Zealand in acting as an important constraint on major banks. In addition, because NBDTs are strongly focused in regional New Zealand, they are disproportionately important to fostering regional growth.

¹ Earlier submission made by WBS and NBS.

² Excluding UDC which is we understand in the process of deregistering as an NBDT.

³ Based on Figure 1A in "Safeguarding the future of our financial system" (Consultation Paper 1 of Phase 2 of the RBNZ Act Review) at page 17.

⁴ For example, New Zealand credit unions service 140,000 members (excluding members of Westforce Credit Union, Police Credit Union and First Credit Union), and WBS, NBS and Heretaunga Building Society have a combined membership of 22,000.

FINANCIAL STABILITY

13. While NBS and WBS submitted that they were comfortable with the objectives relating to "financial soundness and efficiency", the Submitters acknowledge the benefits of the Reserve Bank having a single core objective for prudential regulation. We agree that financial stability as a core objective is consistent with international norms and, as such, we support the change.
14. However, we also believe that there is value in setting out subsidiary objectives to the core objectives. These subsidiary objectives should include:
 - the objectives currently in the Non-bank Deposit Takers Act 2013 (the "NBDT Act") and, in particular, the objective of minimising the regulatory burden on firms; and
 - a specific acknowledgement that the regulatory burden should be proportionate to the risk that a particular entity poses to the financial system as a whole.⁵ This acknowledgement is particularly important if there is a specific power for the Reserve Bank to consider the prudential soundness of the individual entities. Without an appropriate level of proportionality, the pressures on smaller institutions will only exacerbate market concentration and adversely impact on financial inclusion.
15. The Submitters also reiterate the point made previously that it would be valuable if the prudential regulation could make more use of the Government's ability to issue policy statements, specifically statements in relation to matters that the Reserve Bank must have regard to in respect of prudential supervision. For example:
 - (a) recognising the importance of domestically owned banks and NBDTs to financial stability and therefore the importance of policies to encourage their growth; and
 - (b) requiring the Reserve Bank to consider the efficiency of the financial system by having regard to the value that mutual institutions provide to local communities and in financial inclusion. The mutual sector plays an important role in serving these communities that are not well served by mainstream banks, which ensures that the financial system is accessible for those who would otherwise struggle to get adequate financial services elsewhere.

REGULATORY PERIMETER

16. As highlighted at paragraph 6 above, we believe it is premature for any "in principle" decision to be made in relation to the regulatory perimeter.
17. We do, however, believe that it is appropriate to review the current NBDT regime with a view to either:
 - (a) integrating it into a single regime for all NBDTs (i.e. the current "in principle" decision); or

⁵ The BIS Principles for Effective Banking Supervision notes that "The Committee recognises the presence in some countries of non-banking financial institutions that take deposits but may be regulated differently from banks. These institutions should be subject to a form of regulation commensurate to the type and size of their business and, collectively, should not hold a significant proportion of deposits in the financial system."

- (b) harmonising the bank and NBDT regimes – particularly by considering whether modifications and changes made to the regulation of banks in the Phase 2 Review could usefully also be applied to NBDTs, while still retaining two separate regimes.
18. However, as discussed below, there are significant differences between the current regimes for banks and NBDTs. These differences create a risk that if either the integration or harmonisation of the regimes is not carefully considered, the transition and compliance costs for NBDTs may make their business uneconomic. Accordingly, a separate regulatory impact analysis must be completed for incorporating NBDTs into a single Authorised-Deposit Taking Institution ("ADI") regime versus a harmonised parallel regime.

REGULATORY TOOLS AND POWERS

19. NBDTs are regulated through a combination of:
- (a) the NBDT Act;
 - (b) regulations issued under the NBDT Act;
 - (c) exemption notices issued under the NBDT Act; and
 - (d) governance in trust deeds.

This is very different from registered banks where most of the regulation is effected through conditions of registration.

20. The Submitters would welcome some harmonisation of the instruments through which they are regulated. There are certain inefficiencies inherent in having effectively duplicated supervision and two primary sources of prudential regulation (namely, regulations and trust deeds).
21. Neither process currently works that well in business as usual situations (although the credit unions' experience has been that both trustees and regulators have been much more responsive in challenging circumstances). Accordingly, we believe there is an opportunity to consolidate the current regime into a single form of regulation administered by a single regulator, the Reserve Bank.
22. In substance, the Submitters favour the simplicity and clarity of regulation with its attendant checks and balances over conditions of registration. However, we also believe a process for consents or exemptions should be included that largely mirror the current process available to Submitters under their trust deeds. While there is some degree of challenge with the current processes, it is acknowledged that these are generally conducted in a timely and collaborative manner.
23. The Submitters favour either standards or regulations for substantive regulatory matters, provided that the standards or regulations can be accompanied by a reasonably streamlined approach for obtaining exemptions.

SUPERVISION AND ENFORCEMENT OF PRUDENTIAL REGULATION

24. Again, supervision and enforcement of prudential regulation for NBDTs is substantially different from that of registered banks. Most front-line supervision and enforcement is conducted through trustees enforcing provisions in trust deeds. Trustees do not generally do any onsite supervision. They are, however, actively involved in monitoring financial statements and returns required from NBDTs on a regulatory basis. We would not want to see any substantive change to this approach if this responsibility was transferred to the Reserve Bank as regulator. Onsite supervision would be a significant burden in terms of resources and costs, therefore we recommend that the principle of proportionality would apply to any such powers.
25. Submitters generally find that working with their prudential supervisor is effective, although there is sometimes confusion around when and to whom communication needs to be made. At times this can lead to a doubling up of work. Further, different prudential supervisors sometimes have differing ideas on approaches to various issues, which can exacerbate this problem.
26. NBDTs are required by regulation to have specific risk management plans agreed with the trustee (which as a matter of practice the Reserve Bank influences through feedback to the trustees and NBDTs). Again, this system appears to be working well and we would be reluctant to see any significant change to this process if that was, say, required by the Reserve Bank Proportionate Risk Evaluation Surveillance System.
27. The existing approach to risk management works reasonably well, and we would welcome a similar level of engagement and proportionality in reviewing these under the new framework if they are brought into a single perimeter.
28. The NBDT Act currently makes NBDT directors responsible for any breaches of legislation by an NBDT. This means the directors of NBDTs have significantly greater risk than directors of banks, who are only liable in respect of disclosure statements.
29. The Submitters do not believe that this is reasonable or consistent with other areas of the law (such as the liability regime for directors in the Financial Markets Conduct Act 2013 ("**FMCA**"). We support the recommendations in the Consultation Papers to limit liability for breaches of the NBDT Act to the NBDT itself. The NBDT director should only be criminally liable for fraudulent conduct. Any other breach should only give rise to civil consequences.

CRISIS MANAGEMENT

30. NBDTs are currently not subject to the crisis management provisions in the Reserve Bank of New Zealand Act 1989 ("**Reserve Bank Act**"). Statutory management of NBDTs would need to be effected through the Corporations (Investigations and Management) Act 1989 ("**CIMA**"). The statutory management provisions in CIMA are materially different in a number of respects to those in the Reserve Bank Act, including:
 - (a) trigger points entitling the appointment of a statutory manager;
 - (b) the obligations of the Crown and a statutory manager to third parties during statutory management;and

- (c) not having any provisions entitling the Financial Markets Authority or the Reserve Bank to direct a statutory manager.
31. A large number of NBDTs are also not directly subject to the Companies Act 1993 liquidation provisions. Building societies and credit unions (which make up a substantial portion of the NBDT sector) are subject to separate statutory regimes not considered in Consultation 2A.
 32. While we believe that there could be some value in a single statutory crisis management regime applied to all NBDTs, careful thought will be required before doing so. There is a significant risk of unintended consequences.
 33. Furthermore, most NBDTs operate a much simpler business model than most banks and so any crisis management framework should be differently applied, having regard to the complexities of the relevant institutions. For example, applying the open bank resolution policy to NBDTs even if they reach the billion dollar threshold could have significant compliance costs and issues. These costs and issues would be highly disproportionate to the benefit of applying a policy which does not apply to NBDTs now.

FUNDING AND RESOURCING

34. The Submitters note that according to Consultation 2B, there is only one dedicated member of the Reserve Bank staff responsible for NBDTs. While we acknowledge that the resourcing referred to in Consultation 2B does not include resources of trustees involved in the hands-on supervision of the NBDTs, we believe that the area is under-resourced and highly dependent upon the inputs of other sections of the Reserve Bank.
35. In the experience of NBDTs, their issues and questions often take very low priority for the Reserve Bank (perhaps understandably given their relative size). In many cases, decisions can take many months and sometimes over a year. This typically has cost impact for NBDTs and can make it hard for them to plan with any certainty. We would therefore support additional resourcing in the supervision of NBDTs.
36. NBDTs are also currently paying trustees to supervise them under trust deeds. These amounts can be up to \$150,000 for a large NBDT like NBS. Trustees will also generally require their legal and other costs to be paid where specific consents are required. Removal of these costs would certainly be appreciated by NBDTs and would put NBDTs on a level footing with banks who typically do not pay these costs now. However, if a funding regime is introduced and regulated entities are required to pay supervision costs, then we believe:
 - (a) the costs should be less than or at least no greater than those which we are currently paying to trustees; and
 - (b) where costs are being paid for an application for approval to be considered by the Reserve Bank, a timeframe for those matters to be considered should be prescribed and the cost should be no greater than costs charged by trustees now. In effect, if the Reserve Bank is to be paid to consider an application, then the Reserve Bank should agree to allocate and prioritise resourcing such that a response can be obtained within a reasonable period of time and at a reasonable cost.
37. Over the past few years Submitters have found that compliance costs keep increasing, which is starting to have materially detrimental effects, especially on the smaller NBDTs. Every time there are new requirements for NBDTs to follow, lawyer and knowledge specialists are needed, which can be a significant burden. As NBDTs play an important and beneficial role in serving their members, it is important that the

costs of compliance are considered so that these smaller institutions are not driven out of business by these increasing costs – which could have an adverse impact on financial inclusion and a rise in the use of fringe institutions like payday lenders.

OTHER ISSUES

38. While it is unclear what requirements the proposed new framework will impose, some of the rules that apply to all banks, particularly through conditions of registration, could be problematic if applied to NBDTs, in particular, compliance costs. The resulting challenges would significantly outweigh any benefits arising from applying much more sophisticated bank policies to NBDTs. Such policies include:

- (a) **Capital:** NBDTs operate under relatively simple capital rules and there are some instruments (such as perpetual non-cumulative preference shares) that would count as tier 1 capital that do not count to the same extent under current bank capital rules. These instruments would either need to be "grandfathered" under a transition process or separate rules would need to be applied to NBDTs (noting the mutual nature and small size of the sector);

Furthermore, the bank capital rules are particularly complex and extensive (for example, BS2A on Capital for Standardised Banks is over 200 pages long). The equivalent provisions in the Deposit Takers (Credit Ratings, Capital Ratios and Related Party Exposures) Regulations 2010 ("**Deposit Taker Regulations**") are substantially shorter (6 pages and 10 sections). Imposing requirements on NBDTs to undertake detailed risk rating of assets is likely to impose substantial compliance costs with little benefits (noting many of the large banks have had material issues in complying with the policy);

Finally, extensive consultation is currently taking place on the quantum of capital required by banks. The current consultation is considering almost doubling minimum capital requirements for banks - with non systemically important banks (which would presumably be the category that NBDTs would fall into) potentially being asked to hold 15% capital against risk weighted assets. NBDTs currently are only required to hold 8% or 10% (if they do not have a credit rating) against risk weighted assets under the Deposit Taker Regulations. As the proposed rules currently only apply to banks, NBDTs have not been specifically consulted and have not been actively involved in the debate. It would be disappointing if these rules were effectively applied to NBDTs by extending the regulatory perimeter. It would be preferable if NBDTs were consulted with and consideration was given to their relatively small size and impact on financial stability. To this end, the Submitters believe either existing rules should be retained or there should be a graduated buffer for non systemically important NBDTs, while allowing a much bigger buffer for smaller NBDTs (e.g. up to 5% less than for systemically important banks).

- (b) **Liquidity Rules:** Banks are subject to one week, one month and one year liquidity ratio requirement, whereas NBDTs typically have relatively short liquidity requirements incorporated into their trust deeds;

Most NBDTs have very simple treasury functions that do not need the complexity of the bank liquidity rules to manage risks. Again, the compliance costs of imposing these requirements on NBDTs are likely to substantially outweigh the benefits.

DISCLOSURE

39. There are currently substantial differences in the disclosure regime between banks and NBDTs. Banks are required to publish half-yearly disclosure statements and provide information for publication on a dashboard on a quarterly basis. As a consequence, banks are given an exemption from a number of the disclosure requirements in the FMCA because of the different disclosure regime applying to them.
40. NBDTs however, are only subject to the FMCA. Anecdotal feedback is that product disclosure statements for NBDTs are much easier for customers (the general public) to understand than bank disclosure statements. We believe requiring NBDTs to transition to the bank disclosure regime would add significant costs and arguably negatively affect customers.
41. Before any decision is made to adjust the regulatory perimeter, consideration will need to be made on whether to retain differential disclosure requirements (either based on size or category of institution).

DEPOSIT INSURANCE

42. In its previous submission WBS and NBS supported the introduction of deposit insurance on the basis that it extended to all NBDTs to ensure competitive neutrality. The Submitters therefore agree with the "in principle" decision to extend deposit insurance to all NBDTs.
43. The Submitters have some reservations about the proposed \$30,000-\$50,000 cap on deposit insurance. We believe this threshold should be reconsidered in light of international practice in comparable economies to New Zealand, such as Australia, the UK and Canada - all of which have much higher thresholds. We also believe that consideration should be given to extend deposit insurance to large one-off deposits that are only with institutions for a short period of time (for example, the proceeds of house sales - something we understand exists in some markets).
44. The Submitters would like to be closely involved in the design and costing of any deposit insurance scheme. The costs should not be any greater than those imposed with the deposit guarantee scheme implemented immediately after the global financial crisis.

DEPOSITOR PRIORITY

45. We note that Treasury is specifically considering depositor priority in New Zealand. For many NBDTs this already exists (but not NBS or WBS). Typically under a NBDT's trust deed there is a first charge over all of NBDT's assets in favour of its depositors.
46. Accordingly, if there is to be a single regime for banks and NBDTs then the Submitters believe it is vital that the protections currently provided to their customers regarding their priority charge over their assets is preserved. Preserving this protection will be easier if depositor priority is introduced for all NBDTs. However, care will still need to be taken in designing that priority to ensure that current NBDT depositors are no worse off. If a policy decision is made not to introduce depositor priority, then careful consideration will be required on how to ensure that existing NBDT depositors are not adversely affected by the transition.

SCHEDULE 1 – CREDIT UNIONS JOINTLY MAKING THIS SUBMISSION

- 1. Credit Union Baywide
- 2. Fisher & Paykel Credit Union
- 3. Steelsands Credit Union
- 4. Westforce Credit Union

SCHEDULE 2 – CONTACT DETAILS OF SUBMITTERS

Submitter	Contact person	Contact details
Wairarapa Building Society	Lucy Haberfield	f11
Nelson Building Society	Tony Cadigan	f11
Heretaunga Building Society	David Sexton	f11
Credit Union Baywide	Gavin Earle	f11
Fisher & Paykel Credit Union	Jennifer Trittschuh	f11
Steelsands Credit Union	Bruce Ross	f11
Westforce Credit Union	Vic Matrick	f11

