Reviewing the Reserve Bank Act

Phase 2 Submission

By email: rbnzactreview@treasury.govt.nz

9 March 2018

This document is the submission of Xero Limited (Xero) as part of Phase 2 of the Review of the Reserve Bank Act 1989 (the Act) being undertaken by Treasury.

Xero's submission is as follows:-

Background

Legislation

S 1A (1) of the Act gives the Reserve Bank of New Zealand (RBNZ) responsibility for two specific functions, namely

1. Formulating and implementing monetary policy, and
2. Promoting the maintenance of a sound and efficient financial system.

Part 2 of the Act specifies the powers of RBNZ in regard to monetary policy, foreign exchange and currency, but contains no powers relating to the "sound and efficient" responsibility.

Part 5B of the Act (Oversight of Payment Systems) confers on RBNZ the power to collect information or data relating to a payment system. RBNZ appears to have no powers of action in relation to unsound or inefficient payment systems.

Current Financial System Issues

Lagging Innovation

One example of lagging innovation can be found in the EFTPOS system. New Zealand's EFTPOS system was widely recognised as world-leading when it was introduced in the late 1980's. Since then, lack of innovation has seen New Zealand yield payment technology pre-eminence to other countries. This is demonstrated by the advent of contactless EFTPOS debit cards in Australia. Unlike New Zealand, these cards are independent of Visa or Mastercard, and so are significantly cheaper to use.

Another example of lagging innovation is the lack of real-time clearing within the retail bank environment. Some progress has been made with hourly clearing, five days a week. However, 24/7 real time clearing is not yet an option. We understand that the technological power currently exists to make 24/7 clearing a possibility.

<u>Constrained Competition</u>

Research into the New Zealand banking market, referenced by RBNZ in its own publications, concludes that some parts of the New Zealand banking sector operate in a competitive manner and that some parts are not competitive. Markets for transaction services such as credit cards are called out specifically by RBNZ as not being competitive.

<u>Higher Cost</u>

Recently, a Ministry of Business, Innovation and Employment Issues Paper on the retail payments system highlighted that interchange fees on credit cards charged in New Zealand are much higher than the charges in some of our major trading partners (Australia, and EU in particular). The Issues Paper concludes that this mismatch results in higher prices for New Zealand consumers.

<u>Access to Bank Loans for SMEs</u>

SMEs in NZ commonly rank the lack of access to bank funding as one of the major blockers to economic growth. If a SME owner does not own real property or their property is very highly geared, access to bank lending is even more constrained.

Discussion

Our current financial system is not as innovative, as competitive or as cost-effective as it could be. It is Xero's view that one of the root causes of the current position is the lack of clear legislative responsibility and authority to address the issues.

Promoting vs Ensuring

The actions required of a regulator to promote an outcome are necessarily very different from the actions of a regulator with the responsibility and power to ensure an outcome.

Promotion of a sound and efficient financial system will involve support, encouragement and dissemination of best practices. However, by definition, "promotion" implies a voluntary acceptance of the need for action on the part of the recipient. Promotion will work best when the interests of the promoter and the recipient are aligned. However, promotion can fall on deaf ears when those interests are not aligned. A regulator with the responsibility and the power to ensure change will always be more effective than a promoter when interests between the parties are not aligned.

RBNZ recognises lack of competition in some parts of the financial system, and also recognises that this leads to higher prices in some parts of the system. However, at present RBNZ can only "promote" a better outcome. Increased competition and fairer pricing may be better achieved if RBNZ has the legislative responsibility and power to "ensure" change in those parts of the system.

Conflicting views on efficiency

RBNZ expresses mixed views on efficiency in the financial system, but consistently decides for stability over efficiency. The following extracts below are from Bulletin 24, No 2 June 2011-

- *A competitive dynamic that results in razor-thin profit margins for financial institutions might not be optimal for financial stability if institutions have little in the way of financial buffers to absorb negative shocks. Moreover, cost-savings that compromise the quality of the financial services or products supplied by financial institutions may not be desirable.*
- *High profits and a concentrated market structure are often viewed as markers of an uncompetitive market and an inefficient outcome. High or 'supernormal' profits are usually seen as imposing higher costs on customers relative to the case under more competitive conditions.*

- *Analysis by NZIER (2002) found that the markets related to lending and borrowing were more or less competitive, while the markets for some transaction services (surcharge rules on credit cards, for example) did have some competitive issues.*
- *The concentrated nature of the New Zealand banking system raises questions over the level of competition in the New Zealand market. This concentration would be of concern if it allowed banks in New Zealand to maintain excessive margins on lending or high fees on other products.*
- *The average profitability of the New Zealand banking system does appear somewhat high, given the relatively low volatility of returns compared to other industries.*

One interpretation of these comments could be that RBNZ tolerates a lack of competition and the resulting high levels of profit for banks as a tradeoff for stability in the financial system.

Perhaps RBNZ favours stability too much? If so, what price is borne by consumers for this?

The banking industry is highly regulated with considerable barriers to entry. In such an industry, a regulator that does not have power to act to allow true competition entrenches 'supernormal' profits and stifles innovation.

One solution could be to give RBNZ legislative authority to ensure efficiency. Combining this authority with accountability through achievement targets should lead to an optimised efficiency outcome.

Safer payments

Anyone who uses internet banking to pay their bills is familiar with the issue of ensuring you are paying the right person. Anecdotal evidence suggest that many people enter a payee's bank account number, then check it, re-check it and check it again!

A national account register could provide internet banking users with confirmation that the bank account number matches the business name. This confirmation should take place when the internet banking entry is created, and would eliminate the worry of inadvertently paying the wrong account through a transcription error. This matching could also prevent some forms of invoice fraud, particularly those involving falsification of bank account numbers on PDF copies of invoices.

Undoubtedly there are other ways that the bank account number and business identity could be matched before a payment is made in a manner that provides reassurance to the bank customer. This issue has been around for many years, and the banking sector has not addressed this customer experience need. Changing the RBNZ's legislative responsibility to include ensuring a financial system that is open to competition and innovation should provide a market solution to this inertia within the system today.

Changing the RBNZ responsibility from 'promoting" to 'ensuring"   the maintenance of a sound and efficient financial system, with particular responsibility for the retail banking system, may be enough. "Ensuring the maintenance of a sound and efficient financial system" could relieve stress from bank customers through the innovation of safer payments.

SME Lending and Capital Adequacy

It is common knowledge in the SME community that NZ trading banks prefer having mortgage security for loans to SMEs.

One contributor to this preference could be the methodology for calculating the capital adequacy of banks. Capital adequacy calculations require the weighting of the risk of various classes of credit exposure held by a bank. Any lending on a residential mortgages carries a much lighter risk rating than the category of "all other credit exposures". This means that a bank's capital requirement for a SME loan will be substantially lower if the loan is backed by a mortgage, than the capital requirement would be otherwise.

This has the consequence of constraining the majority of bank SME lending into mortgage-backed lending. The actual cost to the greater economy of this outcome is unknown and could be significant.

Issues to be Scoped in Phase 2

- Is RBNZs responsibility of "promoting the maintenance of a sound and efficient financial system" sufficient? Should the responsibility be upgraded from "promoting" to "ensuring"?
- Is RBNZ the appropriate agency for ensuring efficiency within the financial system?
- If RBNZ is the appropriate agency, how should RBNZ measure its performance on the "sound and efficient financial system" responsibility? Should RBNZ have some form of efficiency targets? If so, what should those targets look like, and who should set them?
- Would RBNZ need additional powers for "ensuring the maintenance of a sound and efficient financial system"? If so, what are those additional powers?
- Should the responsibility to ensure a sound and efficient financial system be explicitly extended to include payments systems and the current retail payment system in particular?
- If RBNZs responsibilities were extended to include payment system efficiency, would RBNZ require any additional powers to carry this out? What additional powers would those be?
- Does the current Capital Adequacy framework utilised by RBNZ have the downstream consequence of constraining bank lending to SMEs? If so, what is the economic cost of that constraint? Should the RBNZ be obliged to consider this broader economic cost when setting the framework?

* * *

Thank you for the opportunity to submit on these matters. As part of this consultation process, we would like engage with Officials to discuss the points raised in this submission. I look forward to hearing from you to arrange this.

Yours faithfully

Grant Anderson
Head of Government Relationships

Xero Limited
9(2)(k)