THE TREASURY
Kaitohutohu Kaupapa Rawa

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Safeguarding the future of our financial system

Background paper 1: Who does the Reserve Bank regulate and how should the regulatory perimeter be set?

Phase 2 of the Reserve Bank Act Review

November 2018

New Zealand Government

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Contents

About this background paper 2

Executive summary 3

Part 1: What is the regulatory perimeter, and how should it be set? 4

- The perimeter for prudential regulation 4
- The purpose of the financial system 4
- The rationale for prudential regulation 5
- Lessons from the GFC 7
- New Zealand's experience 10

Part 2: The deposit taking perimeter 12

- The current framework 12
- The case for potential change 16
- What might a revised deposit taking perimeter look like? 21

Part 3: Increasing the flexibility of the prudential perimeter 25

- Options for reacting to new risks to financial stability 25
- Structured oversight of the perimeter 25
- Flexible powers to allow the perimeter to develop 26
- A macro-prudential perimeter 28

Appendix 1: IMF assessment of New Zealand's deposit taking framework 30

Appendix 2: Shadow banking 31

References 32

About this background paper

This background paper accompanies the consultation document, *Safeguarding the Future of Our Financial System: The role of the Reserve Bank and how it should be governed*.[1] The consultation document was released on 1 November 2018.

The background paper accompanies Chapter 3 of the consultation document, which asks, "Who does the Reserve Bank regulate and how should the regulatory perimeter be set?". The 'regulatory perimeter' is the boundary between the 'regulated' and 'non-regulated' sectors of New Zealand's financial system.

The wider context

Together, the consultation document and this background paper are part of Phase 2 of a review of the Reserve Bank of New Zealand Act 1989 (the 'Reserve Bank Act'). The Review aims to ensure that the Reserve Bank's monetary and financial policy frameworks are the most efficient and effective for New Zealand.

Phase 1 focused on improving New Zealand's **monetary policy framework**, and the resulting Cabinet decisions were announced on 26 March 2018.[2]

Phase 2 focuses mainly on the Reserve Bank Act's **financial policy framework**, which provides the basis for prudential regulation and supervision. The Minister of Finance announced its terms of reference on 7 June 2018.

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[1] This paper was prepared by members of the joint Treasury-Reserve Bank Phase 2 Review team. If you have any questions about this paper please send an email to rbnzactreview@treasury.govt.nz.

[2] You can find more information about Phase 1 on the Treasury website.

Executive summary

Chapter 3 of the consultation document considers whether the Reserve Bank of New Zealand's current 'regulatory perimeter' is appropriately targeted and capable of adapting to emerging risks. This topic is included in the consultation because:

- the perimeter is a key part of the Reserve Bank's regulatory framework, especially given its links to other important topics covered by the consultation document, such as the Reserve Bank's objectives and consideration of the merits of deposit protection. This is a good time to reach consensus on how the perimeter should develop over time
- any decision to change the perimeter will have costs and could have significant impacts on some sectors. Phase 2 provides an opportunity to signal and consider any potential changes.

This consultation document discusses the principles for setting an appropriate perimeter. Based on this discussion and the Reserve Bank's current objectives, it then seeks feedback on two questions.

- **Simplifying the deposit taking framework:** New Zealand currently has two parallel regimes that regulate deposit takers: the banking regime and the non-bank deposit taker (NBDT) regime. Chapter 3 asks whether it would improve the efficiency and coherence of the current perimeter to regulate both the banking and the NBDT sectors under the same framework. This would be consistent with the approach in a number of other jurisdictions.
- **Building flexibility into the regulatory perimeter:** in the wake of the 2007/08 global financial crisis (GFC), there has been growing recognition of the risks to financial stability of firms that do not fit neatly into existing regimes, such as 'shadow banks' or FinTech. It may be desirable to provide greater flexibility for the perimeter to adjust or develop over time. This could include the use of macro-prudential tools on entities that are currently outside the traditional prudential perimeter.

This background paper provides further detail on those options, including information on the historical development of New Zealand's current perimeter and recent international experience.

Note the consultation does not review other specific areas such as managed investment schemes (e.g. KiwiSaver). While the prudential regulation of these schemes has been suggested as a topic for consideration, they do not pose credit risk. This is because they pass on both gains and losses to investors rather than promise to repay them fully – so they do not have the capital or liquidity issues that are core to prudential regulation.

New Zealand, in common with most other jurisdictions, applies 'conduct regulation' to managed investment schemes (MIS) that are offered to retail investors. The Financial Markets Authority (FMA) must license the managers of MIS.

Also out of scope for this Review is consideration of perimeter issues for the insurance sector (the boundary between licensed and unlicensed insurers), or the similar issues pertaining to the proposed new financial markets infrastructure (FMI) regime.

Part 1: What is the regulatory perimeter, and how should it be set?

The perimeter for prudential regulation

The regulatory perimeter is a core building block of the prudential regulatory system. It defines the types of firms that are subject to prudential regulation (the 'regulated' firms) and those that are not (the 'non-regulated' firms).[3]

The perimeter needs to be set in a way that provides the regulator (which in New Zealand is the Reserve Bank) with the tools it needs to achieve its objectives. Failing to do so will reduce the effectiveness and credibility of both the regulatory system and the regulator.

Regulatory action also needs to be proportionate, such that it will not result in unintended consequences or costs in excess of the benefits.

The purpose of the financial system

A stable and efficient financial system is a critical foundation for a sustainable and productive economy. The financial system affects the well-being and living standards of all New Zealanders and fulfils a number of important functions for the economy (see Box 1).

Box 1: Key functions of the financial system

- **Intermediation** – the financial sector sits between savers and borrowers, using funds from savers (e.g. through deposits) and lending them to those who wish to borrow (e.g. households and businesses). This intermediary role allows the financial sector to pool resources so that a number of small deposits can be used to make a larger loan. Financial firms also create financial products that meet the needs of investors and borrowers, so capital (society's accumulated wealth) can be allocated to its most productive use. This includes issuing securities to savers at short maturities while extending loans to borrowers at long maturities – a process known as 'maturity transformation'.
- **Value exchange** – matching buyers and sellers of goods and services to facilitate trade. The ability to exchange goods, services, and assets is aided by a stable and reliable currency and payment and settlement systems. Trade enables individuals and countries to maximise welfare by focusing their economic output on areas where they have a comparative advantage.
- **Risk transfer** – matching participants with different risk appetites to allow risks to be distributed and diversified to those most willing and able to hold them. Risk should be priced efficiently to adequately compensate risk-takers for bearing risk. For example, bank accounts pay interest to compensate depositors (people and organisations that place money into accounts with institutions such as banks) not only for the time value of money but also for the risk of loss.

[3] Noting that all sectors of the financial system are subject to at least some degree of regulation. Examples include contract law and the principles of fair dealing.

Insurers provide a method for pooling risk and allow participants to manage their risk by paying a premium today to cover losses that may occur in the future. The financial system offers many forms of risk transformation.[4]

- **Liquidity** – allowing participants to convert certain assets into cash with minimal loss of value. This enables capital to be used effectively; firms and households do not have to hoard cash for unplanned expenditure. Central banks play an important role in providing the financial system with sufficient cash (or liquidity) so that the price of this cash is set at the official short-term interest rate. Central banks also act as a 'lender of last resort' (LoLR) where they provide cash to banks in exchange for assets during times of stress when the demand for cash is particularly high.

These key functions are delivered by a combination of financial firms and financial markets:

- **Financial firms** provide vehicles for intermediation that help perform key functions, such as liquid savings products. They also perform important screening and monitoring functions as they lend or invest those savings.
- **Financial markets** (such as equity markets) help in the identification of investment opportunities, by providing price information and liquidity on secondary markets.

The rationale for prudential regulation

In a broad sense, prudential regulation seeks to preserve the stability of the financial system, and avoid situations where problems in the financial system cause contractions in the real economy through their impact on the payment system, credit flows or asset values.

Trust is central to the delivery of financial system functions. In a narrower sense, prudential regulation is therefore about ensuring that banks and other financial firms are trusted by their customers to meet their obligations and commitments.

Market failures

Prudential regulation primarily seeks to achieve these objectives by addressing three key market failures (Fiennes, 2016):

- negative externalities, namely systemic risk
- moral hazard
- information asymmetries.

Negative externalities

A 'negative externality' is an unintended consequence of an action undertaken by someone that has a negative effect on someone else who is not compensated. The most notable negative externality in the financial system is the somewhat amorphous concept of 'systemic risk'. Systemic risk is the risk that an event such as the failure of a financial firm will cause:

- disruption to the provision of key functions by the financial system
- significant spillovers to the real economy.

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[4] See Reserve Bank of Australia (2014) for a useful explanation of the different types of financial risk.

Absent prudential regulation, individual firms are not well positioned to account for systemic risk. The failure of financial firms can cause losses to the financial system well in excess of the losses to which shareholders and creditors are exposed. The behaviour of financial firms may also be rational at an individual level, while generating fragility at the level of the system.

Moral hazard

Moral hazard is closely linked to the concept of systemic risk. Financial firms banks take excessive risk if they believe the Government will bail them out if they fail (i.e. the 'too big to fail' problem).

As the GFC demonstrated, governments may feel compelled to commit public funds to rescue failing financial firms in order to limit the systemic damage from such events. In New Zealand, some finance companies took excessive risk and failed to manage their cash flow prudently in the run-up to the 2007/08 global financial crisis (GFC). Subsequently the Government issued a sector-wide guarantee, which led some firms to take on even more risk. Some of these firms later failed and a portion of the losses was borne by the taxpayer.

Information asymmetries

Financial firms may have access to more information than their customers – particularly retail customers – or other market participants. The existence of these 'information asymmetries' can prevent customers or market participants from making informed decisions and weaken the incentives on financial firms to operate in a prudent manner.

The tools of prudential regulation

Prudential regulation seeks to address market failures and meet its objectives by aligning the incentives of financial firms and the public interest, and by building greater resilience within both individual financial firms and the financial system.

Examples of prudential regulation include capital requirements, liquidity requirements, governance requirements and risk management procedures. In addition, prudential regulation may also involve arrangements that ensure periods of disruption can be resolved in a way that minimises damage to the broader financial system.

Prudential regulation has historically been most associated with financial firms that generate 'credit risk'. Credit risk is produced when financial firms make financial commitments that require them to repay specified nominal sums of money in the future (e.g. taking deposits).

The existence of credit risk means that the customers of the firm and other market participants that deal with them are subject to the risk that the firm becomes insolvent. Due to the types of functions being provided by these financial firms, their assets, liabilities and exposures can also be difficult to fully understand, even with careful monitoring. Credit risk can be contrasted with 'market risk' (see Box 2).

Box 2: Market risk

Market risk is the risk that an investment will increase or decrease in value.

- MIS, for example, offer returns based on the earnings of a pool of assets managed on a 'best endeavours' basis.

Significant falls in the market value of investments can have detrimental consequences for investors, including creating hardship. Those outcomes nonetheless reflect the risks accepted by the investor. In general, conduct regulation of the product and the issuer and/or the manager will be more appropriate than prudential regulation.

Lessons from the GFC

Prior to the GFC the prudential perimeter within most jurisdictions covered a relatively narrow set of firms, namely deposit takers and insurers (Box 3).[5] This was on the basis that these financial firms:

- generate negative externalities, moral hazard or information asymmetries, and
- provide intermediation, risk transfer or liquidity functions that create credit risk.

Box 3: Deposit takers and insurers

Deposit takers – deposit takers are a core element of traditional prudential regimes. Defined as entities with a primary purpose of both borrowing and lending money, they essentially seek to make a profit by lending money at a higher rate than they are borrowing it (a process known as 'credit intermediation').

Deposit takers are subject to prudential regulation because credit intermediation has a number of risks, including credit risk, liquidity risk, and operational risk. For example, deposit takers borrow for relatively short terms through deposits, and lend for long terms on assets such as mortgages. If depositors want to withdraw their funds but they are tied up in long-term loans, the deposit taker could face liquidity pressures. To avoid such problems, prudential regulation ensures that deposit takers have sufficient liquidity buffers to meet such demands. The failure of deposit takers can have significant impacts on both financial stability and the real economy.

Insurers – insurance is an important form of risk transfer. Insurers "spread the costs of risk events across time and the population, helping to reduce the impact of major risk events on the wider economy. This enables individuals and firms to take on and manage risk, thereby encouraging investment and innovation, and helping to underpin economic activity" (Vucetich et al, 2014, p. 1). Insurers are not generally seen to provide the same level of systemic risk as deposit takers. They are not as exposed to liquidity risk, and are not as interlinked to the financial system as the likes of banks. The failure of an insurer can nonetheless be a source of vulnerability for the financial system.

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[5] Some jurisdictions also applied prudential regulation to capital-linked investment products, such as annuities.

Insurers also generate potential moral hazard and information asymmetry issues. Insurers receive premium income from policyholders upfront. They may nonetheless not have to make payments to policyholders for some time, if at all. The mismatch between premium income and liabilities can incentivise behaviour that is not aligned with the interests of policyholders or society as a whole. This may include taking an overly optimistic approach to underwriting or reserving, or investing in premium income in excessively risky assets. The riskiness of insurers is often difficult to externally assess, particularly when the liabilities of the insurer are long-term.

The two characteristics noted above continue to provide the core rationale for prudential regulation.

Nonetheless, events during the GFC have highlighted two additional principles that should inform the design of the regulatory perimeter (FSB, 2011; IMF, 2013):

- the need to take a 'functional' approach to risk
- the need to apply a 'macro-prudential lens' when considering regulatory action.

A functional approach

A 'functional' approach to regulation is one that focuses on the economic substance and risks of an activity, rather than the type of firm carrying it out.

Prior to the GFC, it was acknowledged that some financial firms were performing functions similar to deposit takers or insurers. These financial firms were not prudentially regulated, given a broad consensus that (Zanforlin et al, 2009):

- only certain sectors could create risks to the financial system, namely banks given their deposit taking function and role in payment systems
- regulation of banks would provide an adequate instrument for ensuring that activities outside the prudential perimeter would capture systemic risk.

It was also considered that extending the perimeter to a wider range of non-bank entities would impose disproportionate cost and reduce innovation. Indeed, it was perceived that the application of regulation beyond traditional sectors could potentially increase systemic vulnerabilities by reducing the effectiveness of financial markets in transferring risk.

The GFC showed this approach to be insufficient. For example, in the United States 'shadow banks' outside the perimeter (entities that did not look outwardly like banks, but carried on similar activities) generated significant systemic risks. Examples included securitisation vehicles and money-market funds. See Appendix 2 for more on shadow banking.

The Financial Stability Board (FSB) – an international body that monitors and makes recommendations about the global financial system – notes that:

> Like banks, shadow banking based on short-term funding of non-bank entities and leverage can be vulnerable to "runs" due to liquidity and maturity transformation, which in turn can generate contagion risk. These features can heighten procyclicality by accelerating credit supply increases during surges in confidence, but cause a precipitate fall in credit supply upon a loss of confidence. Moreover, the risks in the shadow banking system can easily spill over into the regular banking system and become amplified as credit is funded and intermediated through a less transparent chain of entities (2017a, p. 6).

The move towards a more functional approach has seen a broadening of the perimeter in some areas. Beyond a broader review of shadow banking, the most notable change in this area has been in relation to FMIs.

FMIs are entities that provide the 'plumbing' of the financial system. They provide the channels through which payments, securities, derivatives or other financial transactions are cleared, settled or recorded. Bringing FMIs more clearly inside the prudential regulatory perimeter reflects the growing recognition that FMIs can be a source of systemic risk given their essential role in the smooth functioning of the economy and strong connections to banks and other financial institutions.

A macro-prudential lens

A 'macro-prudential lens' is a focus on the system, rather than individual firms: "the wood rather than the trees" (Borio, 2014, p. 2). This is in recognition that while individual firms may appear sound, risks may build-up across the system, for example due to rapid increases in leverage or credit intermediation.

The appropriate objectives for macro-prudential policy in New Zealand remain subject to discussion, and will be considered further in the second phase of consultation for the Review. Subject to that process, the shift towards a macro-prudential lens may have an impact on the design of the prudential perimeter. As has been noted in this Part, financial firms have historically been brought inside the perimeter in order to address externalities closely linked to credit risk. Prudential tools have been based around the likes of capital requirements. Due to its focus on the system, macro-prudential regulation may potentially be applied to a broader set of entities, and in some cases through the application of tools beyond capital requirements, such as loan restrictions or liquidity-related tools. These tools could be applied even where entities do not satisfy the two core criteria for prudential regulation identified earlier.

In shifting towards a more functional approach to regulation, and in applying a macro-prudential lens, it is now perhaps more apt to distinguish between the following in setting the perimeter (IMF, 2009):

- an 'inner perimeter' of entities that are likely to be subject to prudential regulation on an ongoing basis
- an 'outer perimeter' of entities that are subject to ongoing oversight from a systemic risk perspective.

The need for proportionality

In considering any changes or adjustment to the perimeter, there is a need for a clear focus on the costs and benefits of regulation. New regulation may generate risk through additional complexity (Haldane and Madouros 2012).

Regulation needs to be implemented through requirements and tools that are proportionate to its objectives – for example, the regulatory framework for deposit takers should only be extended to new areas such as securitisation after a careful consideration of their relevance, and tailoring of requirements where appropriate (Chiu, 2018). Regulation also needs to be supplemented by close monitoring of the potential arbitrage opportunities it creates.

It is also important to recognise that there may be alternatives to prudential regulation in tackling risks in firms or activities outside the perimeter. This is relevant to costs and benefits, because prudential regulation is more intensive than other regulatory models:

- Most, if not all, participants in the financial sector interact regularly with regulated financial firms. The Reserve Bank may impose measures on regulated firms, and through that indirectly

influence the behaviour of unregulated firms and effectively manage activities that can pose systemic risks.

- Prudential regulation may not be the most appropriate response to some types of risk. In some cases, conduct regulation (the responsibility of the FMA in New Zealand) or other market measures may be more appropriate. An example would be the move by regulators to shift money-market funds to a floating net asset value per share (NAV) after the GFC, rather than a fixed NAV.

To avoid unintended consequences, a well-designed perimeter should align with the attributes and indicators of good regulatory practice (see Table 1).

Table 1: Attributes and indicators of best practice regulation

Growth compatible	Economic objectives are given appropriate weightings relative to other specified objectives, including factors contributing to higher living standards.
Proportional	The burden of rules and their enforcement should be proportional to the issues being addressed and the expected benefits of the regulation.
Flexible, durable	Regulated entities have scope to adopt cost efficient and innovative approaches to meeting legal obligations. The regulatory system has the capacity to evolve in response to changing circumstances (such as market disruptions).
Certain, predictable	Regulated entities have certainty about their legal rights and obligations. The regulatory regime provides predictability over time.
Transparent, accountable	The development, implementation, and enforcement of rules are transparent (clear and easily understood by all those affected).
Capable regulators	The regulator has the people and systems necessary to operate an efficient and effective regulatory regime.

Source: Paraphrased from The Treasury (2015).

New Zealand's experience

The Reserve Bank prudentially regulates three sectors: banks, NBDTs and insurers.

These three sectors are regulated in order to meet the Reserve Bank's current high-level financial policy objective, which is to:

*Promote the maintenance of a sound and efficient **financial system**.*

The Reserve Bank also regulates in order to achieve a series of sectoral objectives (see Table 2).

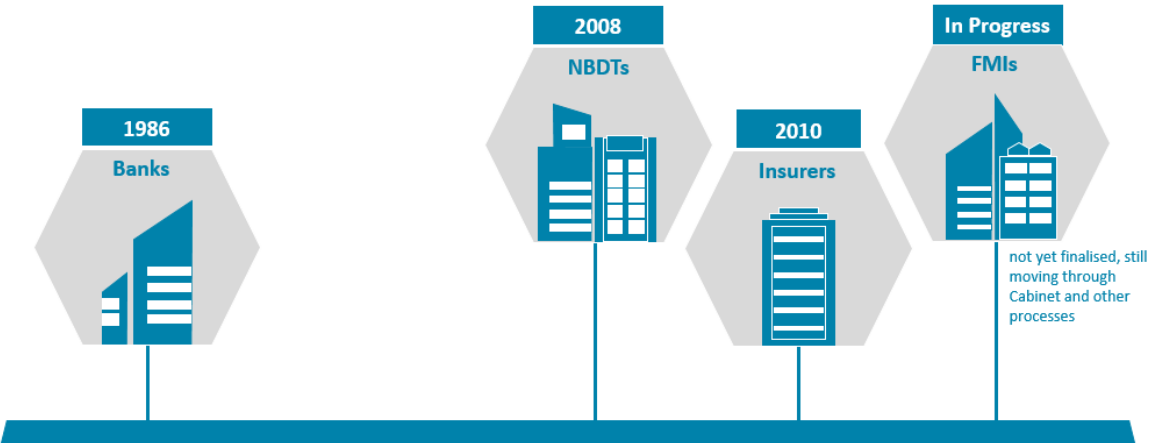
Table 2: Sectoral objectives

Banking	▪ promoting the maintenance of a sound and efficient financial system; or ▪ avoiding significant damage to the financial system that could result from the failure of a registered bank.
NBDTs	▪ to promote the maintenance of a sound and efficient financial system; and ▪ to avoid significant damage to the financial system that could result from the failure of an NBDT.
Insurance	▪ promote the maintenance of a sound and efficient insurance sector; and ▪ promote public confidence in the insurance sector

New Zealand's historic experience with the regulatory perimeter is not directly comparable to those of more advanced jurisdictions such as the US. Complex 'shadow banking' activity has not posed an obvious threat to financial stability. Instead, New Zealand's issues have stemmed from its relatively narrow perimeter. Until 2008, New Zealand's prudential perimeter was limited to banks. It did not include NBDTs or insurers, on the basis that they were not systemically important. These firms were regulated on a more light-handed basis, with a particular focus on disclosure for entities that offered securities to the public.

More than 50 finance companies failed between 2006 and 2011. These failures are discussed further in Part 2. The Christchurch earthquakes also demonstrated the importance of strong solvency standards for insurers who offer catastrophe cover in New Zealand, and resulted in the government rescue of one insurer, AMI. Oversight of both the finance company and insurance sectors has changed considerably since that period. Completing a review that had been initiated prior to the failures, the Government brought NBDTs and insurers within the prudential perimeter, beginning in 2008. The development of the perimeter is set out in Figure 1 below.

Figure 1: timeline for the expansion of New Zealand prudential perimeter



In addition to these three sectors, a process is currently underway to bring FMIs more squarely inside the perimeter for prudential regulation. This is consistent with the developing global practice. FMIs are currently subject to a combination of monitoring and information provision requirements (RBNZ, 2017).

Part 2: The deposit taking perimeter

The current framework

New Zealand currently has two parallel regimes that regulate entities that are 'deposit takers': the banking regime and the NBDT regime. As both the banking regime and the NBDT regime seek to address the same risks, it may improve the efficiency and coherence of the current perimeter to regulate both sectors under the same framework. Part 2 will explore that proposition.

Bringing both sectors under the same framework does not mean that all firms would be subject to exactly the same regulations or the same intensity of supervision. Regulation needs to be proportionate to size and sophistication. Regulation also needs to be capable of supporting innovation.

Creating an integrated deposit taking framework would not be without cost, and feedback is being sought on whether the potential benefits of redrawing the regulatory perimeter are worth the costs (including transition costs) for those firms affected. Any decision to make changes to the perimeter could have material impacts on some sectors. This means that any potential changes will need to be clearly signalled and considered.

The banking regime

Under the Reserve Bank Act, the Reserve Bank is required to 'register' banks and to regulate and supervise those banks once registered. New Zealand's current banking regime has been in place since 1989.[6]

New Zealand's banking regime is 'name-based'. This means that if a firm undertakes financial services and wishes to use certain restricted words in its name or advertisements (e.g. 'bank' or 'banking'), it must register with the Reserve Bank. Entering into this registration process is essentially a voluntary choice on the part of applicants. There is no compulsion for financial firms that operate in New Zealand to become 'banks'. Other firms may carry on bank-like activities (activities tied to borrowing and lending) as long as they do not call themselves 'banks'.

The Reserve Bank's approach to registration is aimed at ensuring only financial institutions of an appropriate standing and repute shall become registered banks. Potential applicants are required to provide evidence that they will be able to comply with all prudential requirements.

Applicants must describe the nature and size of the business they conduct or plan to conduct. A standard condition of registration is that locally incorporated banks must have at least $30 million in capital. The conduct of life and general insurance business underwriting is restricted to no more than one percent of a banking group's consolidated assets. Further, the conduct of any non-financial activities that in aggregate are material in relation to the total activities of the banking group is prohibited.

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[6] Bank registration was introduced in the Reserve Bank Amendment Act 1986. This created a prudential framework for the first time in New Zealand. At that time the perimeter also included authorised dealers in foreign exchange and any other financial institution 'specified' by the Reserve Bank. The 1989 Act narrowed the regulatory perimeter to banks alone.

Other factors, in addition to the size and nature of the business, the Reserve Bank must have regard to when assessing applications for registration include:

- incorporation and ownership structure
- ability to carry on business in a prudent manner
- the standing of the applicant in financial markets
- suitability of directors and senior management
- standing of the owner in financial markets
- any other matters prescribed in legislation.

When determining applications from foreign-owned banks the Reserve Bank will consider the laws and regulations of the home jurisdiction. This will inform a decision on whether to require local incorporation (the bank will operate as a subsidiary), or allow the bank to operate as a branch. Overseas banks will be required to locally incorporate if any of the following conditions are expected to hold within five years of registration:

- if the New Zealand operation has liabilities, net of amounts to related parties, of greater than $15 billion
- the home jurisdiction has depositor preference
- inadequate disclosure requirements in the home jurisdictions
- if the Reserve Bank is not satisfied with the supervisory arrangements and market disciplines in the country of incorporation.

Firms can also choose to voluntarily register as a bank. While the banking regime is defined in the first instance by a names-based approach to registration, a registered bank cannot simply undertake any business of its choosing. In determining applications for registration the Reserve Bank must satisfy itself that the business carried on by the applicant consists of borrowing or lending of money, or the provision of other financial services, or both. This approach helps to ensure that no 'shell banks' are able to be registered.[7] A shell bank is an entity that has no physical presence in New Zealand, and is not affiliated with a regulated financial firm that is subject to effective consolidated supervision in an overseas market.

Prudential requirements are primarily applied to banks through 'conditions of registration', an administrative instrument controlled by the Reserve Bank. In order for an entity to remain a registered bank, it must continually adhere to these conditions and meet the Reserve Bank's regulatory standards.

[7] The Reserve Bank has not attempted to define 'financial' or 'non-financial' services since these may evolve over time, but when considering what constitutes 'financial services' regard is given to the types of services commonly offered in New Zealand. Examples of financial services would include the provision of treasury and payments services. The Reserve Bank expressly restricts the amount of insurance underwriting business a registered bank may undertake.

The NBDT regime

The relatively narrow scope of the Reserve Bank Act has historically meant that entities have been able to structure themselves outside the regime relatively easily by opting not to register as banks.

That said, deposit takers that could be considered systemically important in New Zealand have nonetheless chosen to register as banks – in large part owing to the brand value of using 'bank' in marketing to potential customers, including wholesale customers. Registered banks also receive some additional benefits, including more straightforward access to certain funding and liquidity facilities, as well as exemptions from a number of securities law requirements.

This voluntary nature of the Reserve Bank Act banking regime was identified as a potential weakness by the IMF during the 2003/04 FSAP.[8] The IMF also identified a number of weaknesses with the regulation and supervision of other non-bank financial institutions (NBFIs), such as insurance companies, non-bank lenders, and managed investment schemes. The regulatory framework for NBFIs was fragmented and insufficiently developed, and there were gaps in oversight.

The Government responded to the IMF's recommendations by completing a Review of financial products and providers (RFPP) between 2005 and 2007. One of the key outcomes of the RFPP was a decision to consolidate all prudential regulation functions within the Reserve Bank. Alongside banks, NBDTs were brought into the perimeter in 2008, with insurers following in 2010.

Particular impetus for the development of the NBDT regime was provided by two factors (see Box 4).

- the large increase in credit intermediation that occurred outside the regulatory perimeter during the early 2000s
- the failure of a number of finance companies between 2006 and 2011.

Box 4: Developments in the NBDT sector

The non-bank share of total credit intermediation (lending from financial firms to households, business and the rural sector) increased from 4.5 percent in 2000 to a peak of around 8.5 percent in 2006. This growth in lending helped support a significant increase in asset prices.

Non-bank lenders tended to operate in niche areas, where borrowers typically struggled to receive funding from banks. Finance companies competed in the property development space, lending that was typically on more marginal and riskier housing and commercial property projects. This lending ultimately sowed the seeds of a wave of failures within the sector, beginning in 2006. This included approximately 50 finance companies. Some were wholesale-funded, but the majority were funded at least in part by retail deposits.

The failure of these entities brought to light a number of conduct and prudential issues, including:

- deficiencies in disclosure
- poor governance and risk management
- conflicted conduct (including related party transactions)
- inadequate monitoring and supervision.

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[8] At the time of the 2003/04 FSAP, the Reserve Bank was only responsible for the prudential regulation and supervision of banks.

While not systemically important, the failure of these NBDTs "devastated the savings of many New Zealanders and the trust investors had placed in the sector" (Fiennes and O'Connor-Close, 2012). The total losses to investors from NBDTs put into liquidation, receivership or moratorium have been estimated at around $3 billion.

The non-bank lending sector dramatically declined in size as a result of these failures, compounded by a number of the stronger institutions electing to become registered banks. Today this sector accounts for just three percent of total financial system lending. NBDTs, a subset of this sector, make up just under half of this figure. Over the past few years however, the non-bank lending sector has recovered, with strong growth rates, particularly in consumer lending (credit card lending and other unsecured retail lending such as personal loans and overdrafts).

The NBDT regime was initially introduced by way of amendments to the Reserve Bank Act (Part 5D) in 2008. Regulatory requirements for NBDTs were subsequently carved out into separate legislation following the passage of the Non-bank Deposit Takers Act 2013 (NBDT Act), alongside the introduction of a licensing regime.

In contrast to the banking regime, the NBDT regime operates on an 'activities' based framework that is linked to securities law. An entity is defined as an NBDT if it:

- makes a 'regulated offer' of debt securities under the Financial Markets Conduct Act 2013 (FMC Act), subject to some minor additions.[9] In broad terms, this is an offer made to at least some retail investors, and
- carries on the business of borrowing and lending money, or providing financial services, or both.

NBDTs must be licensed by the Reserve Bank. They must also meet certain minimum prudential requirements (e.g. in relation to capital ratios).

The prudential requirements applying to NBDTs are primarily applied through regulations, which means they require Government approval. The Reserve Bank also has a series of legislative and administrative tools in the NBDT Act:

- It can impose individual requirements on NBDTs through licence conditions.
- It has powers to declare persons or a class of persons an NBDT.
- It can grant exemptions.

Supervision arrangements

The Reserve Bank registers banks, develops various prudential requirements that banks must follow, supervises banks for compliance with these requirements, and takes enforcement action in the event of non-compliance.

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[9] The NBDT Act also captures offers to two types of investors that are considered to be wholesale investors under the FMC Act. The first are 'eligible investors', being persons that have certified they have sufficient experience and knowledge to assess the risks and merits of an offer. The second are persons that are considered to be wholesale investors on the basis that they meet certain investment activity criteria.

In contrast, while NBDTs are licensed and regulated by the Reserve Bank, they are primarily supervised by private sector companies known as 'financial markets supervisors' (FMSs). FMSs are 'frontline regulators' of NBDTs – their role is to "to protect the interests of product holders… and to enhance the investor confidence in financial markets".[10]

FMSs are private but independent businesses engaged to act on regulated offers of debt securities as a matter of commercial arrangement between the issuers and the FMSs.[11] The FMSs' remuneration and any additional duties are written into the relevant trust deed documents.[12]

In addition to their contractual obligations, FMSs are subject to a number of statutory requirements:

- FMSs must be licensed by the FMA under the Financial Markets Supervisors Act 2011 (FMS Act). Currently five supervisors are licensed for regulated offers of debt securities.
- The FMS Act and the FMC Act provide FMSs with a number of powers to enable them to monitor their appointments effectively. NBDTs are also required to provide FMSs with a variety of information on both a periodic and an ad hoc basis.
- Under the NBDT Act FMSs have a role in the risk management of NBDTs.

While the Reserve Bank does not supervise NBDTs, it plays an oversight role in respect of the compliance of FMSs and NBDTs with the regulatory requirements. The Reserve Bank also provides advice and recommendations to the FMA on FMS performance in relation to NBDTs.

The case for potential change

At a high level, the banking and NBDT regimes are interlinked:

- The NBDT regime ensures that all other entities that both take deposits from retail customers and lend are licensed and subject to a minimum level of prudential regulation. FMSs provide frontline supervision of those entities.
- To date, New Zealand's largest and most systemically important entities have elected to become banks. These entities are subject to a comprehensive set of prudential requirements as well as supervision by the Reserve Bank.

Current arrangements were reviewed by the IMF in 2016/17 and found to be largely compliant with international norms. See Appendix 1 for more detail. A prior review of the NBDT regime, while recommending some areas for further exploration, also found the model to be broadly effective.[13]

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[10] Section 3, Financial Markets Supervisors Act 2011.

[11] Public Trust is government-owned and has also historically operated as an FMS.

[12] FMSs have a similar role in relation to managed investment schemes.

[13] When the NBDT regime was included in Part 5D of the Reserve Bank Act, provision was made for a review of the regime to take place before 30 September 2013 (2013 Ministerial Review). A copy of the 2013 Ministerial Review is available on the Reserve Bank website.

The two regimes are nonetheless not fully integrated, and there are a number of potential areas where the framework for deposit taking could potentially be improved. These were noted in Chapter 3 of the consultation document as relating to:

- coverage
- complexity
- efficiency.

Coverage

The banking and NBDT regimes do not capture all deposit takers that could potentially threaten the Reserve Bank's prudential objectives. At the same time, the current NBDT definition has resulted in the unintended capture of a number of entities of limited interest to the Reserve Bank given its existing objectives.

Financial stability

As the banking regime operates on an opt-in basis, the perimeter for deposit taking is set primarily by the definition of NBDT in the NBDT Act. The use of the 'regulated offer' concept in the NBDT Act has benefits:

- while complex, it is understood by market participants
- the definition is aligned with the current supervisory regime. NBDTs making a regulated offer of debt securities under the FMC Act require a FMS
- from an information asymmetry perspective, wholesale investors have less need for regulatory protections than retail investors.

Arguably, the perimeter nonetheless fails to capture all of the firms required to allow the regulator to deliver against its objectives. The regulated offer concept limits the application of the NBDT regime to retail funded entities (subject to certain minor modifications). The use of securities law concepts risks conflating the purposes of conduct regulation and prudential regulation. As discussed in Part 1, prudential regulation is applied to address a different set of risks and market failures than conduct regulation, namely systemic risk, moral hazard and certain forms of information asymmetry associated with credit risk.

For deposit takers it is the process of credit intermediation and maturity transformation that creates these risks. As the GFC highlighted, these risks exist for all deposit takers, even those that are funded by wholesale debt.[14] Conceptually it may therefore be preferable to utilise a more functional definition of 'borrowing and lending' that allowed wholesale-funded firms to be in scope. Consist with this approach, other jurisdictions do not utilise a similar link to securities law, nor do their definitions exclude entities funded by wholesale debt (see Table 3 below).

Within the banking regime, there is also a potential shortcoming in relation to the Reserve Bank's ability to regulate and supervise 'associated persons'. The current definition of associated persons in the Reserve Bank Act does not include all affiliates of registered banks, meaning the Reserve Bank cannot conduct consolidated group supervision. The IMF noted concern in the 2016/17 FSAP that

[14] These risks do not apply to the same degree to other types of lenders (e.g. equity funded lenders or managed investment schemes).

the Reserve Bank was not in a position to fully assess how "the activities of … affiliates may affect the safety and soundness of the bank" (IMF, 2017, p. 27).

Table 3: Deposit taking definitions in peer jurisdictions

Issue	Description
Australia	Carrying on "banking business".[15] Banking business is defined as a business that consists, to any extent, of: ▪ both taking money on deposit (otherwise than as part payment for identified goods and services) and making advances of money; or ▪ other financial activities prescribed by regulations for the purposes of this definition.
UK	Undertakings "whose business is to receive deposits or other repayable funds from the public and to grant credits for their own account".[16]
Singapore	An entity is a deposit taking business if:[17] ▪ in the course of business, money received by way of deposit is lent to others; or ▪ any other activity of the business is financed, wholly or to any material extent, out of the capital or the interest on money received by way of deposit.

Unintended capture

A second issue applies to the degree of inadvertent capture created by the inclusion of 'or providing financial services' in the second limb of the NBDT definition.

The term 'financial services' is not defined in the NBDT Act. Some stakeholders have expressed the view that the term is typically interpreted in line with the definition in the Financial Service Providers (Registration and Dispute Resolution) Act 2008.

Given the broad definition of 'borrowing and lending' in the NBDT Act, the inclusion of a 'financial services' limb is not required to capture deposit takers. Nonetheless this limb generates a number of false positives, including cash management accounts operated by brokers.[18]

Complexity

Where entities perform the same functions, there is a strong presumption that they are regulated under the same framework and with the same objectives. This is not currently the case for deposit

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[15] Section 5, Banking Act 1959.

[16] Article 5, Financial Services and Markets Act 2000 (Regulated Activities) Order. UK deposit takers are considered to be 'credit institutions' under EU law.

[17] Section 4A(7) of the Banking Act 1970.

[18] The NBDT definition has resulted in incidental capture in other areas, such as funding conduits. This type of capture is a consequence of a functional definition, as these entities borrow and lend. As the likes of funding conduits are not in substance 'bank-like', they have primarily been scoped out of the regime by way of exemptions. If there were changes to the deposit taking framework similar allowances would need to be made, either by way of statutory exclusions or through exemptions.

takers in New Zealand, and it arguably adds unnecessary complexity for both the Reserve Bank and regulated entities.

Neutrality and effectiveness

The Reserve Bank faces the costs associated with maintaining two policy frameworks. While acknowledging that different types of regulation will be appropriate for different firms, there are many areas where greater efficiencies could be achieved through standardisation.[19]

Moreover, because the bank and NBDT policy frameworks have developed under different legislative and delegated policy instruments, there are also areas where they meaningfully diverge. These divergences can have consequences for both competitive neutrality and the effective operation of the regulatory regime. A notable example is the difference in resolution tools available for banks as opposed to NBDTs. This was identified as a risk by the IMF in their 2016/17 FSAP (see Box 5).

Box 5: IMF comment on NBDT resolution

A specialised resolution regime for NBDTs would be preferable. The Reserve Bank is established as the prudential regulator under the NBDT Act, but is unable to initiate resolution or recommend resolution. The power to issue directions could be used to require an NBDT to cease taking new deposits, but ultimately seizing control of and resolving a failing NBDT would require the Reserve Bank, upon itself identifying a serious issue or being advised of such by the trustee, to then advise the FMA which could initiate the process of appointing a statutory manager. While not systemic, NBDTs take deposits from the public and thus the public interest and protection of depositors warrant a special resolution regime.

Deposit protection

Complexity has a particular impact when we consider the potential for future regulatory change. For example, were New Zealand to go down a deposit protection route (see Chapter 4 of the consultation document), an obvious question would be ‘which financial firms would be covered by that protection?’

While the specific design of any regime will not be considered until the second round of consultation, one of the core principles behind any deposit protection scheme has typically been competitive neutrality. In Australia, the UK, and other markets, deposit protection schemes are typically extended to all deposit takers on the basis that they are subject to broadly similar requirements. This would be more complicated under the current regulatory framework, given different supervisory arrangements mean the regimes cannot be seen as directly comparable.

Efficiency

Supervisory model

FMS have a clear and long-established role in the supervision of capital markets products issued by some finance companies, such as debentures. FMS act for investors where the NBDT is providing security to support their borrowings. In these cases, the FMS is designed to protect investor interests.

[19] For example, there are different approaches to ‘fit-and-proper’ assessments across the bank and NBDT regimes.

FMS also provide other roles, including being trustee for a variety of instruments, maintaining a relationship with auditors and reviewing the product disclosure statement for any offers.

FMS are arguably less suited to a supervisory role in respect of unsecured banking-style products. Under the NBDT Act, FMS have also taken roles in areas that are less consistent with their historic investor protection role, such as assessing the soundness of NBDT risk management programmes. As a result, through previous reviews a number of stakeholders have suggested that FMSs may add cost and complexity to the business models of NBDTs that offer these types of products, such as building societies and credit unions.

These stakeholders have suggested there may be value in having the Reserve Bank directly supervise NBDTs. Under current arrangements, there is a degree of duplication, with FMS essentially operating as a micro-prudential supervisor, and the Reserve Bank providing higher-level oversight. The Reserve Bank has also had increased involvement in recent years, both since the introduction of licensing and since taking on AML supervision for NBDTs.

In some areas, the Reserve Bank would possess advantages over FMS as supervisor, primarily due to its understanding of broader developments across the financial system. The 2013 Ministerial Review of the NBDT regime noted that existing arrangements may "detract from role clarity and accountability, and hinder the ability to respond promptly and effectively to emerging issues. This issue is particularly acute in a distress management situation, or in the event of problems arising across the NBDT sector as a whole" (RBNZ, 2013a, p.5).

This is not to suggest that FMS themselves have performed poorly. While issues with what was then trustee supervision were identified during the GFC, meaningful capacity and capability improvements have been made since the onset of FMS licensing. The FMS supervision model has other beneficial attributes: FMS have the ability to tailor their level of supervisory oversight, and can provide relatively intensive operational support to NBDTs.

Growth compatibility

A 'challenger' deposit taker seeking to grow is likely to enter through the NBDT regime, given the minimum capital requirements ($30 million) applicable to locally incorporated banks.

There is not a clear pathway for shifting from NBDT status to becoming a bank. As an NBDT the entity must be licensed, and must build its structure around supervision by FMS. If the entity subsequently wishes to become a bank this requires a separate registration process and potentially changes in its internal structure. This contrasts with the situation in Australia and the UK where new entrants can begin to offer banking services within the standard regime (including on a restricted basis).

The need for a simple yet flexible core regime is likely to be heightened given changes happening in the financial sector, including the increased use of new technology. 'FinTech' can be defined as: "technologically enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services" (FSB, 2017b, p. 7). In the future new entrants will come in various shapes and sizes, have innovative business models and use new ways of meeting regulatory requirements. More digital models may struggle with the need to have an FMS.

What might a revised deposit taking perimeter look like?

To address the above issues, there may be value in consolidating the two regimes into one.

This would bring New Zealand's framework in to line with similar models in Australia and the UK. In Australia, deposit takers are regulated as 'authorised deposit taking institutions' (ADIs), and in the UK, the same entities are regulated as 'credit institutions'. Based on the Australian and UK precedents (see Table 4), a framework would likely be based on:

- A single activities-based definition of deposit taking, capturing all entities that are in the business of borrowing and lending. While there are challenges in setting a definition for deposit taking, a definition could be structured to operate on a functional basis, in order to capture firms that generated risk through credit intermediation and maturity transformation.[20]
- A licensing and regulatory framework that aligned the risk and scale of activities carried on by entities with their compliance requirements. A move to an integrated deposit taking framework would not mean that the same rules would apply to all entities.[21] There is a need to support tailored approaches for institutions of different scale or with specific business models, and the regime could be provide for either explicit or implicit tiers.[22]
- The Reserve Bank would regulate and supervise all licensed entities.
- Consistent with international standards, any potential framework would need to retain restrictions on the use of certain words such as 'bank' and 'banking'.[23]

Table 4: Regulatory frameworks in peer jurisdictions

Issue	Regulatory Framework
Australia	There are different types of ADI (banks, credit unions, building societies and other) but these primarily refer to corporate form rather than materially impacting on the prudential standards that are applied.
UK	The concept of deposit taker captures banks, building societies and credit unions, as well as some finance companies. Although prudential and supervisory requirements vary depending on the type and nature of the deposit taker, the Prudential Regulation Authority (PRA) applies a broadly common set of licensing requirements to all entities.

[20] In a leading case in the UK Court of Appeal, Harman LJ observed that "it is notoriously difficult to define the business of banking and no statute has attempted it". See *United Dominions Trust Ltd v Kirkwood* [1966] 2 QB 431 at 457.

[21] Some requirements within the banking framework already contain explicit size-based gradations.

[22] Conditions of registration provide a relatively simple prudential instrument that would allow for differential requirements to be developed and change over time.

[23] For example, principle 4 of the Basel Committee's *Core principles for effective banking supervision*.

Technical issues

As was noted in the consultation document, moving to a single framework for deposit taking would be a significant undertaking, albeit on a transitional basis. It would take time and would involve making decisions on a number of technical issues. In addition to determining an appropriate definition for 'borrowing and lending', areas for particular consideration would likely include:

- the definition of 'deposit'
- the appropriate treatment of wholesale-funded financial firms
- whether there is preference for a tiered regime or a single regime.

The definition of deposit

The current NBDT definition is structured around an offer of a 'debt security'. Not all debt securities are the same. There is a difference, both in liquidity risk and investor interest, between bank-like products and longer-dated products such as debentures.

In a number of jurisdictions the key concept for borrowing is not a 'debt security' but a 'deposit'. These jurisdictions may exclude some longer-dated products from this concept (EBA, 2014):

- In Australia firms that solely offer 'term' debt securities (including to retail investors) are exempt from the requirement to hold a licence as an ADI.[24] 'Term' debt securities must have an initial maturity period of at least 31 days
- In the UK the definition of 'deposit' excludes debentures and bonds, as well as commercial paper issued solely to wholesale investors.[25]

These distinctions are relevant for two reasons:

- Some capital markets products have less 'run risk' and provide fewer externalities. This means they could potentially be regulated most efficiently primarily on a conduct basis
- If deposit protection is introduced, there is a need to limit the application of the safety net so it does not serve to impact on pricing in the capital markets.

In New Zealand it would be possible, as part of the creation of a single framework, for some issuers of longer-dated products to be taken out of the inner prudential perimeter. These issuers would then be subject solely to the FMC Act regime (including FMS supervision).

Treatment of wholesale-funded financial firms

Wholesale-funded lenders make up a relatively small part of the New Zealand market, and provide important diversity in the financial system. As previously noted, they have a different risk profile to retail-funded firms. While wholesale-funded lenders (commonly termed 'non deposit taking lenders', or NDLIs) are not currently perceived to pose a meaningful threat to financial stability, this

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[24] In their 2012 FSAP, the IMF noted that "Australian law permits the existence of nonauthorised and non-supervised deposit taking institutions. The number of such institutions is small and the scale of their activities is predominantly de minimis, however there are major global institutions benefitting from this exemption within the Australian market and deposit-like facilities are being offered to the public". In 2013 APRA consulted on changes to this approach in a discussion paper entitled 'Banking Act exemptions and section 66 guidelines'. This resulted in *Banking Exemption No 1 of 2016*: in order to benefit from the exemption, finance companies cannot lend to retail investors 'at call' or offer transactional accounts.

[25] Article 77, The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

cannot be taken to hold indefinitely. It may be preferable therefore, to draw a definition that initially captures all deposit takers that pose the potential to generate systemic risk, and then provide the Reserve Bank with tools to tailor the application of requirements.

Further work would be required to specify the appropriate treatment of these firms, including potential exemptions (if any).

A tiered regime or a single regime

A move to an integrated framework would not mean that the same rules would apply to all firms. While creating two-tiers of firms is a possible approach, there is a danger that this creates the perception that certain firms are 'second-class'. This may harm the ability of these firms to compete.

Depending on risk appetite and investment in Reserve Bank policy resource, any of the following arrangements could also be considered as part of an integrated framework:

- Providing all deposit takers with access to the current disclosure and governance exclusions in the FMC Act (including from trust deed requirements), in recognition that they were regulated under the same framework as banks. This would align with a shift away from FMS supervision.
- Developing frameworks that allow new entrants to more fully test their business models before needing to hold a licence. Both Australia and the UK have developed restricted or transitional licensing arrangements for new ADIs or banks.

A further question relates to whether all deposit takers could use restricted words.

Australia has recently removed restrictions on the use of the term 'bank' by enabling any ADI to use the word 'bank' in relation their business. Prior to this the use of the tem required separate consent from APRA. The rationale for the change is to reduce barriers for new banking sector entrants, specifically early phase ADIs, particularly given all ADIs are subject to deposit insurance.[26] The Australian Productivity Commission has noted that differences in naming conventions may have hampered the ability and willingness of both potential new entrants and existing non-bank ADIs (such as credit unions) to compete with banks in some markets.

Risks and costs

The NBDT sector is made up of small and often disparate entities. The Reserve Bank currently has a systemically focused high-level objective.

If NBDTs are brought into an integrated deposit taking framework, there is therefore a risk that the Reserve Bank would not apply sufficient policy or supervisory resource to these firms, or would implicitly seek to apply regulatory requirements more appropriate to larger entities such as banks.

While this reflects a genuine concern, it presupposes an inability on the part of both the Government and the Reserve Bank to develop a flexible and growth compatible regulatory framework. An integrated framework should be capable of supporting a variety of business models, provided core regulatory requirements are satisfied. A strong and well-functioning non-bank lending sector is critical to providing intermediation in niche markets. If executed well, an integrated and competitively neutral framework could make this sector more competitive and resilient.

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[26] See Explanatory Memorandum to the Treasury Laws Amendment (Banking Measures No. 1) Bill 2018, p. 37.

There would be transitional costs to the Reserve Bank directly and to government more generally in designing and implementing any new framework. Over time, as compliance capability matures, supervision-related activities will be more readily accommodated within business-as-usual processes and procedures. Depending on the design of the framework, there may be some increase in costs on NBDTs associated with prudential supervision by the Reserve Bank. These costs would be offset to some degree by the removal of FMS supervision, including the costs of FMS fees and the compliance burden associated with FMS supervision.

The potential costs and benefits of any change will be influenced by decisions being made in a number of other areas of the Review, including in relation to the Reserve Bank's objectives, deposit protection, macro-prudential policy, risk appetite, resourcing and the Reserve Bank's funding model.

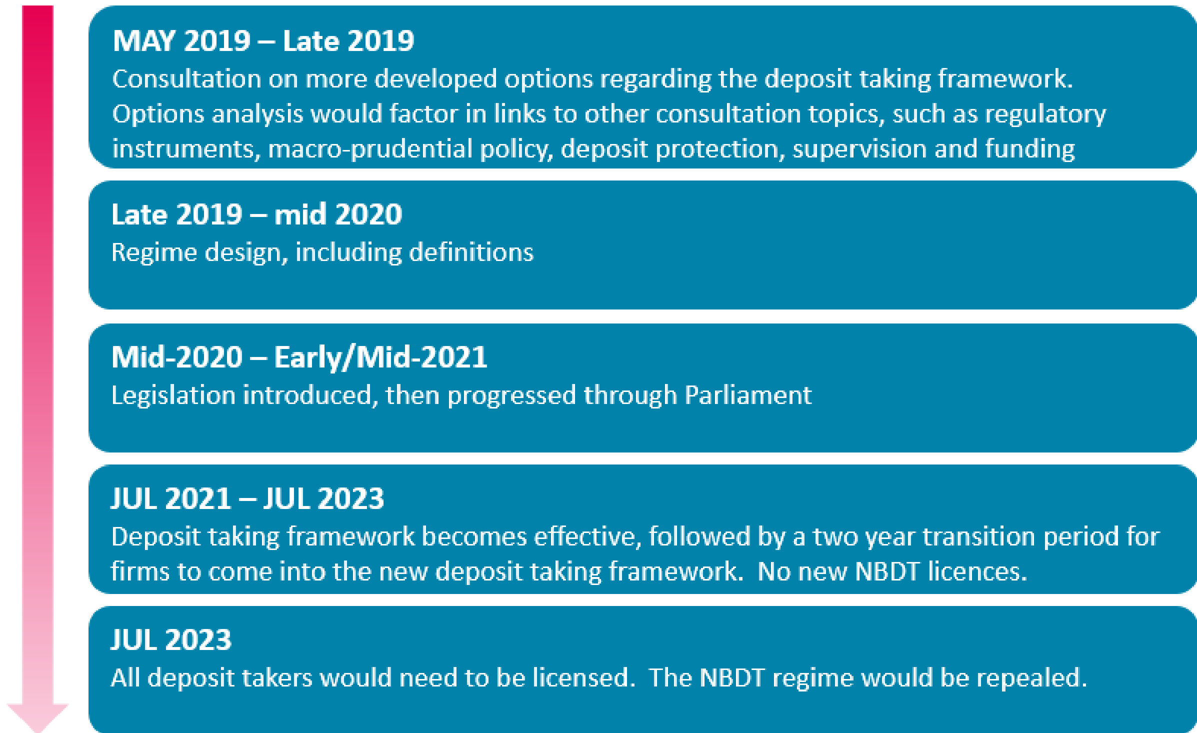
Transitional arrangements

For illustrative purposes, a potential timetable for transition to an integrated deposit taking framework is noted below (see Figure 2).

It is assumed that the Reserve Bank would develop detailed prudential requirements for firms transitioning from the NBDT regime or newly coming into the framework through delegated instruments. If initial regulatory requirements were substantively similar to the existing NBDT regime, this could potentially allow for some degree of transitional or grandfathered licensing of existing NBDT licensees.

The creation of an integrated framework could include the separation of deposit taking legislation from the Reserve Bank Act.

Figure 2: Potential transition timetable



An alternative model would see a shift towards a distinct process split out from the Review. This process could occur sequentially alongside the Review, or trail Review decisions.

Part 3: Increasing the flexibility of the prudential perimeter

Options for reacting to new risks to financial stability

The Reserve Bank currently has a mandate that extends beyond the specific sectors it regulates to the stability of the financial system as a whole. However, the tools available to address risks to financial stability can currently only be applied within the prudential perimeter. Where risks emerge beyond the perimeter, this can create a potential deficit between the scope of the Reserve Bank's objectives and its powers to achieve them.

To address this deficit, one option would be to create a mechanism to allow the regulatory perimeter to flex over time. On the rare occasions when threats to financial stability occur outside the perimeter, this would allow the Reserve Bank to bring relevant entities or activities under its remit, and hence subject to prudential regulation. One reason for doing this now is to future proof the regime to potential new risks, and enable it to adapt to new innovations – including FinTech.[27]

This Part considers three options:

- Structured oversight of the perimeter.
- Flexible powers to allow the perimeter to develop.
- A macro-prudential perimeter.

Structured oversight of the perimeter

In New Zealand, as in many other jurisdictions, reviews of the regulatory perimeter are primarily undertaken in response to concerns arising about a particular activity or firm type. There is not a formal process to ensure that review of financial stability risks (including those posed by non-bank financial entities) includes an assessment of related regulatory gaps or the adequacy of the regulatory framework.

The FSB recommends the establishment of a process that involves (FSB, 2016, p. 3):

- a regular and specific focus on the adequacy of the regulatory perimeter, informed by assessments of financial stability risks
- the participation of all relevant agencies (and not just those involved in financial stability analysis), thereby contributing to a coordinated policy response.

[27] In Australia, for example, the Australian Council of Financial Regulators (Australian CFR) has recently established a 'regulatory perimeter' working group. An early focus of this working group has been on stored-value facilities, many of which are operated by FinTech firms. The Australian CFR has published an issues paper that is available on their website.

While more structured oversight would not alter the mechanism for changing the perimeter itself, it would help ensure that risks were identified early. In order to assist the Reserve Bank in its oversight of the perimeter, there will likely be a need to identify and address data gaps. Consideration will be given to the Reserve Bank's access to data during the next phase of consultation.

Many non-bank financial firms fall within the oversight of the conduct regulator. Examples include MIS and broker-dealers. In many overseas jurisdictions, these sectors have seen very rapid growth.

As a result, oversight of the perimeter is likely to involve greater coordination with the FMA in the future. There has been a greater focus internationally on the role of both prudential and conduct regulators in monitoring the regulatory perimeter (see Table 5). Alternatively, New Zealand's Council of Financial Regulators (CoFR) may be an avenue for discussions on these matters.

Table 5: Additional focus on the perimeter in international standards

Basel Core Principles	'Where the supervisor becomes aware of bank-like activities being performed fully or partially outside the regulatory perimeter, the supervisor takes appropriate steps to draw the matter to the attention of the responsible authority. Where the supervisor becomes aware of banks restructuring their activities to avoid the regulatory perimeter, the supervisor takes appropriate steps to address this'.
IOSCO Principles	'The Regulator should have or contribute to a process to review the perimeter of regulation regularly'. 'A regular review of the perimeter of regulation will also consider the effectiveness of existing regulations and the need to modify them or adopt new regulations in light of new market developments. In particular, that review will need to address the risk of regulatory arbitrage arising from changes to the intensity of regulation across the financial sector. The review of the regulatory perimeter should be integrated into securities regulators' risk management frameworks through formalized processes and arrangements'.

Flexible powers to allow the perimeter to develop

Amending the perimeter currently requires change to primary legislation, which, while ensuring strong democratic accountability, can take a significant amount of time. A timelier option may be to allow for the Government or the Reserve Bank to 'designate' firms into the prudential perimeter, or exempt them from some or all requirements.[28] This may be worthwhile if delays in addressing the risk could let significant vulnerabilities build up over time.

Any such mechanisms would need a high threshold for activation, with clear processes to ensure accountability for decisions. These safeguards are designed to ensure (LDAC, 2018, p. 68):

- a good law-making process (through, for example, requirements to have regard to certain matters or being satisfied that a test is met)

[28] Additionally, New Zealand's COFR may be a venue for discussion of these matters, given the potential for issues to be addressed through conduct regulation.

- transparency (through transparent processes and decisions)
- participation (through consultation or requiring confirmation, concurrence, or consent)
- accountability (through, for example, disallowance via the Regulations Review Committee).

More broadly, delegated powers should not serve to correct incomplete policy development.

Exemptions

Exemptions allow for firms that have been subject to inadvertent capture to be scoped out of a complex regulatory regime. Exemptions can also be granted subject to conditions. Where conditions are imposed, exemptions can be used to reduce unnecessary regulatory burden and tailor requirements to reflect risk.

A broad exemptions regime would provide flexibility for the Reserve Bank to consider individual circumstances and make it easier to deal with, for example, new FinTech products and distribution models as they emerge. Both the FMC Act and the NBDT Act already include tools of this nature, albeit there are some differences, namely in relation to Government involvement and consultation requirements.

A long-standing issue under the Reserve Bank Act has been the appropriate treatment of overseas banks that wish to carry on limited activities in New Zealand, such as providing loans to corporates. While the Reserve Bank Act provides the Reserve Bank with an ability to authorise persons or classes of persons to use restricted words, there are no clear criteria in legislation that guide the use of this tool.[29] This issue may be easier to address under a clearly specified exemptions framework.

Designations

A designation power can be used to 'call in' firms or products that sit outside the perimeter. This power can reduce the potential for firms to undertake regulatory arbitrage. Designation powers can also be used to adjust the perimeter in accordance with underlying objectives of the regulatory framework. MBIE note that "designation instruments allow for policy 'future-proofing' and reflect the fact that one size might not fit all. They can be used as a flexible tool to regulate markets or activities where things are constantly changing" (MBIE, 2017, p. 14).

Under the FMC Act, the FMA has a power to designate 'securities' to be regulated as a particular class of financial products and to reclassify financial products between classes. In the UK, the PRA, which is part of the Bank of England, has the ability to apply prudential regulation to investment firms acting as principals. To date the PRA has applied these powers to the trading arms of a small number of investment banks.

There is a similar designation power in the current NBDT Act. This power is not, however, controlled by the Reserve Bank: instead it requires approval from the Government.[30] In order to ensure it is more effective, it may be preferable to give any such power directly to the Reserve Bank.

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[29] Section 65 of the Reserve Bank Act. The Reserve Bank is currently consulting on its approach to the use of restricted words by overseas banks, with the consultation paper available on their website.

[30] Under the current NBDT Act regime, the Governor-General may, by Order in Council, on advice of the Minister, make regulations declaring that a person or class of persons is or is not an NBDT.

Designation powers provide significant discretion to the decision-maker. For this reason they need to be subject to clear procedural requirements, particularly those protecting the interests of firms that might be substantially affected by a decision. In the context of the deposit taking regime, for example, this might at a minimum require that an activity was in economic substance deposit taking, and a designation was necessary or desirable to address risks to financial stability. As designations can also impact on commercial certainty, MBIE also suggest that the "outer limits on what can be "called in" by a designation should be defined" (MBIE, 2017, p. 14). For the Reserve Bank outer limits could potentially be set on an activities basis (with the chosen activities framed by reference to their potential impact on systemic risk), and aligned to data collection requirements.

Regulations / lists of regulated activities

In the UK, HM Treasury is responsible for establishing both the overall regulatory perimeter and the dividing line between the PRA and the Financial Conduct Authority (FCA). Persons require either authorisation or an exemption to carry out regulated activities. The list of regulated activities is set out in secondary legislation: the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO).

The Bank of England's Financial Policy Committee (FPC) has the power to make recommendations to HM Treasury on the regulatory perimeter, including recommending the addition of new regulated activities to the RAO. It can also advise on which activities should be regulated and whether an institution carrying out regulated activities should be designated for prudential regulation by the PRA rather than the FCA, and vice versa.

If this type of model was introduced in New Zealand, changes to the perimeter would remain reserved for the Government. This means they would remain subject to a significant policy process, likely including Cabinet approval. Designing the regulatory framework with an inbuilt degree of flexibility may nonetheless potentially allow for a more dynamic perimeter, as it could help to develop an iterative process of engagement between the Reserve Bank and the Government.

This model requires providing a high degree of flexibility to either the Government or the regulator, likely through delegated instruments, so that appropriate prudential rules can be put in place for newly regulated activities.

A macro-prudential perimeter

The perimeter is of particular relevance given the expanding toolkit for prudential regulation. As was noted in Part 1, the increased focus on systemic risk has resulted in the introduction of tools that can potentially be applied beyond traditional financial firms such as deposit takers and insurers (e.g. lending standards to address the risks to financial stability associated with credit intermediation).

New Zealand has a relatively simple financial system, with a very small 'shadow banking' sector. The structure of New Zealand's financial system means that the firms at the perimeter that are most likely to generate systemic risk are those related to lending. Gai notes that: "The financial system in New Zealand is … very exposed to highly indebted households and farmers, with mortgage lending and agricultural lending accounting for a significant proportion of bank lending. With elevated house prices, there is a risk that even relatively modest shocks could be amplified with far-reaching, and prolonged consequences" (2017, p. 3).

Macro-prudential tools are currently applied through conditions of registration and hence only apply to registered banks. Increasingly, other jurisdictions are seeing the potential merits in applying similar tools more broadly, in order to minimise the possibility that lending simply shifts outside the perimeter, to NDLIs or other alternatives such as peer-to-peer lenders. The IMF note that:

> Macroprudential policy aims at containing risks across the financial system as a whole. Since banks are significant providers of credit to the economy, macroprudential policy typically applies its policy levers to the banking system. However, as capital market activity and market-based financing expand, macroprudential policymakers also need to be able to monitor systemic risks from activities outside the banking system, as well as to develop and implement policy responses to contain those risks (IMF-FSB-BIS, 2016, p. 4).

In responding to these changes, one option would be to provide for differentiation between a core 'inner perimeter' of entities subject to prudential regulation under the deposit taking, insurance, and FMI frameworks, as well as an 'outer perimeter' that was subject to risk assessment, with the ability to apply specific macro-prudential requirements if required, likely on a time-varying basis.

This would only be relevant where this was appropriate and meaningful, for example if there was a significant shift of lending toward NDLIs during a period of high credit growth. APRA has recently been granted a designation power of this nature.[31] This allows APRA to make rules in respect of the lending activities of non-ADI lenders, should these activities be determined to be materially contributing to risks of instability in the Australian financial system. APRA has been clear that this is a 'reserve power' only, and it will only be used at the top of the economic cycle.

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[31] See Treasury Laws Amendment (Banking Measures No. 1) Act 2018.

Appendix 1: IMF assessment of New Zealand's deposit taking framework

Over the course of 2016 the IMF undertook a second FSAP for New Zealand. As part of this assessment, the Reserve Bank's approach to banking regulation and supervision was benchmarked against the Basel Committee's 29 'core principles' for effective supervision (BCPs). Two BCPs are of relevance:

- BCP 4 assesses the extent to which the 'permissible activities' of institutions that are licensed and subject to supervision as banks are clearly defined, and the use of the word 'bank' in names is controlled. The Reserve Bank received a 'largely compliant' grade – a pass mark.
- BCP 5 assesses the extent to which the licensing authority has clear criteria to set requirements for applicants, and reject applications that do meet such requirements. The Reserve Bank's registration process received a 'compliant' grading.

Principle 4: Permissible activities

Largely compliant: The term 'bank' is legally reserved to those financial entities that are registered by the Reserve Bank. Registration by the Reserve Bank is what constitutes a bank, and not what business an entity carries on. This situation may have created lack of clarity in the past, but this has been subsequently clarified when the Reserve Bank assumed responsibility for licensing and regulating NBDTs.

A registered bank must be carrying on the business of borrowing and lending money or providing other financial services (or both). The activities it may undertake are restricted through the conditions of registration imposed on banks. The taking of deposits is restricted to registered banks (and licensed NBDTs). Insurance activities and non-financial activities carried on by registered banks are limited to non-material amounts.

The authorities need to assess the risks posed by companies registering in New Zealand and offering bank-like or other financial services solely outside New Zealand.

Principle 5: Licensing criteria

Compliant: The Reserve Bank Act identifies the Reserve Bank as the bank licensing (or 'registration') authority and sets out the criteria the Reserve Bank must use when determining an application for registration. The Reserve Bank has published the principles it uses in applying those criteria. The Reserve Bank can reject applications for establishments that do not meet the criteria. The criteria the Reserve Bank must use in making registration decisions are set out in the Reserve Bank Act. These criteria are consistent with those applied in ongoing supervision. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home supervisor is obtained.

The Reserve Bank has a policy to keep, to a minimum, impediments to the entry of new registered banks in order to encourage competition in the banking system. In practice, the registration process is highly demanding, as is common practice in most jurisdictions, and prudential safeguards disincentivise the number of new players.

Appendix 2: Shadow banking

The FSB defines shadow banking as "credit intermediation involving entities and activities outside the regular banking system" (FSB, 2011, p. 1).

In the lead-up to the GFC there was significant credit growth in this sector, from an estimated US$27 trillion in 2002 to US$60 trillion in 2007.

Much of this shadow banking activity involved entities taking positions in long-term illiquid assets while relying on funding from short-term debt markets (Acharya and Richardson, 2009). The primary source of funding came from reliance on the wholesale commercial paper markets, rather than customer deposits. Importantly, the shadow banking system was directly connected to the traditional banking system, allowing bank-like firms, and entities connected to banks, to benefit from explicit and implicit forms of liquidity support. The resulting moral hazard and a lack of adequate regulation of banks' exposure to shadow banking entities contributed to excessive risk taking: this would result in billions in write-downs on banks' balance sheets during 2007 and 2008.

Key examples included money-market funds (MMF) and special investment vehicles (SIVs):

- **MMFs:** MMFs invest in cash and fixed income assets. They have a liability structure that is very similar to banks. Prior to the GFC they priced at a fixed NAV and promised investors the ability to redeem their funds very quickly. Due to US bank regulation that restricted interest on deposits, they were attractive to investors as they were able to offer a higher return. Over time, investors progressively began treating MMFs as a substitute for deposits, while the funds themselves began to invest in riskier assets. The MMF structure led to a run in 2008 when, following the collapse of Lehman Brothers a major money-market fund could not meets its liabilities to investors (Rosengreen, 2014).
- **SIVs:** prior to the GFC banks used a number of SIVs to move loan portfolios off their balance sheet. The SIVs then issued the banks with securities. In total, banks set up SIVs to securitise assets worth US$1.3 trillion. Oftentimes, a bank would provide implicit or explicit liquidity support to the vehicles as a backup in case there was a problem rolling over funding. Under the accounting and capital regulations at the time, the capital charge to finance loans in this manner was lower than the capital charge associated with holding the loans directly on the bank's balance sheet. In practice SIVs did not effectively shift risk – many of the assets had to be taken back on banks' balance sheets during the GFC as a consequence of wholesale runs.

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