The Treasury

Reserve Bank Act Review Phase 2 Submission Information Release

October 2019

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MCF Mutual Credit Finance

16 August 2019

Phase 2 of the Reserve Bank Act Review
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Thank you for the opportunity to comment on the consultation documents 2A "Safeguarding the future of our financial system: The role of the Reserve Bank and how it should be governed" and 2B "The Reserves Bank's role in Financial policy: tools, powers, and approach" as part of Phase 2 of the Reserve Bank Act Review.

Background:

Mutual Credit Finance Limited (MCF) is a Christchurch based Non-Bank Deposit Taker (NBDT) finance company established in 1956. MCF provides loan funding to commercial entities and consumers for a variety of purposes and as a NBDT is regulated and licenced by the Reserve Bank with Trustee Executors Ltd as its Supervisor.

MCF provides significant value to the local economy by providing access to consumer and commercial finance that is unavailable through traditional bank sources, delivering this responsibly and ethically for businesses to grow and thrive. MCF is also an alternative term deposit option for investors traditionally providing a superior return to that offered by the trading banks.

Given our size and the area of the market we operate in, not every question posed in the Consultation Document is relevant to MCF with answers provided as follows only to those questions that are in some way relevant.

Questions for consultation

Consultation Document 2A: Phase 2 of the Reserve Bank Act Review

Chapter 1: Should prudential regulation remain with the Reserve Bank?

As detailed in our submission of 25 January 2019 in response to Consultation Document 1, MCF considers the status quo works well and Reserve Bank is doing a good job in its current role. MCF believes the Reserve Bank should be given more resource to undertake this role and

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agrees with the Ministers in-principle decision not to separate the prudential regulation and supervisor functions from the Reserve Bank.

Chapter 2: What financial policy objectives should the Reserve Bank have?

2.A What other objectives should the Reserve Bank have?

- **Which of the objectives discussed in Chapter 2 should feature in the Reserve Bank Act, and why?**
- **A Are there other objectives not covered in Chapter 2 that should be considered?**

As detailed in our submission of 25 January 2019 in response to Consultation Document 1, MCF is of the view that the Reserve Bank should promote the prosperity and wellbeing of New Zealand and contribute to an efficient, stable and sound productive economy. We believe this is achieved by ensuring the financial system remains resilient with the minimum of regulatory burden on participants with regulatory resources used cost-effectively. This in turn should facilitate effective competition and innovation in the financial sector, the development of New Zealand's capital markets and promote efficient credit allocation.

Accordingly, MCF is not in favour of providing the Reserve Bank with too many detailed objectives as this may not allow them the flexibility they may require to deal with a variety of circumstances. MCF submits that the objectives of protecting and improving the stability of New Zealand's financial system and maintaining the efficiency of the financial system are the only objectives the Reserve Bank should be required to achieve.

2.E What is your view on creating a new "Deposit Takers Act" that combines material from the NBDT Act with the Reserve Bank Act's banking regulation material?

MCF strongly opposes the suggestion of creating a new "Deposit Takers Act" which would merge the Reserve Bank Act's content on the banking sector with the NBDT Act's content to unify the deposit-taking regime. There are many reasons why MCF takes this position which are summarised as follows:

- We are not a bank. We do not offer products similar to those of banks. We are considerably simpler in our operations than banks as we effectively have only two products on offer – term deposits and term loans. We do not offer transactional products or more complex lending products such as credit cards and insurance. We therefore do not require the same supervisory regime as that which applies to banks;
- We are a much smaller entity than banks and do not have the resources or sophisticated technology they possess. We are a team of four so do not have large resources dedicated to regulatory compliance and have therefore built up a relationship with our current supervisor who understands our structure and complexities. There is a very real risk that applying the same supervisory regime as that which applies to banks could be too large a compliance burden for us to handle;

- Although small, the NBDT sector is quite diverse and finance companies, building societies and credit unions differ considerably in the nature and scope of their activities, as well as in their size. A "one size fits all" model is not appropriate as the ability to engage closely and to tailor supervisory activity ensures timely identification of issues as well as being cost efficient.

<u>Chapter 4: How should the regulatory perimeter be set?</u>

4.A What is the appropriate definition of "deposit taker"? Do you agree that the definition should be framed around entities that take retail "deposits" and lend? If not, what approach do you consider would be preferable?

MCF supports the definition of "deposit taker" being changed to lenders that "*take deposits from the public*" rather than those that "*offer debt securities*". This definition more realistically captures what it is that NBDTs do which is to take retail deposits and lend.

Having said this, however, MCF notes that the in-principle decision has been made to bring the bank and NBDT regulatory regimes together into a single "licensed deposit taker" framework and refers to the answer provided to question 2.E above which provides MCF's concerns with respect to this proposal.

MCF also strongly agrees with the suggestion made on page 77 of the Consultation Document that different rules between different types of firms should be allowed for under whatever the new regime looks like. MCF absolutely supports the concept of proportionality to ensure that the burden of rules and their enforcement is proportional to the issues being addressed and the expected benefits of regulation. MCF is extremely concerned that there is a genuine risk, as articulated, in the Consultation Document, that the creation of a single licensed deposit-taker framework could mean the application of requirements designed for larger and more complex businesses will apply to smaller firms such as ourselves.

The NBDT market, which provides a viable alternative for small investors such as people wanting to supplement their superannuation income, has already shrunk significantly since the Global Financial Crisis came to an end. This is primarily because the regulatory hurdles put in the way of small finance companies wanting to fund their lending activity in this way were considered too great and too costly to allow them to continue to raise funds via retail deposit. MCF would not support any change to the current regime which further deterred existing NBDTs from carrying on their deposit-taking activity or from smaller new deposit takers entering the market.

4.B Should the Reserve Bank's ability to monitor non-licensed entities be enhanced, for example through increased data reporting requirements? What do you consider would be the costs and benefits of such an approach?

MCF does not support the suggestion that the Reserve Bank's regulatory perimeter should be expanded to include such institutions as Non-Deposit-Taking Regulatory Institutions (NDLIs).

As they are not in the business of raising deposits from the public to fund their operations, they are clearly not "deposit takers" under any of the definitions used. They are however lenders and as such they are regulated by the Credit Contracts and Consumer Finance Act 2003 (CCCFA) which is enforced by the Commerce Commission – as are deposit takers who are also lenders. It seems entirely sensible to MCF that the deposit taking activity of a bank or NBDT should be regulated by the Reserve Bank but MCF strongly submits that the lending activity of banks, NBDTs and NDLIs should be left to the Commerce Commission.

The CCCFA was significantly reviewed and improved in the wake of the Global Financial Crisis to the extent that clear Lender Responsibility Principles were written into the Act which came into force in June of 2015 together with the guidance for lenders as to how to meet these Principles that is contained in the Responsible Lending Code. The Commission has significantly increased its enforcement activity against irresponsible lenders in recent times and MCF believes they should be allowed to continue this work without interference from a second regulator.

4.C Should the Reserve Bank be given discretion to extend the perimeter within clearly specified parameters to avoid regulatory arbitrage (such as designating in entities with business models economically similar to deposit takers)? Do you agree that changes that are more significant may be more suited to legislative change, supported by pre-positioning?

As noted in the answer to 4.B above, under the current model where the Reserve Bank regulates deposit takers and the Commerce Commission regulates lenders, it is absolutely clear who is the regulator responsible for what activity and this clarity should be retained.

4.D Should tools that are not linked to licensing have a different perimeter? For example, it is common internationally for non-bank lending institutions to be subject to macro-prudential lending tools, even though they do not take deposits.

MCF is not supportive of any proposal to bring either NBDTs or NDLIs into the scope of the Reserve Bank's regulatory perimeter for the reasons previously stated. These lenders who were not subject to the Reserve Bank's LVR restrictions because they were outside of the regulatory perimeter at the time (for example) did so with a clear understanding of the risk they were taking on if they provided any credit outside of those restrictions and they have done so without incurring any further risk to their existing lending portfolio.

The NBDTs and NDLIs provide a viable alternative to a small number of people who would otherwise not have been able to access finance because of the restrictions in place and have not suffered from any significant default or loss as a result. The overall size of these NBDTs and NDLIs is relatively small and they individually and collectively have no discernible impact on the overall economy and therefore there is no benefit to be gained by including them in the Reserve Banks regulatory perimeter.

Chapter 5: Should there be depositor protection in New Zealand?

5.A Are the interactions between depositor protection and the other parts of the financial safety net set out in Part 1 of Section 2 described appropriately?

MCF notes that the in-principle decision to start developing a formal scheme to protect depositors in New Zealand has been made by the Minister and believes that the interactions between depositor protection and the other parts of the financial safety net set out in Part 1 of Section 2 are described appropriately. However, as noted in our earlier submission in January, MCF does not believe there is a need for depositor protection in NZ. Depositors need to understand that any type of investment has a certain amount of risk and they need to trade off this risk with any returns. Any form of deposit guarantee scheme can distort this comparison and will have the effect of increasing costs for participants and / or reducing returns to depositors. The introduction of a depositor protection scheme could also result in an increase in deposits being placed with higher risk deposit takers due to the increased returns often offered by these deposit takers but with the additional risk removed via the guarantee.

5.B What objectives should the depositor protection regime in New Zealand have? Should its objectives be:

- **To protect depositors from loss?**
- **To contribute to public confidence and financial stability?**
- **Both of these?**
- **Something else?**

MCF understands that the objectives of protecting depositors from loss and contributing to public confidence and financial stability are the key objectives for a depositor protection regime. MCF is still not convinced that such a scheme is required if adequate disclosure is required from deposit takers and responsible lending compliance obligations are adhered to by lenders and enforced by regulators.

5.C The Minister has made an in-principle decision that the depositor protection regime should have a limit in the range of $30,000-$50,000. Given your answer to 5.B, what coverage level would be best within this range?

A large number of MCF's investor deposits fall within this range. Given our size compared to the larger institutions (ie: banks) that attract larger deposits, it is of concern to MCF that we may have the situation where a larger proportion of our deposit book is covered by the depositor protection regime than those of larger institutions with a disproportionately large cost falling to us as a result. MCF believes that considerably more consultation as to if such a scheme is necessary and if so, the way in which a depositor protection regime might work and what it will cost is required to take place before we could reasonably answer this and other questions about such a scheme.

5.D How would your preferred limit affect depositor wellbeing, public confidence, and depositors' responsibilities for their financial choices?

MCF believes depositor wellbeing, public confidence and depositors' responsibilities for their financial choices may be distorted by a depositor protection regime. With the comfort of a deposit guarantee, MCF believes that many depositors will undertake a lesser amount of due diligence, if any, when considering the risk of placing a deposit with a deposit taker for amounts within the guarantee threshold, instead relying on the backstop of the guarantee for protection.

Consultation Document 2B: Phase 2 of the Reserve Bank Act Review

<u>Chapter 2: What role should the Reserve Bank play in macro-prudential policy?</u>

2.B What are your views on the conduct of macro-prudential policy in the past five years? It may be useful to read the recently released framework document (Lu, 2019) and the sub-questions below:

- **Are there any lessons to be learned from New Zealand's experience with loan-to-value ratios (LVRs) to date?**
- **Do you think LVR policies that have greater impacts on certain buyers (e.g. investors) or regions than on others are appropriate?**
- **Has the Reserve Bank's "speed limit" approach reduced risks without affecting too severely buyers who may need high LVR loans owing to special circumstances?**
- **Would a greater use of macro-prudential tools other than LVRs have been appropriate during the recent housing boom?**

MCF supports the application via the Banks of the current macro-prudential capital and liquidity-related tools, including the use of LVR restrictions that the Reserve Bank has as its controls. These have proved sufficient and effective as controls to prevent the build-up of systemic financial risks. MCF believes the 'speed limit' approach adopted has reduced risks but at the same time has allowed some flexibility for borrowers who needed high LVR loans due to their circumstances or to access funding via other sources including NBDTs and NDLIs. MCF does not believe new powers such as debt-to-income (DTI) restrictions are necessary. As previously outlined, we consider the CCCF Act and Responsible Lending Code are sufficient in providing controls on lenders where DTI restrictions might otherwise apply.

Should the Reserve Bank consider the use of macro prudential tools other than LVR restrictions or look to apply these to NBDTs and NDLIs, we believe that the Reserve Bank needs to be careful that such tools address the perceived risk in a non-competitive way such that market investors willing to pay for risk are not precluded from doing so unless there is a system stability issue that warrants the approach. The use of prescriptive tools can force a one-size-fits-all approach to funding availability which does not serve an efficient competitive marketplace for consumers.

2.C Is it appropriate to regulate lending standards (e.g. LVRs)? How broad should these powers be (should they include other tools such as debt-to-income restrictions)?

- **Should lending standards apply only to deposit takers or to all lenders?**
- **Should there be special governance arrangements for these tools?**
- **Should the Reserve Bank reconsider its view that these tools should only be applied temporarily?**

In its response to the first consultation document, MCF did not support the extension of the Reserve Bank's regulatory perimeter to NBDTs and NDLIs and this view is unchanged. Both provide options to consumers/businesses who for a variety of reasons are unable to access finance from the banking sector. The overall size of NBDTs and NDLIs is relatively small and individually and collectively, have no discernible impact on the overall economy and therefore there is no benefit to be gained by including them in the Reserve Banks regulatory perimeter.

Lending rules as a whole have been considerably tightened since the GFC with the review of the CCCFA in 2015 which introduced Lender Responsibility Principles and the Responsible Lending Code providing guidance as to how to meet these. Further tightening is probable with the review of the Act currently being undertaken and due to come into force in 2020. MCF believes that these existing lending rules that apply to all Lenders provide the protection required.

2.D Other than lending standards, when the Reserve Bank makes time-varying use of standard prudential tools such as capital ratios, are there any concerns or reasons for wider political oversight?

MCF submits that given that NBDTs represent a very small proportion of New Zealand's overall financial system, they therefore have very little impact on system stability. However, the introduction of time changing capital ratios would have a disproportionate impact on such smaller entities if applied as a one-size-fits-all approach.

<u>Chapter 3: How should the Reserve Bank supervise and enforce prudential regulation?</u>

3.A What do you think are the strengths and weaknesses of the Reserve Bank's current approach to supervision and enforcement?

MCF is not in favour of the in-principle decision made by the Minister of Finance to integrate registered banks and licensed NBDTs so that the Reserve Bank will likely assume formal responsibility for supervising these entities. MCF is a very small entity relative to most of the registered banks in New Zealand. Our activities are different to that of the banks and a lot simpler – we simply raise funds via deposits from the public to fund our lending activities and do not provide any of the additional services banks provide.

MCF has built up a strong relationship with our trustee supervisor which goes back even before the introduction of the NBDT Act in 2013. Our trustee understands our operations and it seems to be counter-productive to remove that function from the trustee to replace it with supervision by the Reserve Bank who will have to firstly resource then spend time developing an understanding of the sector and the individual participants in it and the way in which they differ from registered banks and each other.

MCF's view is that the Reserve Bank's current supervisory and enforcement model, at least in respect to NBDTs, is working well and should not be changed. In saying this, MCF would also like to have the ability to directly engage with the Reserve Bank on regulatory matters. We do not believe the present approach of the supervisor being the only avenue for discussion on matters affecting us to be productive.

3.D Do you think the Reserve Bank should take a more intensive approach to verifying supervisory information? If so, which verification model do you favour?

It is difficult for MCF to determine which verification model proposed in the Consultation Document would be the most favourable when the Consultation Document does not provide any specifics as to how these models would affect NBDTs. In spite of this, Option 1: the enhanced status quo would seem to MCF to be the most favourable as it is the least resource-intensive option, especially relative to our size on a scale compared with the major banks.

Chapter 5: What features should New Zealand's bank crisis management regime have?

5.E In principle, should the Reserve Bank have the power to "bail in" specified categories of unsecured liabilities (with details of eligible liabilities to be determined and subject to creditor property rights safeguards – see below) in order to recapitalise a failing large bank after its owners have absorbed maximum losses, and to minimise the need for taxpayer support? Alternatively (or in addition), should the recapitalisation of a failing large bank be funded through industry-wide levies?

MCF does not support the proposal to provide the Reserve Bank with the power to "bail in" specified categories of unsecured liabilities in order to recapitalise a failing large bank after its owners have absorbed maximum losses, and to minimise the need for taxpayer support, unless the liabilities are those instruments (Hybrid) where this possibility is explicitly stated and priced by investors. This is because there is an inherent conflict between deposit guarantee of the implied $30-$50,000 and then a haircut for any balance beyond that. Depositors will spread their deposits as widely as possible to prevent losing any balance beyond that subject to a guarantee.

The other issue we see here is that applying a haircut to deposits at one impacted bank could still trigger a run on the remaining unaffected banks when depositors realise others are losing (access at the very least) to their savings. Thus, this approach could create the very thing it is established to avoid, i.e. a run on a bank, and create a run on the remaining system.

MCF also does not support the recapitalisation of a failing large bank being funded through industry-wide levies. MCF believes that the Consultation Document is correct in its assertion that prudent and small banks should not be required to pay for the failures of large and less-prudent banks. An industry-funded recapitalisation would also reduce the incentives for banks to manage their business prudently.

5.G Should the resolution authority always be required to respect property rights (including the hierarchy of creditors in liquidation)? Or should it have discretion to override property rights as long as compensation is made available to creditors left worse off than they would have been in a liquidation? Or should no change be made to the protection of creditor property rights?

MCF believes that the resolution authority should not have the discretion to override property rights whether or not compensation is made available to creditors left worse off than they would have been in a liquidation. To preserve the confidence of investors, other creditors and shareholders, the property rights and ranking of creditors should not be amended or altered.

Chapter 7: How should the Reserve Bank be funded and resourced?

7.D Should the Reserve Bank continue to be fully funded from revenue (seigniorage and investment income) and fees, or should other funding sources be considered? In particular, should the Reserve Bank have the option to introduce an industry levy to fund the Reserve Bank's prudential supervisory function?

MCF is against making any significant changes to the way in which the Reserve Bank is funded without robust consultation with those affected by any of these possible changes. For small NBDT members, they already incur significant fees and levies in order for them to be able to continue to provide their deposit-taking offering to the public. These include levies to the FMA and the cost of having a Trustee as supervisor.

The Consultation Papers 2A and 2B are already suggesting further fees, levies or charges that would fall to deposit-takers. These include the proposed deposit-protection regime together with the possible implementation of an industry-funded resolution fund. Should the proposal to move to the Reserve Bank becoming the supervisor for all deposit-takers under the single licensed deposit-taker framework become a reality, presumably there will be further charges to the deposit-takers to cover the cost of the Reserve Bank's activities in this area (although presumably NBDTs would no longer have to pay the cost of Trustee supervision under this model).

Our concern is that all these costs on top of each other will make small NBDTs unviable. This would result in a loss of the bespoke financing and investment solutions provided by those entities (which are not generally available through larger organisations which have a more generic approach) and a diminution of competition and choice in the market.

Thank you for the opportunity for MCF to respond to the questions raised in the Consultation Documents. Please do not hesitate to contact me if there is anything further you wish to discuss.

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CHIEF EXECUTIVE OFFICER

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