The Treasury

Reserve Bank Act Review Phase 2 Consultation 3 Submission Information Release

February 2021

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22 October 2020

Phase 2 of the Reserve Bank Act Review
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Phase 2 of the Reserve Bank Act Review – Mayne Wetherell Submission on the third Consultation Document

Introduction

1. This is the submission of Mayne Wetherell on the paper entitled "Safeguarding the future of our financial system. Further consultation on the prudential framework for deposit takers and depositor protection. Phase 2 of the Reserve Bank Act Review – March 2020" (**Paper**).

2. Mayne Wetherell regularly advises financial institutions, including wholesale debt funded financial institutions (**WFFIs**) on their origination and funding arrangements. This submission is made on our own behalf and not on behalf of any client or industry body.

3. Our submission in relation to the Paper is set out below, although our submission dated 25 January 2019 on the paper entitled "Safeguarding the future of our financial system. The role of the Reserve Bank and how it should be governed. Phase 2 of the Reserve Bank Act Review – November 2018" (**2019 Submission**) remains our position and should be read contemporaneously with this submission. The 2019 Submission is appended to this submission for reference.

4. This letter contains submissions on the Paper by reference to the matters on which feedback is sought in the following questions for consultation set out in the Paper:

   (a) 3.A to 3.E;

   (b) 3.S;

   (c) 3.T; and

   (d) 4.A to 4.L (by reference to how and to what extent any standards would apply to WFFIs and the resulting uncertainty).

   We have focussed on these aspects (only) as we consider these to be the most important areas for input based on the overall direction of the Paper.

Submission

5. If WFFIs are regulated we consider that there is a real risk that it will materially harm the industry and competitive tension. Please refer to the arguments set out under the heading "wholesale debt funded financial institutions" in our 2019 Submission for further detail. We consider that the flexibility of WFFIs to fund themselves as they do is one of the very key things which provides competition to the lending market and decreases concentration and market risks. In short, we think "deposit takers" should be those taking debt under regulated offers (akin to the current regime under the Non-Bank Deposit Takers Act) and not include WFFIs.

6. Regulation would be particularly detrimental where a WFFI became subject to capital ratios, minimum capital, liquidity, rating or similar requirements which look to regulate the means and manner in which WFFIs are funded and which are primarily aimed at investor protection. Most of the Standards proposed in section 4 of the Paper are primarily of that aim. As regards the extent to which WFFI failure presents (or does not present) systemic risk concerns, please see our 2019 Submission. Asset side reporting (disclosure of information) and regulation (lending standards in relation to mortgages) is, however, of materially less concern and we understand there is a degree of voluntary disclosure to the RBNZ already. We can see the overall policy benefits of macro prudential policy (lending standards) applying to WFFIs. However, the Paper does not include any material detail on the Standards and, more importantly, indicate that the Standards would not generally apply to WFFIs which is of material concern for the reasons noted above.

7. Assuming it is sensible for WFFIs to be captured for reporting and macro prudential (lending standards) reasons, we consider this best done on a call-in basis (as set out in the last sub-section of 4.3 in the Paper) along the lines of how this practically works in Australia at present. This would apply to reporting and macro-prudential (lending standard – LVRs and DTIs) regulation only. In any event, it would be preferable for it to apply only once the applicable Standards are understood and known as to how they might apply to WFFIs.

8. Failing the adoption of a call-in regime as set out in paragraph 7 above, the systematic importance threshold (Question 3.C) should be set at a level which reflect systemic importance (call it 3-5% of system assets or similar) which is above NZ$15bn at present. However, we reiterate our concerns in paragraph 5 above and in the 2019 Submission and query what systemic impact the failure of a WFFI (which is generally funded in a manner to spread and allocated credit risk to well informed wholesale funders) would have.

Contacts

9. Please contact Dave Wetherell, Daniel Meikle or Mei Nah if you have any questions regarding our submission.

Yours faithfully
Mayne Wetherell

Appendix: 2019 Submission

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25 January 2019

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Phase 2 of the Reserve Bank Act Review – Mayne Wetherell Submission

1. This is the submission of Mayne Wetherell on the paper entitled "Safeguarding the future of our financial system. The role of the Reserve Bank and how it should be governed. Phase 2 of the Reserve Bank Act Review – November 2018" (**Paper**).

2. Mayne Wetherell regularly advises financial institutions, including wholesale debt funded financial institutions on their origination and funding arrangements. This submission is made on our own behalf and not on behalf of any client or industry body.

3. The schedule to this letter contains submissions on the above Paper by reference to Questions 3 and 4 of the proposed submission form. We have focussed on these aspects (only) as we consider these to be of the most importance.

4. Please contact Dave Wetherell, Daniel Meikle or Mei Nah if you have any questions regarding our submission.

Yours faithfully
Mayne Wetherell

Schedule: Submissions

Question 3: What are your views on the costs and benefits of moving from the current perimeter to an ADI (authorised deposit-taking institution) type of framework? Based on your views, is this an issue worth pursuing?

At a conceptual level, we are not materially concerned about the taxonomy which sets the prudential perimeter. If a singular ADI type framework were to be used to set the perimeter as it currently applies to registered banks and NBDTs we don't see any substantive concern. That said, we see little to be gained (aside from notional simplicity), and only uncertainty introduced, in changing the current approach. We would be materially concerned if that framework were associated with an adjustment in the existing prudential perimeter. In that regard, see our response to question 4 below.

We observe that there is some suggestion at pages 43 and 44 of the Paper that the Australian approach (and so an ADI type framework applied in New Zealand) would "likely include wholesale funded entities". At present, there is a material non-ADI sector in Australia who are wholesale debt funded financial institutions including finance companies and securitisers who are not (and, in our view, rightly) subject to prudential regulation. While the perimeter may not be cast in the same fashion or one-for-one identical to the New Zealand perimeter, in our experience, it is not materially different at present.

Question 4: Is new legislation the most appropriate way to adjust the prudential perimeter, or could a timelier mechanism be better? What accountability processes would be necessary to accompany any new mechanism?

In our view:

1. any adjustment to the prudential perimeter should be made by Parliament, not the Reserve Bank (or other regulator, and through any legislative instrument other than an Act of Parliament);
2. if the Reserve Bank (or other regulator, and through any legislative instrument other than an Act of Parliament) is given the power to adjust the perimeter, the scope of that power should be kept as narrow as possible and such scope (along with the limitations of that scope) should be made explicit and certain;
3. we do not see any material benefit in adjusting the current prudential perimeter (to increase or decrease coverage); and
4. if any changes are to be made to the current perimeter (whether by Parliament or the Reserve Bank or other regulator), such changes should not include wholesale debt funded financial institutions (**WFFIs**).

Ability to adjust the perimeter

Any adjustment to the prudential perimeter, now or in the future, should be made by Parliament passing new legislation rather than the Reserve Bank (or other regulator, and through any legislative instrument other than an Act of Parliament) exercising delegated authority. It is a fundamental rule of law that only the elected legislature should be able to impose law and limitations. Adjustments to the prudential perimeter (presumably to widen and not narrow the scope) will impose additional restrictions, oversight, limitations and cost to particular financial institutions (**FIs**) which are not currently subject to regulation – substantial changes that should only be imposed by Parliament.

Requiring changes to go through Parliament will allow FIs (a) the opportunity to consult on such changes and (b) the certainty required to plan their activities. If the Reserve Bank (or other regulator, and through any legislative instrument other than an Act of Parliament) is given the power to include FIs into the prudential regime as it sees fit, the FIs are deprived of the ability to accurately forecast their future costs and activities as they might be pulled in without sufficient warning. Allowing the Reserve Bank the power to adjust the boundaries of the prudential regime may also stifle the market, as new FIs would have to incur additional compliance costs up front (or run the risk of additional compliance being imposed at a later, less convenient time). Any existing risk would then be concentrated in the few FIs that can afford to comply. We think this will result in a (further) concentration of FIs and, in fact, increase financial stability risks as a result.

We also do not see the need for a timelier mechanism in this case. If the regulator has concerns about emerging industries, it should raise these with the government early on to allow for the legislative change required. If concerns only become apparent at a late stage, it is unlikely that increasing prudential regulation for those FIs at risk would have a significant impact.

Regulator's limitations

If the Reserve Bank (or other regulator, and through any legislative instrument other than an Act of Parliament) is given any powers to adjust the prudential perimeter, the scope of those powers should be as narrow as possible, and should be made as explicit as possible (along with the limitations on those powers) in order to avoid the uncertainty referred to above. The regulator should not be given the ability to include FIs into the regulatory regime purely because it thinks they are at risk, too large or too important.

Such powers should also be as consistent with Australia as possible, to ensure entities operating in both jurisdictions can do so with a minimum of additional effort.

Wholesale debt funded financial institutions

If the prudential perimeter is to be amended or widened, such changes should not impose any additional requirements on WFFIs as the concerns leading to regulation are not present in the case of a WFFI. The three market failures highlighted in the Paper are:

1. information asymmetries;

2. moral hazards; and

3. systemic risk.

The information asymmetries between entities and their investors or other market participants present in the banking and NBDT contexts are not relevant in relation to WFFIs. As shown by the distinction in financial markets regulation between retail and wholesale issuers, wholesale investors have the means and the resources to obtain relevant information and assess their credit risk without additional regulatory oversight. Many securitisation warehouses are funded by banks who are already subject to the prudential regulation. That prudential regulation can, should, and does, consider the risks associated with lending to a WFFI. Adding further compliance requirements on the WFFI itself would increase costs and reduce efficiency (along with causing a mis-match between the regulator's requirements and that of the FMCA) without affecting the actual risks.

Moral hazards, relating to FIs taking excessive risk if they believe the Government will bail them out if they fail, similarly do not apply as there is no such bail out available. In fact, we believe that increasing the prudential perimeter or indeed providing a means to do so outside of Parliament will be more likely than not to create a moral hazard by creating the expectation on the part of investors that, as and when required, the regulator will, in a timely and prudent fashion, prudentially regulate WFFIs.

Failure of one or more WFFIs will also not have the same systemic risk impact that failure of a bank or NBDT may have as they are not involved in payment systems (like banks) or the retail deposit sector (like NBDTs) (in that regard, we do not consider that NBDTs themselves are systemically important other than as a matter of public confidence). Failure of a WFFI should instead be treated in the same manner as failure of any other corporate entity in whom investors have knowingly taken a risk on by investing. Although failure of one or more WFFIs may have some flow on effects to general financial stability, that is an accepted risk in having a financial market (as it is in having a building industry, retail industry, and so on in which participants fail from time to time).

As set out above, imposing additional regulation on WFFIs would result in fewer being established, concentrating any potential risk instead of dispersing it. We think excess regulation in this instance will only serve to actually create systemic risk. Needless to say, the effect would also be detrimental on competition and choice for borrowers.