The Treasury

Additional Documents Related to Phase 2 of the Reserve Bank Act Review - December 2019 to April 2021 - Proactive Release

June 2021

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Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

[7] 6(e)(ii) - to prevent serious damage to the economy of New Zealand by disclosing prematurely decisions to change or continue government economic or financial policies relating to the regulation of banking or credit

[27] 9(2)(ba)(ii) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely otherwise to damage the public interest

[29] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment

[36] 9(2)(h) - to maintain legal professional privilege

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

TE TAI ŌHANGA
THE TREASURY

Joint Report: Further information on finance companies

Date:	28 February 2020	**Report No:**	T2020/371 (TSY) #5384 (RBNZ)
		File Number:	SH-11-4-3-2-6

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the recommendations	

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
James Campbell	Principal Advisor, Reserve Bank Act Review	[39]	N/A (mob)	✓
Tamiko Bayliss	Director, Reserve Bank Act Review		N/A (mob)	
Geoff Bascand	Deputy Governor / GM Financial Stability		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Enclosure: Yes (attached)

Joint Report: Further information on finance companies

Executive Summary

Following the Reserve Bank's report of 23 January 2020, you requested further advice on:

- the current role of finance companies in credit markets,
- the implications of the proposed reforms to prudential regulation and the introduction of deposit insurance on finance companies, and
- the Reserve Bank's future supervisory approach to finance companies.

Retail-funded finance companies play a comparatively minor role in credit markets, with assets in the sector equating to approximately 0.1 percent of total bank and non-bank sector assets. While finance companies provide funding to some sectors where banks have had limited appetite, such as higher-risk SME lending, the failure of a finance company is not likely to have a significant impact on credit availability. In general, alternative funding and investment channels will be available for credit-worthy projects, such as from wholesale-funded lenders, which undertake a much larger proportion of lending than finance companies. **Appendix 1** provides an overview of the sector portfolio.

The introduction of a single regulatory framework for deposit takers and of deposit insurance raises questions about the future treatment of finance companies. If finance companies were able to offer insured deposits, the ability to offer risk-free returns would incentivise greater risk-taking on the part of finance companies (moral hazard). Higher regulatory requirements (such as stricter licensing requirements and more intensive supervision) or sufficiently differentiated risk-based levies for insurance would be required to address these risks. Finance companies may find it difficult to comply with these requirements under their current business models, with the potential flow-on impact of reducing the availability of credit to higher-risk ventures and the diversity of investment opportunities available to retail investors.

The Phase 2 review will consult on the future treatment of finance companies in coming weeks. One of the options considered is creating a separate licence category for finance companies that would allow them to issue retail debt securities other than insured deposits. This option would seek to allow for a more differentiated and proportionate treatment of finance companies, without creating the moral hazard issues associated with insuring finance company debt securities.

While the regulatory approaches to finance companies being explored through the Phase 2 review would have different supervisory implications, they are unlikely to result in a substantial increase in supervisory resourcing on the part of the Reserve Bank. The main reason for this is the relatively low impact to the financial system should a finance company fail, and consequently our risk appetite tolerates a moderate risk of failure. If licensed financial market supervisors retain responsibility for frontline supervision of finance companies, the Reserve Bank's oversight resourcing would likely remain at 1 FTE. If the Reserve Bank takes on responsibility for directly supervising the sector, it would likely expand this supervisory resourcing to 1.5 FTE, supported by additional crisis management resources where necessary. This would probably be less intensive than the current licensed supervisor (trustee model) approach.

Recommended Action

We recommend that you:

a **note** that the finance company sector currently plays a relatively minor role in New Zealand's credit markets and that concerns about credit availability are unlikely to justify government intervention in the event of the failure of finance company.

b **note** that if finance companies are able to offer insured deposits under the proposed deposit insurance scheme, higher regulatory requirements will be required that may not be compatible with finance companies' higher risk/return business model. In the absence of these requirements, finance companies would present a significant moral hazard risk.

Tamiko Bayliss
Director, Reserve Bank Act Review

Geoff Bascand
Deputy Governor, Reserve Bank

Hon Grant Robertson
Minister of Finance

Purpose of Report

1. To respond to your request for further information on:

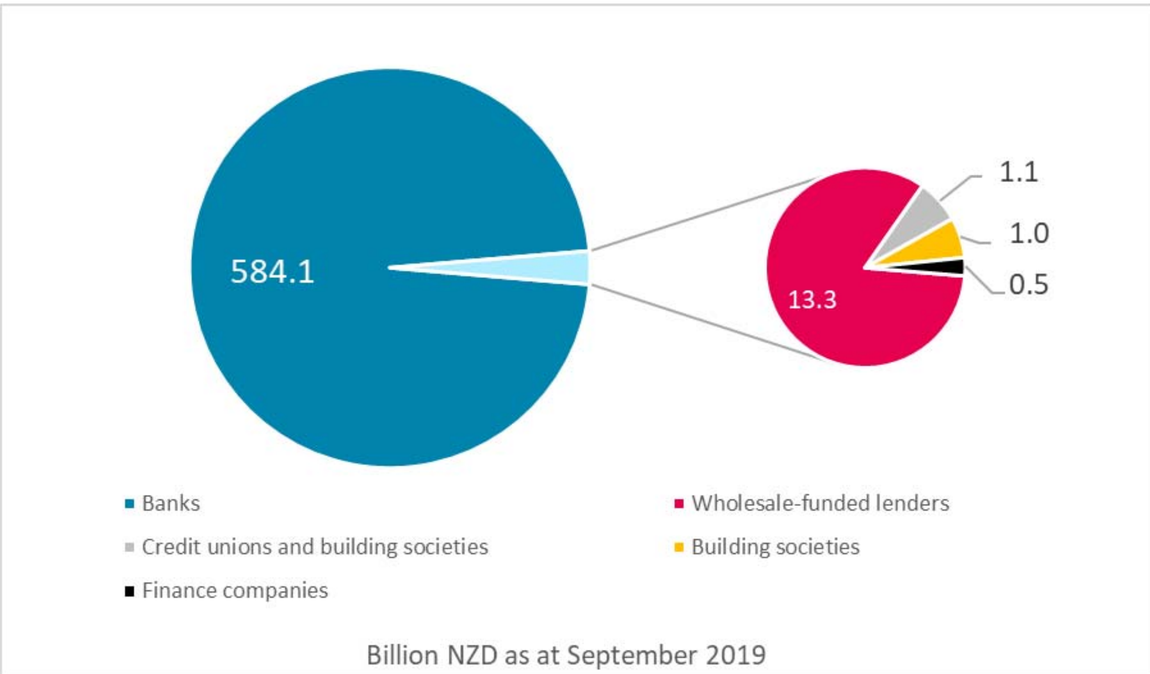
   - the current role of finance companies in credit markets,
   - the implications of the proposed reforms to prudential regulation and the introduction of deposit insurance on finance companies, and
   - the Reserve Bank's future supervisory approach to finance companies.

Finance company sector overview

2. The term "finance company" typically refers to lenders that raise funds by issuing debt securities to retail investors but do not provide transactional banking services. The debt securities issued by these companies are referred to as debentures but are similar to term deposits and are often marketed as such.

3. The finance company sector comprises 8 companies with total assets of approximately $493 million, as at end December 2019. This equates to approximately 0.1 percent of the total bank and non-bank sector assets following the withdrawal of UDC Finance in January 2020, which had represented 80 percent of the finance company sector.[1] Business strategies vary widely and reflect the risk appetite of investors and interests of the shareholders.

Figure 1: Bank and non-bank lending sector assets



[1] While UDC, a subsidiary of ANZ Bank, continues to operate, it is no longer retail funded and cancelled its non-bank deposit takers licence on 15 January 2020.

4. The typical finance company business model provides small to medium sized personal and business loans that are in turn used by borrowers to finance autos, business assets, and property development. Finance companies tend to serve niche markets and have a higher risk/return profile than registered banks. Finance companies are typically funded by offering term deposits to the public with yields one to three percent higher than those offered by banks, credit unions and building societies. The largest finance company, Christian Savings Limited, stands out from other finance companies as it does not operate under this higher risk/return model, but instead specialises in ethical, Christian-related investments and lending.

5. The aggregate sector loan portfolio is dominated by a high volume of small value ($10k – 100k) loans and larger property or development loans. Loans may be secured on the asset being financed with the risk on larger loans occasionally distributed to other lenders and investors. **Appendix 1** provides an overview of the sector lending portfolio and shows concentrations to residential mortgage and property development lending, and asset finance. The majority of SME loans are originated by one finance company which specialises in in low value (circa $10k) SME office and technology leasing and asset financing to a broad range of businesses. A number of other lenders provide similar lending products.

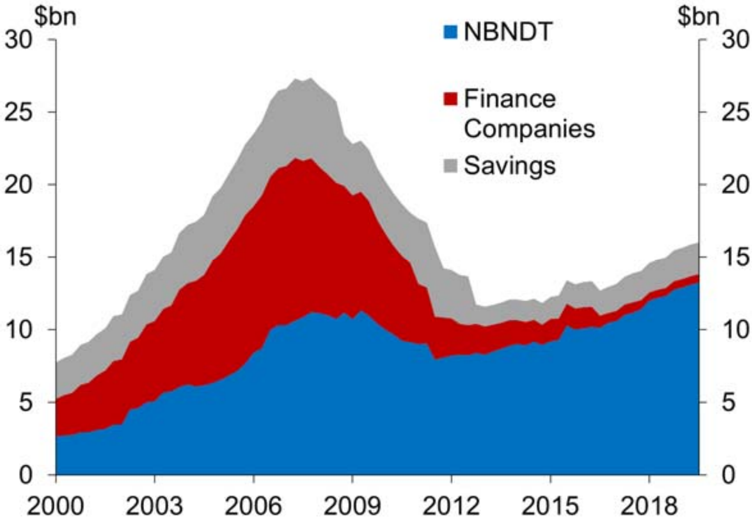
6. Finance companies do not provide client transaction accounts and have limited on-call accounts. Investors in finance companies would therefore generally be expected to also maintain other mainstream banking relationships. Retail funding is by issue of debt securities (often badged as term deposits) with related product disclosures and governance requirements under the Financial Markets Conduct Act 2013.[2] Current outstanding retail funding of $410m is held by around 4,350 investors. The investor base is typically widely dispersed with $50k average investment amount at terms concentrated below 1 year. The investor base is also geographically split across New Zealand with an 11% non-resident investor base.

7. As this sector represents a very small proportion of total financial system assets with varied business strategies and widely dispersed lending, the failure of one finance company is not anticipated to cause the failure of others. The only risk of contagion is if a high profile failure causes widespread damage to investor confidence in the sector such that investors no longer wish to place their money in these institutions.

8. Although finance companies provide funding to some sectors where banks have had limited appetite, access to alternative funding and investment channels are generally available. In particular, wholesale funded lending institutions (i.e. institutions that do not take funding from retail investors) operate in many of the same markets as finance companies. These entities are substantially larger than the finance company sector and would have the capacity to provide credit to those who had previously borrowed from finance companies.

[2] These requirements include providing investors with a product disclosure statement, minimum trust deed requirements and supervision of FMC Act compliance by a licensed Financial Markets Supervisor. Registered banks are largely excluded from these requirements.

*Figure 2: Composition of the non-bank lending sector over time**



* 'Savings' represents credit unions and building societies. Non-bank non deposit takers (NBNDTs) are wholesale funded lenders.

Implications of regulatory changes and deposit insurance

9. Finance companies are currently prudentially regulated under the Non-Bank Deposit Takers Act (NBDT Act) on the basis that they issue debt securities to retail investors. Finance companies are also subject to conduct, governance and disclosure requirements under the Financial Markets Conduct Act (FMC Act). By contrast, wholesale-funded lenders are not prudentially regulated and are exempt from governance and disclosure requirements under the FMC Act.

10. Prudential regulation of this sector is aimed at improving the overall resilience to adverse market conditions, while the Financial Markets Authority's (FMA's) market conduct regulation imposes conduct and governance requirements and requires disclosure to investors of the risks and returns. Prudential regulation is not aimed at eliminating the risk of failure, but rather that institutions are adequately managing their risk, while recognising that failures will occur from time to time in a healthy and competitive financial system.

11. The Government has agreed in-principle that a single prudential regulation framework will be created for both bank and non-bank deposit takers and that deposits will be insured up to $50,000, per depositor, per institution.

12. The treatment of finance companies under the new regulatory and insurance regimes will have significant impacts on the future of the sector. While the definition of a deposit taker has yet to be finalised, you have indicated that prudential regulation of finance companies should be maintained under the new regime. A key issue is whether finance companies should be included within the scope of the deposit insurance scheme.

13. Two options are presented in the third consultation document for the Review (C3):

- Option 1: maintain prudential regulation of the sector but provide a specific licence category for finance companies that want to issue retail debt securities but do not wish to take insured deposits.

- Option 2: require finance companies to be licensed and supervised as a deposit taker in order to issue any type of retail debt securities. Under this option finance companies would likely be able to take insured deposits.

14. Of the two approaches, Option 1 is more likely to provide a regulatory environment for finance companies that is compatible with their current business models. The regulatory regime would be similar to the status quo, with regulatory requirements that are more accommodating of a higher risk/return business model. Finance companies operating under this licence category would likely face some additional restrictions in order to clearly differentiate their debt securities from insured products (e.g. restrictions on their ability to offer transactional accounts or on the use of words such as 'deposit' to describe their products). Finance companies that want to take insured deposits could seek to be licensed as a full deposit taker, but would face more stringent licensing and regulatory requirements.

15. Option 2 would theoretically allow finance companies to more easily attract funding by offering insured deposits to retail investors (who would be insulated from loss), which could result in greater risk-taking by finance companies (moral hazard). In order to address these moral hazard risks licensing requirements, prudential standards, and insurance levies would need to be set at a level that is likely to be incompatible with finance companies current high risk/return business models. Option 2 is therefore more likely to result in finance companies either shifting away from retail funding (and therefore out of the regulatory perimeter) or moving to a lower risk business model (in order to meet licensing and other regulatory requirements). This could reduce the diversity of investment opportunities available to retail investors and (at the margins) the availability of credit to higher risk ventures.

Future supervisory approach

16. Under the current supervisory framework, a licensed financial markets supervisor (FMS) supervises finance companies' compliance with the terms of an agreed trust deed on behalf of debt and equity investors. The trust deed allows the FMS and finance company to agree the basis of supervision and oversight, including maximum exposure concentrations, and minimum capital and liquidity requirements. Reserve Bank regulation currently consists of licensing, oversight of prudential requirements, suitability assessments and limited engagement with trustees and regulated entities. At present the Reserve Bank allocates approximately half an FTE to this function – growing to one FTE under the proposed new five year funding plan. The FMA is responsible for licensing FMSs and for overall oversight and enforcement of compliance with conduct and disclosure requirements.

17. While the two options in C3 to be consulted on provide different levels of supervisory workload for the RBNZ, the resourcing implications are not materially different:

- Option 1 would likely retain FMS supervision of finance companies, as per the status quo. FMS supervision of finance companies is relatively intensive relative to company and sector size. The Reserve Bank's responsibilities would continue to focus on licensing, relevant regulatory transactions (exemptions, change of control applications and suitability assessments), and overall oversight of the sector. Under this approach the Reserve Bank expects that its resourcing for oversight of the sector would remain at about 1 FTE.

- Option 2 would involve the Reserve Bank directly supervising finance companies (as will be the case for other deposit takers). Finance companies would not be subject to FMS supervision. The Reserve Bank expects that an additional 0.5 FTE of resourcing would be dedicated to this role in business-as-usual situations as they would take a proportionate approach across the population they supervise and these entities would be supervised as a portfolio i.e. not relationship supervised. In some cases this could lead to less supervisory intensity than under Option 1 and lower direct costs for the finance companies (as regulated entities pay directly for FMS supervision). This resourcing would be supplemented by additional crisis management resources in the event of a crisis situation, which can be disproportionately resource intensive.

18. Both options would also have supervisory implications for the FMA and would require further consideration of disclosure and other requirements for finance companies under the FMC Act.

APPENDIX 1: FINANCE COMPANY SECTOR PROFILE

Regulated Institutions	8
Total Assets	$493m
Total Loans	$396.4m
Number of Borrowers	8,800
Loan concentrations	
SME	4,867 (Majority by 1 finance company)
Consumer loans	2879
Residential property	564
Debentures Outstanding	$410m
No Debenture Investors	4,354
Lending Concentrations	
Property	**60%**
Residential	*37%*
Development	*36%*
Other Property	*27%*
Commercial	**27%**
SME	*92%*
Other	*8%*
Consumer Loans	2.5%
Average Loan per Customer	c$125k
Loans Impaired	c$11m
Loan Capital inc. Interest	$181m
Risk Weighted Assets	$439m
Loan loss Provision	**$7m**
Collective	*$2m*
Specific	*$5.3m*
Loan Security	**$385m**
Property	$335m
Other Assets	$50m
Debenture Investments	$410m
No. Debentures Outstanding	8415
No. Investors	4354
Average Balances	
Per Investment	$50k
Per Investor	$90k
Investor Balances	
<$50k	70%
$50k-$150k	15%
$150k-$250k	10%
>$250k	5%
Geographic Distribution	
Auckland	36%
Rest North Island	25%
South Island	28%
Non-resident	11%

Data as at 31 December 2019