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

[26] 9(2)(ba)(i) - 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 to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied

[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: Deposit Takers Act – approach to finance companies

Date:	3 December 2020	**Report No:**	T2020/3517
		File Number:	MC-1-7-3-1-13

Action sought

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

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
James Campbell	Principal Advisor	[39]	N/A (mob)	✓
Tamiko Bayliss	Director, RBNZ Act Review		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Refer a copy to the Minister of Commerce and Consumer Affairs.

Enclosure: Yes (attached)

Joint Report: Deposit Takers Act – approach to finance companies

Executive Summary

The Deposit Takers Act will provide for a new prudential regulatory regime for firms that are in the business of borrowing and lending and establish a deposit insurance scheme. Within this regulatory perimeter, firms that offer transactional 'banking' services (such as banks, credit unions and some building societies) generally present the strongest case for prudential regulation, given the potential negative externalities associated with failure of these firms.

The proposed regulatory perimeter for the Deposit Takers Act would also capture firms that do not take on-call deposits or offer transactional services, but that issue other types of debt securities to retail investors. We refer to these as "finance companies" and it should be noted that this is a description of a business model, and does not necessarily equate to the highest risk institutions. You have previously indicated that finance companies should continue to be prudentially regulated.

A key issue for the most recent round of consultation was how finance companies should be regulated under the Deposit Takers Act, in particular whether:

- finance companies should be licensed as deposit takers and eligible to take insured deposits, or
- a separate licence category for 'regulated debt issuers' should be established that enables these firms to issue some retail debt securities (e.g. longer-dated retail bonds or debentures) but not take insured deposits.

Stakeholders were split on whether the establishment of a separate licence category would be desirable. Some, including the finance companies, were not in favour of its establishment, preferring to be licensed as deposit takers and have access to deposit insurance. They argued that few additional regulatory requirements would be necessary to manage moral hazard risks associated with finance companies and that access to deposit insurance would be important in allowing them to continue to attract funding. Others supported the establishment of a separate licence on the basis that it would allow for a more differential approach to higher risk/return entities and avoid moral hazard risks.

Both the Treasury and the Reserve Bank support finance companies being fully inside the deposit taker perimeter and permitted to offer insured deposit products, with licensing requirements, prudential supervision and risk-based pricing used to manage any moral hazard risks. This preference reflects the desirability of a simple, consistent and coherent regulatory framework for all deposit takers.

In light of your decisions on the recommendations in this paper, we will provide you with our final advice on the overall regulatory perimeter early next year. We also recommend that you refer this report to the Minister of Commerce and Consumer Affairs for his information, given the implications of these decisions for his portfolio.

Recommended Action

We recommend that you:

a **note** that the proposed regulatory perimeter for the Deposit Takers Act would capture 'finance companies' – lenders that issue retail debt securities, but do not take on-call deposits or offer transactional services.

Noted.

b **agree** that finance companies should be required to be licensed as deposit takers, with the Reserve Bank managing moral hazard by imposing sufficient robust regulatory requirements and risk-based pricing for deposit insurance (recommended approach) .

Agree/disagree.

c **note** that the alternative approach tested as part of public consultation was to establish a licence category for 'regulated debt issuers' that would allow finance companies to issue longer-dated uninsured retail debt securities, but not to take insured deposits or offer transactional facilities.

Noted.

d **Note** that the Treasury and the Reserve Bank will undertake further detailed design work in light of your decisions on the recommendations in this paper and report back to you alongside other policy decisions on the Deposit Takers Act in February 2021.

Noted.

e **refer** this report to the Minister of Commerce and Consumer Affairs for his information.

Refer/Not referred.

Tamiko Bayliss
Director, RBNZ Act Review

Hon Grant Robertson
Minister of Finance

Joint Report: Deposit Takers Act – approach to finance companies

Purpose of Report

1. To seek your agreement to the approach to finance companies under the Deposit Takers Act, specifically whether finance companies should be licensed as deposit takers and eligible to take insured deposits.

2. We expect to deliver a broader suite of recommendations for your consideration on the Deposit Takers Act in February 2021. However, we are seeking a decision on the treatment of finance companies because it will have consequential impacts on other parts of the legislation, and it will allow us to focus on the detailed design of the agreed option.

Context

3. The Deposit Takers Act will provide for a new prudential regulatory regime for firms that are in the business of borrowing and lending and establish a deposit insurance scheme.[1] Within this regulatory perimeter, firms that offer transactional 'banking' services (such as banks, credit unions and some building societies) generally present the strongest case for prudential regulation, given that the failure of these firms could have negative impacts on the broader financial system and the wider economy.

4. The proposed regulatory perimeter for the Deposit Takers Act would also capture lenders that issue retail debt securities, but do not take on-call deposits or offer transactional services – referred to for the purpose of this report as 'finance companies'.[2] Finance company debt securities are often referred to as debentures but are also marketed as 'term deposits' and 'secured term deposits'. Finance companies are currently licensed and prudentially regulated under the Non-Bank Deposit Takers Act 2013 (NBDT Act).

5. Finance companies seek to fill a gap in the credit market by undertaking a range of lending that banks may not be willing to undertake, including personal, car, business and property lending. In doing so they provide customers with access to finance and improve the diversity of New Zealand's credit markets (although wholesale funded lenders offer similar products and have a much larger market share). Because finance companies are generally willing to lend for riskier ventures based on lower credit security than banks and other NBDTs, they often charge higher interest rates. In turn, they often attract funding from investors by offering higher returns than are offered on many deposit products. **Annex 1** provides an overview of the current finance company sector in New Zealand.

6. The inclusion of finance companies within the regulatory perimeter raises questions on whether they should be able to offer insured deposits. Finance companies do not

[1] We will provide you with further advice on the extent to which the perimeter should capture firms that borrow solely from wholesale investors.

[2] The term 'finance company' is also sometimes used to refer to equity or wholesale funded lenders – this report only relates to finance companies that raise funds from the general public by issuing debt securities to retail investors.

necessarily have all of the characteristics that necessitate the provision of deposit insurance:

- they do not offer products that play the 'public utility' role of transactional deposit accounts, which are necessary for participation in the modern financial system
- they are subject to more extensive product disclosure requirements aimed at promoting investors' understanding of risk
- given the often lower negative externalities associated with the failure of a finance company, it is less obvious that there is an implicit guarantee that should be managed by a formal pre-funded deposit insurance scheme.

7. Coverage of finance company debt securities by deposit insurance is likely to generate more significant moral hazard concerns than banks and other deposit takers.[3] Finance companies present a particular moral hazard risk as their business models are often premised on being able to offer superior returns by engaging in higher risk lending niches. To the extent that finance companies have access to deposit insurance and can maintain this return premium over lower risk institutions, they are more likely to attract insured funds.

8. Licensing, prudential standards, supervisory intensity and risk-based pricing for insured deposits are all tools that can be exercised to reduce and manage moral hazard risks, however, finance companies may struggle to comply with these requirements under their current business models. In particular, these tools may limit the ability of finance companies to offer the higher returns that underpin their business model, either by directly constraining their ability to engage in their current lending practices, or by imposing additional compliance costs that finance companies would struggle to absorb.

Previous advice and [29], [33]

[29], [33]

[3] Moral hazard in this context refers to the risk that entities that offer higher returns may experience significant growth under the guarantee and subsequently undertake less prudent lending to maintain these higher returns. Insured depositors have little incentive to monitor this risk taking or to exert market discipline on the entity as they are insulated from the results of failure. Moral hazard increases the deposit insurer's exposure and ultimately undermines financial stability. Moral hazard is distinct from the likelihood of an entity defaulting at the time that the guarantee is offered.

[29], [33]

Analysis

13. Consultation document 3 (C3) presented two options for how finance companies could be regulated under the Deposit Takers Act:

    1. Require all entities within the regulatory perimeter to be licensed as a '**deposit taker**'.

    2. Establish a restricted '**regulated debt issuer**' licence as an option for entities that do issue retail debt securities but do not take insured deposits.

Option 1

14. Under Option 1, the Deposit Takers Act would not draw a distinction between finance companies and other types of deposit taker, requiring them to be licensed as deposit takers in order to issue any retail debt securities. In turn, finance companies would be members of the deposit insurance scheme and able to take insured deposits.

15. The Reserve Bank could choose to treat finance companies as a class of deposit taker – issuing different standards on some matters or granting exemptions from requirements that are not relevant or necessary – but the bulk of the regulatory regime would likely be similar to that applying to other deposit takers.

16. The challenges associated with this option primarily relate to whether regulatory requirements could adequately manage the risk of a finance company being able to take insured deposits, while still being compatible with finance companies' generally higher risk and return business models and the desirability of maintaining financial sector diversity.

17. Licensing tests, prudential standards, supervision and risk-based insurance pricing would seek to address these moral hazard issues. However, this may require finance companies to adopt a risk- and return-model similar to that of other deposit takers, potentially reducing the availability of credit to higher risk ventures (at the margins) and the diversity of investment opportunities available to retail investors. Some finance companies may not be able to meet the relevant regulatory requirements, in which case

they would need to either wind-down or shift to a different funding model (e.g. wholesale or non-debt funding).

Option 2

18. Under Option 2 a separate 'regulated debt issuer' licence category would be established in legislation for lenders that would like to only issue uninsured retail debt securities. These firms would be subject to requirements that clearly differentiate their debt securities from insured deposits, including:

    - being described as 'regulated debt issuers' (or similar) rather than as 'deposit takers' and not being permitted to describe their products as 'deposits'.
    - full product disclosure requirements under the Financial Markets Conduct Act (FMC Act), including clear labelling that products are uninsured
    - not being permitted to offer transactional accounts or products that could be easily confused with an insured deposit (e.g. on-call or very short maturity debt securities).[4]

19. Regulated debt issuers would be subject to separate prudential standards targeted at finance company business model risks. They would continue to be subject to the governance and disclosure requirements in the FMC Act (unlike deposit takers which will be excluded from these requirements) and could potentially continue to be supervised by licensed supervisors, rather than by the Reserve Bank directly. It may also not be necessary for regulated debt issuers to the crisis management of the Deposit Takers Act (given that receivership or liquidation are more likely to be viable resolution options).

20. Under Option 2 firms would decide whether to seek a regulated debt issuer licence or a deposit taker licence. Finance companies that want to take insured deposits would have the option of applying for a full deposit taker licence but would need to meet more stringent licensing and regulatory requirements. For example, Christian Savings offers on-call savings accounts and attracts funds due to its social purpose rather than by offering particularly high returns. It would have the option of either restricting its product offering in order to operate as a regulated debt issuer or seeking a full deposit taker licence.

21. Option 2 would require clear communication to investors on the distinction between insured deposits at a deposit taker and uninsured debt securities at a 'regulated debt issuer'. If investors had a false impression that their investments are insured, this would create the risk of both harm to individual investors and of an ongoing implied expectation on the Crown to step in to prevent failure or compensate investors.

Option 1: Licensed as a deposit taker	
Pros	Cons
• Less legislative and administrative complexity than option 2 • Licensing, prudential requirements, supervisory intensity and risk-based insurance levies	• Challenges managing the moral hazard risks associated with deposit insurance while maintaining financial sector diversity. Potential that some existing firms are decide to wind

[4] Similar requirements apply in Australia, where Registered Financial Corporations can issue uninsured debt securities without obtaining an ADI licence, provided that they do not describe their products as deposits, provide a warning statement in their disclosure documents, and do not provide transactional, on-call or short maturity debt securities.

provide options for managing moral hazard risks. • Regulatory perimeter for prudential regulation aligns with eligibility for deposit insurance • Higher prudential requirements and more intensive supervision may reduce risks to investors	down or stop taking retail deposits • Impacts of this option are somewhat dependent on the regulatory approach that the Reserve Bank chooses to take. • Does not allow for different product disclosure and governance requirements for finance companies (compared to other deposit takers) under the FMC Act
Option 2: Regulated debt issuer licence	
Pros	Cons
• Allows firms to decide whether to be a regulated debt issuer or a deposit taker with access to deposit insurance but with a higher regulatory burden. • Allows for a more differentiated treatment of firms whose products do not have the characteristics that necessitate deposit insurance. • Manages moral hazard risks by preventing regulated debt issuers taking insured deposits • Restrictions on product scope, labelling and disclosure reduce the scope for public confusion	• Additional legislative complexity and separate regulatory standards • Finance companies may not be attracted to becoming regulated debt issuers due to concerns that they will not be able to raise funds without access to deposit insurance. • Potential complexity of different supervision models • Residual risk of public confusion

Consultation

22. Submissions on the approach to finance companies were mixed. A joint submission from five finance companies as well as submissions made by an individual finance company and the Financial Services Federation were supportive of Option 1. Finance companies were concerned that the establishment of a separate licence category could exacerbate a public perception that finance companies are high-risk and that without deposit insurance they will not be able to compete on a level playing field with banks and other deposit takers. The joint finance company submission is, however, in favour of limiting new entrants to the market to a ‘restricted deposit taker’ licence, without access to deposit insurance, for a period of up to 3 years.

23. The joint finance company submission argued that the sector is already well regulated, does not present a significant risk to the deposit insurance regime and should have access to deposit insurance without a significant increase in regulatory burden. It argued that a small increase in capital requirements should be sufficient to manage their risk profile, while acting as an effective brake on an influx of depositors due to the introduction of deposit insurance. The submission argued that deposit insurance levies should not be risk-based.

24. Submissions from the Trustees Corporations Association (TCA), KPMG and one individual submission supported Option 2, arguing that this will:

    - enable a more proportionate regulatory approach for finance companies with lower compliance costs, minimising barriers to entry and better providing for

competition and a diversity of investment and credit options in New Zealand

- avoid the moral hazard risks associated with an influx of insured deposits into the finance company sector, which would encourage a reduction in lending standards
- allow for finance companies to be treated differently to deposit takers under the FMC Act, not having the disclosure and governance exclusions that are currently available for registered banks and that C3 proposes to extend to all deposit takers.

25. One submission, from former Governor Grant Spencer, argued finance companies should instead have the option of obtaining a licence under the FMC Act if they solely want to issue uninsured debenture products. This is most similar to option 2 but would mean issuers of uninsured debentures would not be prudentially regulated (but would be subject to various FMC Act licensing requirements).

26. Both MBIE and the FMA have been extensively consulted in the development of these options. MBIE does not have a strong view on a preferred approach, while the FMA, on balance, would support Option 1 provided finance companies are adequately prudentially supervised by the Reserve Bank and the FMC Act disclosure settings are worked through. The FMA recognises there are consumer and investor understanding challenges to manage under both options.

Recommended approach

We recommend Option 1 on the basis that it is less complex and any moral hazard risks can be adequately managed

27. The Treasury and the Reserve Bank support Option 1, with finance companies being fully inside the deposit taker perimeter and permitted to offer insured deposit products. This preference reflects the desirability of a simple, consistent and coherent regulatory framework for all deposit takers, which is more understandable for stakeholders and efficient to operate. It is also a more proportionate response to the small size of the existing finance company sector.

28. We consider that the moral hazard risk associated with this option can be suitably addressed by the application and supervision of minimum prudential standards, restrictions on the use of protected words, and charging risk-based premiums for insured deposits.

29. We acknowledge that an updated set of prudential controls will have an impact on current finance company business models. However, the alternative option that was consulted on can also be expected to adversely affect current finance company business models by putting them at a competitive disadvantage due to their not being covered by the deposit insurance scheme. The very small scale of Finance companies today (as shown in **Annex 1**) suggests that any adverse impacts on financial system diversity would be relatively small, and not materially affect the range of investment opportunities and funding sources available to retail investors and other market participants

30. Some finance companies may also choose to adjust their funding programs away from retail debt sources and operate fully outside the prudential perimeter. This would help preserve the diversity of lenders while also minimising moral hazard. A similar outcome was observed when prudential oversight was first applied to finance companies with the establishment of the NBDT regime.

Next steps

31. Subject to your agreement to the recommendations in this paper, Depending on your preferred approach, there will be a number of second order issues that we will need to resolve in relation to finance companies, including the detailed approach to FMC Act disclosure requirements. The Treasury and the Reserve Bank will work through these issues, in consultation with MBIE and the FMA, prior to providing you with final advice on the Deposit Takers Act in February 2021, alongside other policy decisions on design of the regulatory perimeter.

32. Given the linkages between the proposed treatment of finance companies under the Deposit Takers Act and the operation of disclosure and governance requirements under the FMC Act, we recommend that you refer this report to the Minister of Commerce and Consumer Affairs for his information.

Annex 1 – Current finance company sector

Institution	Investors	Retail investment	Credit rating	Current deposit rates
Asset Finance Limited	[26]		B-	2.95% (9m) - 5.00% (5y)
Christian Savings Limited [5]			BB	0.10% (call) - 1.40% (5y)
Finance Direct Limited			N/A	1.30% (6m) - 5.85% (5y)
General Finance Limited			BB-	2.40 (6m) - 3.55 (5y)
Gold Band Finance Limited			N/A	2% (6m) - 5.10% (5y)
Liberty Financial Limited			BBB-	2.45% (3m) - 3.25 (5y)
Mutual Credit Finance Limited			N/A	3.75% (12m) - 5.10% (5y)

[5] Christian Savings could potentially be excluded from this list as they offer much lower returns than other finance companies and attract funds based on their charitable purpose.