RESERVE BANK
OF NEW ZEALAND
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Date: 14 March 2013

To: Minister of Finance Bill English
cc: Associate Minister Steven Joyce
Associate Minister Jonathan Coleman

Aide Memoire: Financial disintermediation and macro-prudential policy

This note is intended as background to the Reserve Bank consultation on "Macro-prudential policy instruments and framework for New Zealand".

Introduction

The Reserve Bank's consultation paper notes a number of risks around the implementation of the proposed macro-prudential instruments. These include the possibility of financial disintermediation whereby the application of macro-prudential instruments for banks results in domestic lending shifting to other domestic institutions, foreign bank branches or other lenders based offshore. Disintermediation could serve to undermine the effectiveness of the macro-prudential instruments, particularly in terms of dampening the credit cycle.

This note briefly discusses the disintermediation risks surrounding macro-prudential policy, the Reserve Bank's assessment of the risks and how these would be managed.

The boundaries of macro-prudential regulation

Under the Reserve Bank's current proposals, macro-prudential instruments would be implemented for registered banks using conditions of registration. Adjustments to the core funding ratio, the countercyclical capital buffer (CCB) and sectoral capital requirements would apply to all locally incorporated banks (which have their own balance sheet in New Zealand), while loan–to-value restrictions would apply to all registered banks, including branches of foreign banks (Table 1).

Table 1: Regulatory boundary by macro-prudential instrument

Type of lender	Share of financial system assets*	Assets ($Sbn)	Regulatory authority	Macro-prudential instrument			
				Core funding ratio	Countercyclical capital buffer	Sectoral capital requirements	Residential mortgage LVR restrictions
NZ-owned banks	5.5%	23	Reserve Bank of New Zealand	Yes	Yes	Yes	Yes
Foreign bank subsidiaries	81.9%	339	Reserve Bank of New Zealand	Yes	Yes	Yes	Yes
Foreign bank branches	9.8%	41	Home country banking regulator	No	Yes, under Basel III reciprocity from 2016	No	Yes
Non-deposit taking finance companies	1.7%	7	Financial Markets Authority	No (RBNZ) regulatory jurisdiction			
Non-bank deposit takers (credit unions and building societies, finance companies)	1.0%	4	Reserve Bank of New Zealand	No, but could extend regulatory perimeter			
Offshore lenders	n.a.	small, mainly corporate	Home country regulator (if regulated)	No regulatory jurisdiction			
Memo item:							
Lending to household sector by other domestic lenders (e.g. solicitors, managed funds, and life insurance offices)		0.465	Various	No (RBNZ) regulatory jurisdiction			

* Excludes funds under management, and firms in moratorium/receivership
** For banks in Basel III compliant jurisdictions

As Table 1 shows, financial institutions in the non-bank sector would not be subject to macro-prudential regulations as currently proposed. This would include the non-bank deposit takers such as credit unions, building societies and finance companies and the non-deposit taking finance company sector. In sum these lenders currently account for a small share of total lending, at around 3 percent of total financial sector assets.

The domestic lending of branches of foreign banks operating in New Zealand would be directly affected by LVR restrictions (assuming the branch in question is a lender for housing purposes). In addition, under the international Basel III 'reciprocity' proposals, the imposition of counter-cyclical capital buffers in New Zealand would require the home country to add the CCB to total group capital (in proportion to the branch lending undertaken in New Zealand) assuming the jurisdiction in question was Basel III compliant. These reciprocity arrangements are expected to take effect in 2016.[1] The

[1] The Basel III global standard envisages reciprocity arrangements to help maintain a level playing field between banks that are regulated locally (including the subsidiaries of the Australian parent banks) and foreign banks that are not regulated by the local supervisor (such as the branches of foreign banks operating in New Zealand). Under reciprocity, the CCB that would apply to each bank at a consolidated level would reflect the geographic composition of its portfolio, i.e. a weighted average of buffers across the group's regional operations.

Core Funding Ratio or sectoral capital requirements would not apply to these banks, although we may be able to negotiate some further reciprocity with key regulators in the future.[2]

There are a range of other domestic parties that can potentially undertake housing or other lending that would not be captured by macro-prudential regulations. This includes person-to-person lending, lending via solicitors' trust accounts and housing lending through life insurance offices, superannuation schemes and managed funds. Such lending activity is estimated to account for just 0.1 percent of total financial system assets, having fallen markedly over the past 30 years. However, lending to households by solicitors and funds accounted for about one quarter of all such lending during the 1970s, during which time the core banking system was heavily regulated.

Lenders based offshore with no branch operations in New Zealand would also not be subject to any macro-prudential regulations as these institutions fall outside the regulatory reach of New Zealand.

Financial disintermediation risks

The existence of lenders to households and businesses residing outside of the regulated banking system raises the risk that the use of macro-prudential tools will encourage greater lending by these non-regulated entities. While these risks will need to be carefully monitored, we believe they are likely to be manageable in practice and – at least given the current financial landscape – of a scale unlikely to undermine the effectiveness of macro-prudential tools. This view takes into account a number of factors:

- First, the banking system accounts for the lion's share of financial sector activity in New Zealand and the scope for significant lending to occur outside the sector appears to be small at present. The capacity of the non-bank deposit taking sector to fund a high volume of domestic lending appears relatively limited, particularly given depositors' current preference for bank deposits. Moreover, in the case of credit unions and building societies, these institutions tend to be conservatively managed and are often relatively constrained in their capacity for rapid growth given their structural form. Under current prudential requirements, the non-bank deposit takers must hold greater capital against housing lending than is the case for the banking sector with significantly higher requirements for high-LVR lending. This would be expected to dampen incentives to increase such lending in response to a macro-prudential policy change.

- While there is a possibility that some lending activity could be displaced to offshore lenders, including non-bank lending institutions, this would have the effect of shifting the credit risk to foreign balance sheets. In other words, even if such lending occurred, it would potentially be of less concern in terms of the overall stability of the New Zealand financial system. It would however, tend to

[2] A precedent exists with the Reserve Bank's prudential liquidity policy. APRA recognises New Zealand requirements when setting group liquidity requirements.

reduce the effectiveness of the tools in dampening the credit and asset price cycles.

- Macro-prudential tools are expected to be applied temporarily and relatively infrequently (to handle periods of excess in the credit cycle) rather than in a continuous fashion. Accordingly the incentives for lending to shift outside the regulated banking system are expected to be smaller than would be the case if a permanent regulatory wedge were put in place.

- The majority of the proposed macro-prudential instruments are likely to work via pricing incentives rather than through outright restrictions on lending. This means that banks would still be able to lend but the cost of that lending might be higher and/or profit margins might be reduced. Non-regulated entities that attempt to profit from a temporary reduction in competitiveness would still have to compete against the existing banks, which are well established and have extensive branch networks.

- Even in the case of LVR restrictions, if these were to be imposed via limits on the proportion of new high-LVR lending (an option highlighted in the consultation paper), other high-LVR lenders would still have competition from the existing banking system.

It should be emphasised that some level of financial disintermediation is both likely and unavoidable when macro-prudential instruments are used. In many ways, the risks are similar to those applying to the introduction of a new tax or levy, where some degree of avoidance is to be expected. What matters ultimately is whether the tools in question can have a meaningful effect on reducing financial system risk or dampening lending activity overall.

Monitoring and managing disintermediation

The Reserve Bank intends to closely monitor the activities of financial institutions within its regulatory perimeter, as well as keeping a watching brief on potential “shadow banking” sector activity. We would also expect to be quickly apprised by the banks of any emerging new lending channels. The Reserve Bank has good statistical coverage of most non-bank lending, and some coverage of the lending that occurs from offshore parties.

The Reserve Bank already heavily prescribes the type and level of assets that the major banks can hold through their New Zealand branch operations, and there is scope to respond if banks attempted to avoid macro-prudential policy requirements via greater lending through their branches.

As noted in the consultation paper, the macro-prudential regime could potentially be extended to non-bank deposit takers (which are currently regulated by the Reserve Bank). This would likely require orders in council. Such an extension would not capture the non-deposit taking institutions (such as international finance companies operating in New Zealand) but would potentially help to stem any emerging disintermediation. Broader regulatory change could also be contemplated if became clear that lending activity was shifting well beyond the core financial system.