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A tale of small branches: NBDT sector performance under increased regulatory scrutiny

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Non-technical summary

New Zealand's financial ecosystem is made up of a diverse range of products and services that help support a well-functioning economy. For example, banks and other lenders such as credit unions, building societies, and finance companies play the important economic role of connecting those who have funds available (investors and savers) with those who want funds (borrowers). This process is called credit intermediation and it sits at the heart of the banking business, along with other core services like making and receiving payments.

A useful pūrākau (story) to illustrate the Reserve Bank's role in the financial system is the legend of Tāne Mahuta, guardian of the forest. In this story, Tāne's roots have inherited mana from legislation; Tāne's trunk is the payments and settlements system that connects the financial system together and allows the sap (our money) to flow, and Tāne's branches are the entities we regulate, such as the banks. Just as Tāne provides shelter and food for those in his forest, we care for New Zealand's financial ecosystem as kaitiaki (caretakers), working to promote soundness and efficiency in the financial ecosystem.

This paper takes a closer look at some of Tāne's smaller branches, called Non-Bank Deposit Takers (NBDTs), which are lenders that were grafted onto Tāne's trunk in 2008 following the government's Review of Financial Products and Providers in 2006. As suggested by their name, NBDTs hold deposits for the public and make loans to their customers. There are 24 licensed NBDTs operating in New Zealand, including credit unions, building societies, and finance companies. NBDTs are typically small and tend to serve niche markets, which means that they play an important role in complementing the services provided by registered banks. These characteristics also mean NBDTs have a different risk profile than the larger and more diversified registered banks.

In its caretaker role, the Reserve Bank sets prudential requirements in areas such as governance, risk management and capital, amongst others. These requirements strengthen the resilience of NBDTs without imposing excessive costs. The wave of finance company failures seen between 2007 and 2012, largely before the Reserve Bank was made responsible for NBDT regulation, serves as a useful reminder of the risks that can materialise in the absence of effective regulation and scrutiny. The Reserve Bank regularly reviews its rules to ensure that they remain fit for purpose and are achieving the desired outcomes. For NBDTs, these outcomes include restoring investor confidence and increasing resilience in the sector,

ultimately helping to promote stability in the wider financial system. Even well-designed regulations impose costs, which should be measured against any benefits, such as improved trust and resilience.

This paper looks at the 2010-2018 period to see how the NBDT sector has adjusted to new regulations. This is a very challenging task at the best of times, but is made more difficult in our case because of data limitations, which reduce the strength of our findings somewhat. We analyse lending growth, investor confidence, profitability, and changes in the number of NBDTs to make our assessment about the health of the NBDT sector during this time. A quick overview of the evidence is in table 1.

Taken together, the indicators we have examined paint a picture of an NBDT sector that appears to have adjusted reasonably well to increased regulation since 2010. We do not find evidence of the regulatory framework having constrained the sector. The analysis also reinforces the different risk profile that NBDTs operate under compared to registered banks. For example, we have some lingering concerns about the ability of the smaller NBDTs to keep pace with technology changes and cover their strategic risks. One such risk is from fintech credit providers, such as peer-to-peer (P2P) and buy-now-pay-later (BNPL) lending platforms, which are starting to make their presence felt in New Zealand. It is still too early to determine how these new fintech credit providers will affect the traditional banking business model over time but they do present a challenge to banks and NBDTs, which will likely need to innovate to stay relevant to their customers.

1 Introduction

Banks and other lenders play an important role in the economy

A simple way to describe what banks do is that they help move money around the economy. This happens in a very direct way when cash is withdrawn from ATMs or when payment cards are used to make purchases. Banks also provide a safe place for households and businesses to store their money, which in turn provides a source of funds that banks can use to provide loans to their customers. This process of channelling money between those who have funds available (investors and savers) and those who want funds (borrowers) is called credit intermediation and it sits at the heart of the banking business.

In New Zealand, these services are provided by a diverse group of entities, including registered banks, credit unions, building societies and finance companies. More recently, new groups such as buy-now-pay-later (BNPL) services and peer-to-peer (P2P) lending platforms have also started to provide lending services. While the vast majority of lending is still provided by registered banks, the other lenders, which we collectively call ‘non-banks’, also play an important role in the economy[1] (see figure 1). They tend to serve niche markets that are often underserved by banks and support financial inclusion for those who might not otherwise be able to access traditional banking services.

1 Registered banks accounted for 97% of outstanding loans in 2018

Table 1
Summary of results

Indicator	Evidence	Interpretation
Lending growth	NBDT lending is growing at a reasonable pace without an apparent increase in risk taking. NBDTs are growing faster than other similar lenders that work under less regulation. Use of fintech lending platforms (person-to-person (P2P) networks and buy-now-pay-later (BNPL) schemes) is growing quickly.	Fairly stable NBDT business models. Evidence against lenders trying to avoid regulatory scrutiny by the Reserve Bank. Fintech credit providers are a growing competitor to traditional banking business models.
Investor confidence	Depositors and investors continue to place their funds with NBDTs.	Depositors and investors show confidence in the sector.
Profitability	Low and stable profits for credit unions and building societies (relative to fianance companies). The recent decline in profits for some credit unions since 2016 should be monitored but could be related to IT system investments. High and more variable profits for finance companies (compared to credit unions and building societies).	Pattern of profits reflects underlying business models and reveals sources of risk. Business models that deliver low and stable profits may find it more difficult to absorb cost increases (e.g. technology upgrades). Business models that deliver high but variable profits are inherently more vulnerable.
Changes in the number of NBDTs	Steady decline in the number of licensed NBDTs since the completion of licensing in 2015 due to mergers, a few exits and the lack of any new entrants. This trend is not unusual by international comparison and might continue. A simlar pattern is observed in other countries such as Australia and the United States, but over a longer period of time.	The common experience across several countries suggests that consolidation and the lack of entry are from broader market forces rather than the result of regulation. Exits of large NBDTs suggest some incentive exists to move to a wholesale funding model if size allows.

All lenders who offer deposit services are regulated to promote financial stability because risks can materialise in the absence of effective prudential controls.

In this article, we take a closer look at those non-banks that hold deposits for the public, called Non-Bank Deposit Takers (NBDTs). They are the credit unions, building societies, and finance companies that offer deposit services to the public. This group came under increased regulatory scrutiny from the Reserve Bank and other regulators starting in 2008. The need for more regulatory controls on NBDTs was identified by the IMF through its 2004 Financial Sector Assessment Program and confirmed by the Governent's 2006 Review of Financial Products and Providers. This also coincided with the collapse of nearly 50 finance companies between 2007 and 2012, although the principal decision to regulate pre-dated these collapses. With more than 170,000 depositors affected by the failures, the types of risks that can emerge without effective prudential controls on this sector quickly became clear. The failures also heightened the importance of restoring confidence and improving resilience via the new prudential regulatory scheme. This became the focus of the Reserve Bank, under its mandate to promote soundness and efficiency in the wider financial system (Barker & Javier, 2010).

Accordingly, from 2008 onwards, the sole responsibility for prudential regulation of the sector fell to the Reserve Bank, though the first regulations did not come into effect until 2010. The requirements covered policies to do with governance, credit ratings, solvency (capital), the ability to pay debts as they come due (liquidity), risk management and restrictions on lending to related parties, and were generally designed to prevent the significant damage that can arise in the event of an NBDT failure.[2] The calibration of these policies was based on those already in place for banks at the time, but adjusted to suit the smaller size and generally higher risk nature of NBDT business models. To ensure compliance, trustee companies are retained by NDBTs, which have since supervised the sector's compliance on behalf of the Reserve Bank. The licensing process for NBDTs was completed by May 2015. See Appendix A2 for full information on the regulatory phase-in process.

The Reserve Bank aims to ensure that its regulatory settings remain fit for purpose

As kaitiaki (guardians) for the financial system and its soundness and stability, the Reserve Bank actively monitors developments in the NBDT sector and routinely reviews its regulatory settings to ensure that they remain appropriate to the sector and are ultimately fit-for-purpose (Fiennes & O'Connor-Close, 2012). For example, the 2013 Review of the NBDT regime and the 2015 Regulatory Stocktake considered whether the regime was working as anticipated and if there was any room for improvements. These reviews largely determined that the prudential regime for NBDTs was meeting its objectives, but also resulted in some targeted adjustments. For example, several entities (such as small charities) were exempted from prudential regulations altogether and credit ratings exemptions were widened (Reserve Bank of New Zealand, 2015).

2 See Tables A2 and A3 in the appendix for details of major regulations introduced in this period that affected NBDTs.

We look at the financial health of NBDTs to judge how the sector has adjusted to increased regulations

After nine years since the first prudential regulations came into effect, and four years since the licensing process for NBDTs completed, we are interested in assessing how the sector has performed in this time. Our approach is to analyse financial data and other indicators to help judge if the NBDT sector is operating as anticipated in light of increased regulatory controls. Specifically, we examine indicators of lending activity, investor confidence, profitability, and sector participation to achieve this. Some background detail on the non-bank sector is provided in the next section to give context to the various indicators we examine.

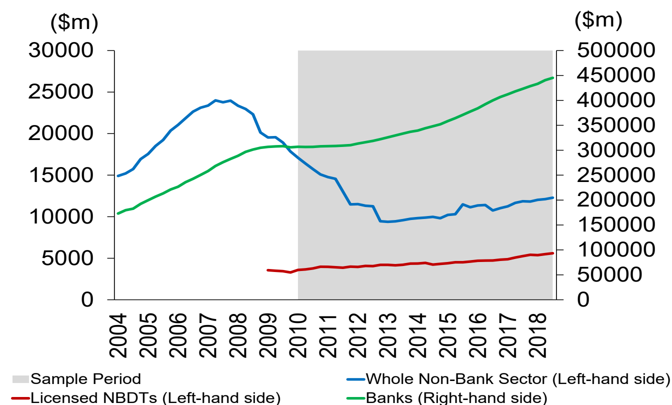
Regulations impose costs but also deliver benefits

Regulation can be costly for a sector, and even well-designed regulations impose some costs. These have to be measured against benefits, such as improved confidence and resilience. This is the lens through which we judge the health status of the sector in this paper. Throughout, we must distinguish between barriers that are necessary to promote resilience and those that impose unnecessary costs on competition and efficiency in making this assessment.

The analysis is backwards looking and may not be a good indication of what lies ahead

Finally, we are cautious to not make any forecasts about NBDT sector performance in this piece. Our emphasis on a retrospective lens is due to the inherent riskiness of many NBDT business models and the rapid pace at which the credit intermediation providers are being challenged by new Fintech services, many of which are still in their infancy. It also owes to the relatively mild economic conditions experienced in our sample window following global recovery from the Global Financial Crisis experienced in 2007-12 and a lack of data on the performance of NBDTs from prior to 2010. In short, the status quo for this sector is probably not a reliable indicator for what lies ahead. We caveat our conclusions accordingly; depositors should continue to assess the risks involved with banking at different types of institutions as new information is released and economic conditions continue to change.

Figure 1
Total claims for banks and non-banks
($millions)



2 The non-bank sector

Non-bank lenders grew rapidly by lending to the risky property development sector but risks materialised

Non-bank lenders grew quickly from the late 1990s until 2007, largely fuelled by lending to risky property projects. During this same period, several non-bank lenders also chose to become registered banks, which

further reduced the size of the sector to around 3% of lending activity by 2013.[3] Since 2013, the non-bank sector[4] has been relatively stable and lending has resumed an upwards trajectory.

Licensed NBDTs have generally grown steadily since increased prudential controls have been in place...

Aligned with the trends of the wider non-bank sector, licensed NBDTs have also experienced steadily growing lending books since 2010, shown as the red line on figure 1. Since 2010, licensed NBDTs have had to adjust to the new regulatory requirements set out by the Reserve Bank and other regulators. The introduction of oversight on the sector can be easily identified in figure 1; the first comprehensive data collection on NBDTs' performance by the Reserve Bank's statistics department starts in 2009.

The general observation that the growth trends of NBDTs broadly align with the growth of other non-banks already provides a fairly strong indicator that prudential regulations are having the desired effects of increased resilience and restored confidence to the sector. However, we want to dig below the surface to better understand how the sector has adjusted to prudential controls, which will ultimately help us to better judge whether regulatory controls remain fit for purpose.

3 SBS Bank in 2008; Co-Operative Bank in 2011 and Heartland Bank in 2012.

4 This includes NBDTs and other non-bank lenders that do not take deposits, but instead fund their lending with 'wholesale funds' from investors.

NBDTs share some common characteristics that give context to the coming results

Before continuing, it is useful to set out clearly in one place the expectations we have for how the NBDT sector might have adjusted to increased regulatory scrutiny and some underlying characteristics of the sector that will help to contextualise our findings. This is difficult to do without foreshadowing the later conclusions, but doing so will help set out a spectrum for what is surprising or particularly unsurprising in the coming results.

Our main expectations for the 2010-18 adjustment period are that increased regulatory scrutiny will have:

- Increased resilience and investor confidence in the sector (which are the main objectives of imposing prudential requirements).
- Carried costs that will have increased barriers to entry for the sector, increasing the risk of 'regulatory arbitrage' to other sectors as some firms may have moved to operate in less regulated spaces. To an extent, some barriers are 'by design' and are essential for improving the resilience of the sector, but we want to check to see whether these barriers have been excessive.

Similarly, there are also some inherent features of this market that are worth noting:

- First, we highlight that there is an inherent risk in being a small player in the financial sector, and we have hinted at this already. A small size makes some NBDTs more vulnerable to shocks and downturns than some of New Zealand's larger banks. From time to time if risks materialise, we could expect to see an NBDT get

into financial trouble. The minimum regulations we implement are designed to prevent that, but failure is not impossible.

- Similarly, we know that some NBDTs may find it strategically sensible to leave the sector over time, either to register as a bank or to use alternative sources of wholesale funding to make loans, possibly from sophisticated investors or a parent company willing to provide these funds. We also expect some entry by new players into the sector in a normally functioning market, except where a highly competitive market deters some entry (OECD, 2007).
- Finally, we note that consolidation and lack of entry among NBDTs is a broader trend we are observing in other countries over a range of business cycles. Our sector participation trends are likely reflecting more fundamental changes in the business of banking (like the long running shift to online banking and the resulting benefits of increasing scale), as well as changes in the regulatory regime.

3 Reference group

Mutuals and finance companies have notably different business models

We compare 'small NBDT finance' companies, which captures seven finance companies with less than $25m in assets in 2010, with 'NBDT mutuals' organisations, which includes the 18 credit unions and three building societies (a full list can be found in appendix A1) that operated in this time period. The distinction between groups is made to allow for nuanced discussion, as the business models for the two groups are quite distinct. For example, credit unions and building societies operate under a not-for-profit objective, whereas many small NBDT finance companies tend to invest in riskier property projects and are for-profit entities.

One group that is included in some cases and not others are the largest NBDTs in the sector: UDC Finance, Medical Securities Limited, and Fisher and Paykel Finance. This is because the three finance companies are particularly large and their inclusion distorts the results. They also have all exited or, in the case of UDC, are intending to exit the deposit-taking sector by the end of 2019. Where the group is included in the analysis, we have labelled the group 'Small + Large NBDT Finance'.

Survivor bias is limited by looking at trends over time

Some other important exclusions are also made from the reference group. For example, around 60 deposit-taking entities are not included because of the charitable or religious exemptions they hold from our prudential regulations. A small number of non-banks that left the sector prior to licensing and three NBDTs that have been licensed are also excluded. While these groups are of interest for comparison purposes, they are necessary to exclude due to data limitations.

The presence of these limitations creates some potential for survivor bias in our results, though the direction of this bias is unclear as the excluded group might include both strong and weak performers. This is minimised in two ways. First, the reference group is fixed and includes NBDTs that have exited or consolidated and the analysis focuses on aggregate trends, which means that the impact of excluding weak performers reduces over time. Second, we compare the performance of licensed NBDTs to other non-banks not subject to our prudential regulations to help judge the possible extent of any regulatory arbitrage to less

Table 2
Lending growth
(average year on year change in total claims)

	Full sample	1st half	2nd half
	2010-2018	2010-2014	2015-2018
All sectors (aggregate credit)	4.13%	2.37%	6.33%
Other non-banks (>100m A) (24 firms)	1.37%	-1.77%	5.14%
NBDT all (28 firms)	5.5%	4.84%	6.33%
- NBDT x (25 firms)**	10.61%	9.86%	11.56%
- NBDT mutuals (18 firms)	10.49%	10.37%	10.63%
- Small NBDT finance (7 firms)	10.77%	1.94%	21.8%

*Other non-banks are the non-deposit taking entities that rely on wholesale sources to fund their operations.

**This group excludes the Large Finance companies, UDC Finance, Fisher & Paykel Finance and Medical Securities Limited.

regulated areas. Still, some caution is warranted when interpreting the results.

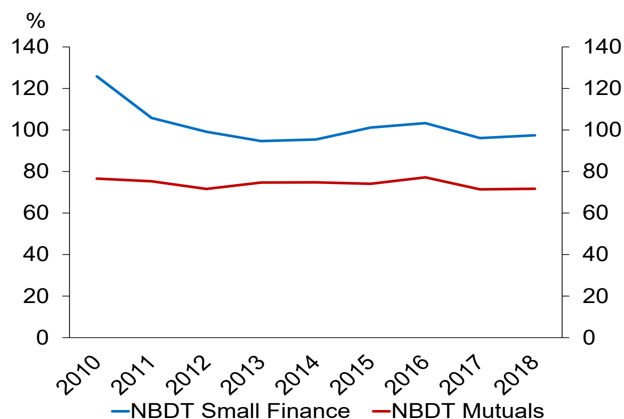
4 Analysis: lending activity

Loan books continue to grow under increased regulatory scrutiny

The first indicator we look at to determine the sector's health is lending activity. As stated, we are interested in seeing how lending activity has been affected by regulations since 2010 and whether NBDTs are taking on more risk to stay competitive. From figure 1, we know that NBDTs have grown steadily since 2010 but it is also useful to compare this aggregate credit growth (which is an indication of the macroeconomic context) and with other lenders operating in the same niche markets but not subject to the same regulatory requirements. In this case, we are able to make a comparison with lending by other non-banks that do not take deposits from customers. Aggregated data for these groups are set out in table 2.

The numbers presented in Table 2 show lending growth by the NBDT sector as a whole was considerably higher than other non-banks in our reference group (5.5% compared to 1.4%) between 2010 and 2018 and somewhat higher than aggregate credit growth (at 4.1%). With the large finance companies removed, the remaining 25 NBDTs have grown considerably faster than aggregate credit growth (10.6% vs 4.1%), albeit from a smaller base. Comparatively, NBDT mutuals organisations reported double digit lending growth consistently over the 2010-2018 period. The profile of lending growth for small NBDT finance companies was more varied and at times these companies reported very rapid growth. The key observation is that NBDTs have grown faster than other non-banks; an early indication that lending activity has not been adversely affected by increased regulatory scrutiny since 2010.

Figure 2
Risk weighted assets as a percentage of total assets



Increase in residential mortgage lending since 2016 following tightening of Reserve Bank's LVR policies

Lending portfolios of NBDT mutual organisations have been stable since 2010. Credit unions and building societies are mostly involved in residential mortgage lending, which has accounted for about 60 percent of their total lending activity since 2011. For small NBDT finance companies, there has been a recent shift towards residential mortgages and away from consumer and business lending, which can be generally correlated with adjustments of the Loan-to-Value Ratio (LVR) restrictions for banks in October 2016. While residential lending for this group increased to $83 million in 2018, compared with $260 billion of housing lending by banks in 2018, the scale is still comparatively fairly minor. By comparison, the large NBDT finance companies predominantly dealt in consumer and business or agricultural lending over this time. There may be an increase in this lending activity by other NBDTs when UDC exits, though most likely this business will transfer outside of the NBDT sector with UDC.

As a reference, other non-banks have also been increasing their residential mortgage lending in recent years, shifting away from business lending, whereas consumer lending by these organisations has been comparatively stable since 2010. Most of the residential mortgage lending growth has been driven by a small number of lenders such as Mike Pero Group and Resimac, which can also be correlated with adjustments made to the Reserve Bank's LVR ratios in 2016.

No evidence of increased risk-taking by sector

One measure of risk taking is an entity's risk-weighted assets (RWA). Figure 2 shows NBDT mutuals institutions have a very steady risk appetite over the 2010-2018 period, while risk taking by smaller NBDT finance companies has declined after 2010-13 and remained relatively steady since, with a small rise in 2016. For these small NBDT finance companies, the level of RWA relative to total assets was lower in 2018 than in 2010.

Collectively, the RWA of these firms show that NBDT business models appear to have been fairly stable since 2010. Evidence of business model stability is supported by trends observed at the aggregate level in figure 1, and it has also been echoed by KPMG (2016; 2017; 2018) in its recent annual FIPS reports on the non-bank sector.

Fintech growth likely to start competing for NBDT lending activity in coming years

The emergence of new financial intermediation services with a strong technology focus, collectively called Fintech, presents a new set of threats and opportunities for NBDTs and the wider banking sector. At this early stage, it is difficult to make predictions about the impact of Fintech in New Zealand for credit intermediaries, especially as data on

P2P lending platforms, one of the more obvious sources of competition for NBDTs, have only been published by the Financial Markets Authority (FMA, 2018) since 2017. The data published shows that the use of P2P platforms is growing quickly in New Zealand and there are a growing number of participants using the services to access loans each year. For example, the balance of outstanding loans on P2P platforms reached $489 million in 2018, up 50 percent from 2017. This compares with about $4.6 billion in lending through the NBDT sector. Participation in P2P platforms was fairly widespread in 2018, with 270,000 borrowers and 10,176 active investors. The majority of loans made on P2P platforms are for less than $5000, but a bulk are also being financed by large players. For example, 459 users invested more than $100,000 in 2018, while 6,850 users invested less than $5,000. The full impact of these services on NBDTs and other lenders remains obscured, but further data collection over time will help in determining this; early numbers suggest it is likely to be significant. As the recent report on Fintech credit market by the BIS notes, it is fairly common for banks in other jurisdictions to be experimenting with P2P platforms, especially the use of automated credit decision tools (Claessens, Frost, Turner & Zhu, 2018).

Another emerging Fintech credit service with potential to disrupt the NBDT business model are the pay-later platforms. These platforms provide short-term, low-value, and interest-free loans to consumers who then pay back the value in 4-6 instalments or pay fees for missed payments. Similar in scale to P2P lenders, one prominent pay-later platform, Afterpay, had 220,000 participants in 2018. Between these two examples, it becomes clear that the Fintech credit market is growing in New Zealand and this inevitably poses threats and provides opportunities for NBDTs. We will continue monitoring these sectors to assess for signs of regulatory arbitrage and other risks emerging as a result of these new entities.

Table 3
Retail funding
(annual percentage change)

	Full sample 2011-2018	1st half 2011-2014	2nd half 2015-2018	Since 2017
Banks	8.58%	8.76%	8.39%	7.03%
NBDT all (28 firms)	10.06%	20.68%	-0.56%	-6.85%
- NBDT x (25 firms)*	23.39%	34.92%	11.87%	11.34%
- NBDT mutuals (18 firms)	24.47%	38.04%	10.91%	10.00%
- All NBDT finance (10 firms)	1.8%	13.98%	-10.38%	-22.37%
- NBDT finance small x (7 firms)**	20.10%	15.47%	24.74%	28.27%

*This group excludes UDC Finance, Fisher & Paykel Finance and Medical Securities Limited.

5 Analysis: investor confidence

Investors appear confident in the sector

Confident investors and the stable source of funding they provide are crucial to the ongoing viability of the NBDT sector and are consistent with a well-functioning prudential regulatory regime. In this section, investor confidence is assessed using three metrics; retail funding growth, reinvestment rates, and the average maturity of investments since 2010.

For retail funding, we compare NBDTs with registered banks because they tend to compete for this source of funding. In table 3, we see that since 2011, NBDT mutuals and small NBDT finance companies have reported positive retail funding growth that has generally exceeded that of banks. This is a good indication that investors are confident in the NBDT sector, but the strength of this indicator is limited somewhat because we are not able to make comparisons with retail funding growth from the period before increased prudential requirements were put in place. The negative growth rates for all NBDT finance companies between 2015 and 2018 reflect the exits of two of the large players from the sector (Medical Securities and Fisher and Paykel Finance).

Reinvestment rates remain high and stable

Reinvestment rates and the amount of time that money is placed with NBDTs (that is the maturity of investments) are further indicators of investor confidence. For most NBDTs, both of these measures are either steady or have increased over the sample window, which lends support to the view that people who invest in NBDTs remain confident in the sector (see figures 3 and 4).

Figure 3
Call funding and reinvestment rates for NBDT mutuals

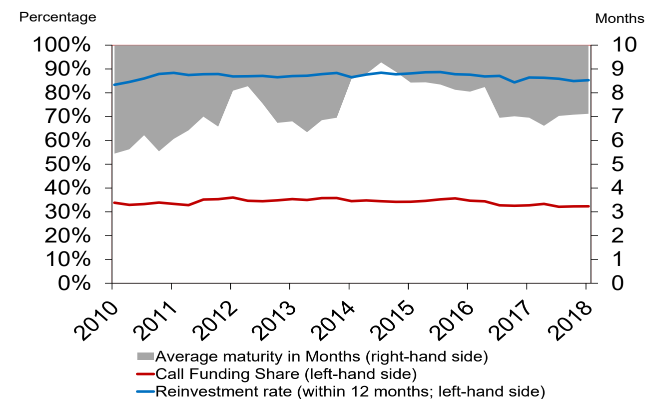
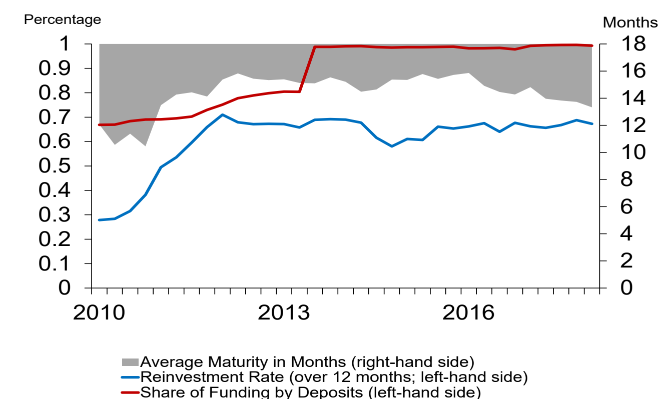
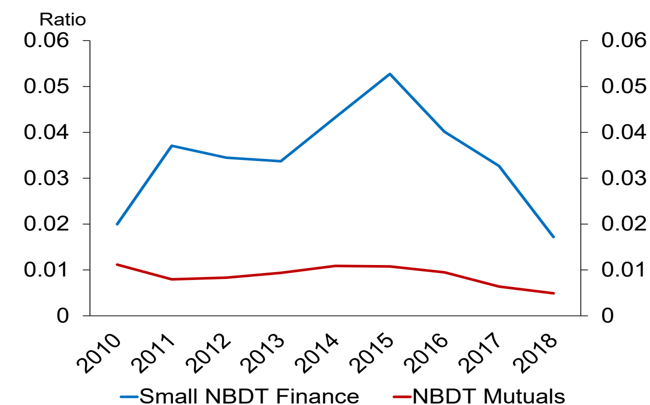


Figure 4
Retail funding share and reinvestment rates for small NBDT finance companies



The average reinvestment rate has been high and steady since 2011 for NBDT mutuals and since 2012 for small NBDT finance companies. Since 2014, nearly all funding for small NBDT finance companies has been from retail deposits. Anecdotally, we are also aware of several finance NBDTs that have been able to attract new equity investment in this time period, or else existing equity ownership has changed hands. These observations may also suggest that investors are confident in the sector but there are also alternative interpretations and we lack the data to make substantive conclusions at this stage. Taken together, the indications we have examined lend support to the conclusion that investors are exhibiting confidence in the NBDT sector following increased regulatory scrutiny.

Figure 5
Profits scaled by the loan book



6 Analysis: profitability

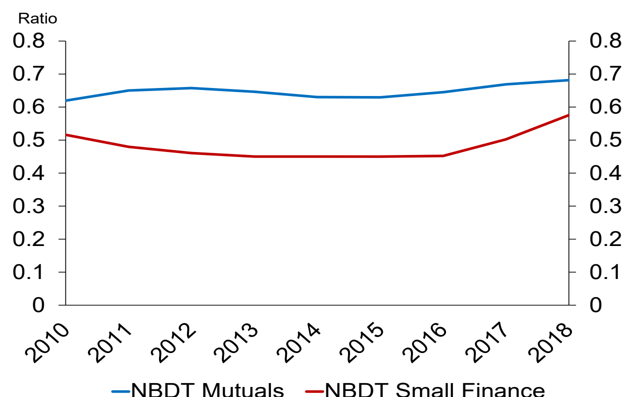
In this section, profits and operating costs are examined to determine if lending growth has been achieved in a sustainable manner. Reductions in profitability or increased operating costs after 2010 may indicate that compliance costs have been excessive and require further adjustment.

Low or variable profitability is a source of vulnerability for small NBDTs

First, profits are scaled by the value of the loan book to get a meaningful measure to compare over time. Figure 5 shows that NBDT finance companies have experienced high but also more variable profits over the sample period. The likely reason for the variability in profits for NBDT finance companies is because they tend to hold highly concentrated exposures to risky investments which can result in profit variability. In this case, we found the recent decline in profits by finance companies since 2015 to be largely idiosyncratic, rather than reflecting a sector-wide decline. Still, variable profits are an inherent characteristic of finance companies, and are often the trade-off for higher rewards when investments are successful. Profits for most of the group remain positive overall.

By comparison, the co-operatively owned nature of NBDT mutuals makes it difficult to evaluate profitability movements, as their profits are typically low by design. In recent years, some credit unions have experienced losses, or lower than normal profits, which in some cases can be correlated with technology upgrades. We note that the extent of the decline among credit unions is being masked by strong profitability growth from building societies over this time, suggesting that macroeconomic conditions or market shifts have not been the primary cause of this decline. Accordingly, the comparative strength of building societies suggests that recent losses by credit unions could be temporary. In saying this, a broader question of sustainability and

Figure 6
Operating costs scaled by Income



technological relevance is raised. There is perhaps a strategic risk where a low-profit environment prevents firms from investing for the future.

Operating costs also remain stable

We scale operating costs by income to help assess whether operating costs have increased in light of more regulatory controls. Although we are unable to assess the one-time costs of increased compliance from regulations introduced starting in 2009, we see that operating costs have remained fairly steady for NBDT mutuals as a group and have risen since 2016 for small NBDT finance companies. The increase in operating costs relative to income for finance companies also appears to be idiosyncratic, rather than reflecting a trend affecting the wider group.

Collectively, the data available on profitability and operating costs suggests that changing regulatory costs have not been excessive since 2010. However, there are other factors on profitability for NBDTs such as increased technology requirements that are likely putting pressure on these firms.

7 Analysis: sector participation

No new entry, exits of three largest NBDTs, and sector consolidation amongst credit unions

This section details changes in the number of licensed NBDTs since May 2015 (see table 4) to explore the question of whether prudential settings are appropriate. We look at changes in the sector after 2015 to only capture the firms that opted in to the licensing scheme after it had been fully phased in. We also use the word 'explore' here because of the inherent challenge involved in interpreting firm turnover. The challenge is where the same signals can have alternate interpretations. For example, some positive level of entry and exit can be expected from well-functioning markets, but a lack of entry can also be a sign that markets are operating competitively and not generating profits to a point that motivates entry (OECD, 2007).

Table 4 shows a decline in the number of NBDTs and a lack of entry by new players since the licensing process was completed in May 2015. Since this time, there have been eight NBDT licence cancellations; three due to consolidation among credit unions and one due to a name change and subsequent 're-entry'. The remaining four cancellations were companies that exited the sector entirely. Further consolidation among credit unions can be expected; a merge of four credit unions occurred in May 2019. We also note the likely exit of UDC, which has recently stopped taking new retail deposits and will most likely wind up its deposit taking activity by September 2019.

Table 4
NBDT licence cancellations since May 2015

Name of NBDT	Date of licence cancellation	Reason for licence cancellation
Napier Building Society (NBS)	Dec 2016	**Consolidation:** NBS transferred its loan portfolio to Heretaunga Building Society.
Alliance Group Credit Union (ACU)	Dec 2016	**Consolidation:** ACU transferred the business to Steelsands CU.
Propertyfinance Securities Limited (PFSL)*	Nov 2016	**Exit:** PFSL was in moratorium when it was licensed and expected to be wound up when the moratorium arrangements were completed in 2016.
Medical Securities Limited (MSL)	Sept 2016	**Exit:** MSL wound up its deposit taking activity and cancelled its NBDT licence.
Nelson Enterprise Loan Trust*	July 2017	**Exit:** NELT was expected to exit to operate under a small offers exemption when it became licensed as an NBDT. It moved to operate as a small offer taker under the FMC Act when it could comply with the exemption requirements.
Christian Savings Incorporated*	September 2017	**Consolidation and re-entry**: Changed name and licence to Christian Savings Limited.
Fisher & Paykel Finance	March 2018	**Exit:** Fisher and Paykel Finance wound up its deposit taking activities and shifted to operate under a different funding model.
Caxton Credit Union	November 2018	**Consolidation:** Following its transfer of engagements to Credit Union Central, Caxton Credit Union subsequently cancelled its NBDT licence.

*these organisations are not in our reference group but are included here for completeness.

Declining number of non-bank lenders is a wider trend and not necessarily concerning but will be monitored

New Zealand's experience with the turnover of firms in the NBDT sector (like numerous exits, the lack of any new entry, and consolidation among credit unions) is similar to the experiences of other jurisdictions such as Australia and the United States. For example, consolidation of credit unions in the United States has occurred at a rate of 4 percent (about 250 credit unions) per year for over two decades (National Credit Union Association (NCUA), 2016). This consolidation has been explained by the NCUA (2011) as necessary to promote economies of scale in the sector and to ensure its long-term viability, although it also cites concerns around concentration risks for the wider financial system brought about by fewer operators in the sector.

Like the NCUA, we share similar concerns for New Zealand, although the credit union movement is considerably smaller in New Zealand compared to the US. Our view on the lack of any new entrants to the NBDT sector

is that the same trend is also apparent in the broader banking industry in recent years. Another likely reason relates to the recent growth of Fintech providers into the business of credit intermediation. It may be easier for a start-up to compete with less regulation (while posing less system risk because they are not offering deposit services to the public) on the perimeter of the banking sector than compete with established bank and non-bank entities. Further monitoring of Fintech growth in future years will help fully quantify this assessment.

There may be an incentive for larger NBDTs to shift to wholesale funding

The exit of some large NBDTs is noteworthy because these are businesses that have opted to change their funding model following several years making profits operating as licensed deposit takers. The question is whether this change in funding model is to avoid regulatory requirements, a reflection of underlying economic incentives such as possible cost advantages of wholesale funding compared to retail-deposit funding, or a mix of the two. It is reasonable that an unintended consequence of increased regulatory scrutiny on NBDTs has been that wholesale funding has become comparably cheaper, so some large NBDTs may be incentivised to shift towards wholesale funding sources and away from retail deposits. This is especially likely if ownership of an NBDT is transferred to an entity that is able to easily access wholesale funding, which we have seen in the case of Fisher and Paykel Finance. A shift in funding models like this aligns with our overarching expectation that larger NBDTs may 'graduate' from the regime from time to time. We will continue to monitor the situation.

A further experience in Australia is worth discussing. Australia's Productivity Commission (2018) recently cited a number of initiatives that have been introduced in recent years aimed at encouraging new entrants in the Australia banking sector. These include reducing minimum size requirements for smaller banks, equivalent to our NBDTs, by loosening restrictions on the use of restricted words such as 'bank' or 'banking', and establishing a special class of banking licence with fewer requirements to support new firms that want to develop and test their business models before committing to a full banking licence.

In comparison to this, we note that prudential regulatory settings for NBDTs in New Zealand are comparatively less intensive than for ADIs (the equivalent of non-banks in Australia) and there is less obvious room to reduce costs without compromising our stability mandate. For example, there is no minimum size requirement for NBDTs to operate in New Zealand, which has resulted in several very small entities becoming licensed. Small NBDTs are also exempted from other requirements, such as having a credit rating, albeit with the quid pro quo of higher capital ratio requirements. That said, the fact that NBDTs pay for supervision by trustees, whereas registered banks do not, is a pain point for NBDTs and a possible area for further consideration should lack of entry continue (Reserve Bank of New Zealand, 2015).

In considering all of the available information, we suspect New Zealand's experience with the turnover of NBDTs likely reflects a mix of both increased compliance costs and a wider experience of sector decline that is bringing about reduced sector participation and entry in other jurisdictions beyond New Zealand. We note the framework for registered banks and NBDTs is being considered by the Government during its Phase 2 review of the Reserve Bank Act this year.

8 Conclusion

This analysis has been backward looking and no projections have been made about the ongoing viability of the NBDT sector in New Zealand. It is important to emphasise this, because the performance of NBDTs will continue to change as new risks are realised, economic conditions change, and competitive pressures brought about by fintech developments continue to grow. What we have been able to do is bring together a range of evidence on the sector performance of NBDTs under increased regulatory scrutiny between 2010 and 2018. This has been particularly useful in assessing whether regulatory costs have achieved the right balance between promoting soundness and preserving competition and efficiency at this time, and to see if NBDTs are performing as per our general expectations for the sector.

These are some of the main conclusions drawn throughout the analysis:

NBDT businesses are performing as expected under increased regulatory scrutiny

We discussed four main indicators of sector performance in this paper, related to data the Reserve Bank collects on NBDT entities each quarter. The data largely showed that the sector has been performing as anticipated through the sample window; lending activity has increased without heightened risk-taking, investors appear to remain confident in the sector, profitability generally has been satisfactory though declining in recent years for portions of the sector, and sector consolidation trends are largely unfolding as per the experiences of other jurisdictions. Altogether, we find considerable evidence of underlying business model stability following increased regulation starting in 2009.

NBDTs continue to have a different risk profile from banks. In spite of increased regulatory scrutiny, they can have a bigger exposure to risk, largely due to their small size, unique business models, and niche lending markets. Extending this, low or variable profitability means that NBDTs can be more vulnerable to financial stress or may find it more challenging to adequately invest in their systems to keep pace with technology. Similarly, although compliance costs have gone up and remained steady due to the current regulatory framework, this has also come with improved investor confidence. Overall, we have a sector that is performing relatively as expected, with some exceptions regarding entry.

A marked decline in the number of sector participants raises some concern for competition and efficiency

A defining observation for this sector has been the reduction in participants over time. This trend is also evident in Australia and the United States. This is likely a broader phenomenon and not a direct consequence of prudential regulations, although we acknowledge that compliance costs will have increased for NBDTs and this is likely to be deterring entry. We will be highlighting these issues during the Government's Phase 2 review of the Reserve Bank Act this year, which considers the NBDT regulatory scheme.

No evidence that lending activity has migrated to other lenders or P2P platforms at this stage

Based on current evidence, we do not believe lending activity is migrating away from the NBDT sector in a meaningful way as a result of prudential settings, but the continued rapid growth of Fintech credit markets (especially P2P lending platforms) may change this assessment if they continue to grow rapidly. We also acknowledge that an unintended

consequence of increased regulatory scrutiny on deposit takers may have been that wholesale funding has become comparatively cheaper for some large NBDTs, and this is likely driving some exits by larger NBDT finance companies. Further monitoring will be required to better understand the forces driving funding market dynamics for this sector.

Taken together, the indicators we have examined point to an NBDT sector that appears to have adjusted reasonably well to increased regulation since 2009, and there are no obvious indications that excessive regulatory costs are adversely affecting the sector. However, there are some lingering concerns about sector consolidation trends and the ability of smaller NBDTs to keep pace with technology and cover strategic risks from a relatively low profit base, but at this stage we do not see need for further intervention. Overall, we conclude that the sector has performed relatively as expected between 2009 and 2018.

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Appendix 1

Table A1
Reference and comparison groups

Licensed non-bank deposit taking (NBDT) lenders	
NBDT Mutuals	**Finance companies**
Alliance Credit Union	Asset Finance Limited
Aotearoa Credit Union	FE Investments Limited
Caxton Employees Credit Union	Finance Direct Limited
Christian Savings (excl. from analysis)	Fisher & Paykel Finance Limited
Credit Union Auckland	General Finance Limited
Credit Union Baywide	Gold Band Finance Limited
Credit Union Central	Liberty Financial Limited
Credit Union South (Trading as NZCU South)	Medical Securities Limited
First Credit Union	Mutual Credit Finance Limited
Fisher & Paykel Credit Union	*Propertyfinance Securities Limited (excl. from analysis)*
Heretaunga Building Society	UDC Finance Limited
Napier Building Society	
Nelson Building Society	
Nelson Enterprise Loan Trust (excl. from analysis)	
New Zealand Employees Credit Union	
New Zealand Firefighters Credit Union	
Police and Families Credit Union	
Steelsands Credit Union	
Wairarapa Building Society	
Westforce Credit Union	
Other non-bank lenders (non-deposit-taking, assets >100m)	
Advaro Financial Services Limited	
American Express	
ASAP Finance	

(continued p 22)

Table A1 (continued)

Avanti Finance Limited
Basecorp Finance Limited
Bluestone Mortgages NZ Ltd
BMW Financial Services Limited
BOQ Equipment Finance Limited
CSG Finance (NZ) Limited

Table A2
Summary of recent NBDT sector regulatory developments

Date	Regulatory development
2008	Part 5D inserted into the Reserve Bank of New Zealand Act. Reserve Bank becomes the prudential regulator of NBDTs
2009	NBDT credit rating and risk management requirements come into effect. AML/CFT Act enacted
2010	NBDT governance, capital, related party exposure and liquidity requirements come into effect
2011	Financial Markets Supervisors (FMS) Act (trustee licensing legislation) enacted. Establishment of the Financial Markets Authority
2013	Non-bank Deposit Takers Act 2013 enacted. Financial Markets Conduct (FMC) Act 2013 enacted. Transitional arrangements under the AML/CFT Act end
2014	Reserve Bank starts issuing NBDT licences. Changes to financial reporting legislation come into effect
2015	Reserve Bank completes issuing NBDT licences
2016	Transitional arrangements under the Financial Markets Conduct Act and new financial reporting legislation end

Table A3
Relevant legislation and summary of implications for the NBDT sector

Legislation	Implications for the NBDT sector
NBDT Act (2013)	Minimum prudential requirements that licensed NBDTs must comply with: Capital Credit ratings Governance Liquidity Related party exposure limits Risk management Minimum entry requirements for licensing.
AML / CFT Act (2009)	A regime for the supervision, monitoring and enforcement of AML/CFT obligations. Set of requirements for reporting entities (such as customer due diligence, account monitoring and suspicious transaction reporting requirements). New civil and criminal offences and a framework to detect and deter money laundering and terrorist financing.
FMC Act (2013) & FMS Act (2011)	New disclosure requirements for product offerings Revised rules around trustees and trust deeds