Australian Securitisation Forum

New Zealand Market Subcommittee

Australian Securitisation Forum

Level 32, 200 George Street, Sydney
NSW 2000

T +61 (0)2 8277 4141
E asf@securitisation.com.au

www.securitisation.com.au

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Phase 2 of the Reserve Bank Act Review
The Treasury
P.O. Box 3724
Wellington 6140

By email: rbnzactreview@treasury.govt.nz

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

This submission is made on behalf of members of the New Zealand Market Subcommittee of the Australian Securitisation Forum (**ASF**) and other interested stakeholders.

The Subcommittee advocates on behalf of participants in the New Zealand securitisation industry. Our members include registered banks, wholesale-funded non-bank lenders, trustees and investors that participate in securitisation transactions domestically and internationally. A primary role of the ASF is to facilitate the development of industry views and to represent those views to policy makers and regulators in Australia, New Zealand and globally.

Members and other stakeholders represented in this submission include the following organisations:

- Avanti Finance
- Bluestone Group
- Flexigroup
- UDC Finance
- Latitude Financial Services
- Eclipx Group
- Westpac
- Motor Trade Finance
- Resimac
- Toyota Finance
- Pepper Finance

Each of the non-bank lenders represented here operates a business model based on responsible, sustainable and relationship-based lending funded by wholesale investors, primarily through a securitisation funding model, rather than by retail deposits. For the purposes of our submission, we have used the term Non-Bank Lending Institution (**NBLI**) to refer to these entities (and others who operate in the same manner).

We provide funding to New Zealand individuals and businesses in the following areas:

- Vehicle fleet leasing and floor plan financing.
- Consumer and commercial lease and vendor financing.
- Personal and consumer finance, including motor vehicle financing and credit or store cards.
- Home loans.
- Business finance, primarily funding the working capital and investment needs of small to medium sized enterprises (**SMEs**) and the self-employed.
- Finance to the government and education sectors.

We fill a significant gap in the lending market by providing credit in the areas set out above, where in many cases it would otherwise be unavailable to borrowers on reasonable terms. The scale of our operations and systems we use mean we are closely connected to our customers, with whom we often have very long term relationships.

As at September 2019, non-deposit taking NBLIs comprised $11.6b of the lending market.[1] Lending is split approximately 55% consumer and 45% business, servicing 1.3m retail customers and over 88,000 businesses. These loans have helped consumers and businesses meet their financial goals, and stimulated downstream economic activity. The NBLI sector itself creates significant economic benefit, providing over 2,500 jobs.

We have each been in business in New Zealand for at least 10 years (and for as long as 80 years) and have a long term commitment to this market. We have robust systems, processes, and governance, and have operated successfully through many cycles over this period, including helping fund New Zealand households and businesses through the 2007-09 Global Financial Crisis and the recent Covid-19-induced economic downturn. We add a level of diversity and dynamism to the New Zealand lending market, which is imperative in maintaining a competitive market for the benefit of both consumer and SME borrowers.

Recent capital market securitisation transactions successfully undertaken by two of our members have shown the resilience of the sector in the face of the Covid-19 crisis, during which we were called on to provide significant support for customers affected by the pandemic and the associated lockdowns. We appreciated the dialogue we had with officials during that period to help identify vulnerabilities and find solutions to health and economic issues as they arose.

These transactions also demonstrate the confidence in this sector of local and international capital market participants and mark out asset-backed securities as an increasingly important asset class for a diverse set of institutional investors, including sovereign wealth funds, KiwiSaver funds and other asset managers.

Our primary focus in this submission is on the new proposals concerning the regulatory perimeter, and the proposed maximum size threshold for the exclusion of wholesale-funded non-bank lenders. A number of the submissions we have made in this regard involve complex and specialised matters, or questions of detailed design, which we would be happy to discuss with you in person or otherwise to provide you with further written information. In addition, we have noted the bond market discipline which underpins our sector's funding model and sustainable growth. We would be happy to facilitate meetings with investors and/or credit rating agencies to discuss their credit processes, engagement with our businesses and the scrutiny they undertake.

Yours sincerely

Chris Dalton
Chief Executive Officer
Australian Securitisation Forum

Simon O'Connell
ASF New Zealand Market Sub-committee Chair
and Director – Structured Finance, Westpac

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1 Underlying data from the RBNZ Bank Balance Sheet (BBS), RBNZ Standard Statistical Return (SSR).

Please address any inquiries or correspondence to:

Mark Mountcastle / Paul Jamieson

CEO / Treasurer, Avanti Finance Limited

Private Bag 11 917, Ellerslie, Auckland 1542

By email:
mark.mountcastle@avantifinance.co.nz /
paul.jamieson@avantifinance.co.nz

Bianca Spata

Group Treasurer, FlexiGroup Limited

Level 7, 179 Elizabeth Street, Sydney, NSW,
AUSTRALIA 2000

By email:
bianca.spata@flexigroup.com.au

Debbie Long

Director, Treasury and Securitisation, Resimac NZ Home Loans Limited

PO Box H284, Australia Square, NSW,
AUSTRALIA 1215

By email:
debbie.long@resimac.com.au

Simon O'Connell

Chair of ASF Subcommittee and Director, Structured Finance, Westpac New Zealand Limited

PO Box 934, Auckland 1010

By email:
simon.oconnell@westpac.co.nz

Phase 2 Reserve Bank Review, Consultation Document 3 – Responses to Questions for Submission

2.A Do you agree with the proposed purposes? If not, what changes would you propose to the purposes? Are there any other purposes that we should be considering?

We are concerned that there remains a lack of alignment between the ambitions of the over-arching objective in section 1A of the RBNZ Act and the suggested formulation of the financial stability objective for the proposed Deposit Takers Act (**DTA**). What is absent is any 'first level' criterion that goes to the effective functioning and efficiency of the *financial system* itself.

This is relevant to NBLIs, given the proposals for the Reserve Bank to be able to flex the regulatory perimeter. NBLIs contribute to a sustainable and productive economy by adding diversity in the credit channel and, on the funding side, by creating an attractive asset class for KiwiSaver and other institutional investors. Each of these create a healthy degree of competitive tension at the relevant level of the financial system, which in turn supports dynamism for the benefit of borrowers and the economy. It is important that the contribution of different business models within the financial system is taken into consideration from the point of view of the system's ultimate delivery on its productivity and well-being objectives (for example we note that the "competition" decision-making principle relates only to those sectors regulated by the Reserve Bank).

These proposals need to be approached with a degree of caution, given they set the tenor of the substantive provisions of the DTA and the broader policy remit, and their impact has the potential to hinder (and, at the extreme, significantly obstruct) the overall level of competition in the lending market, and the efficient operation of the financial system.

3.A Do you agree with the proposed approach to defining the overall regulatory perimeter? If not, what approach would you suggest?

Yes, we agree with the overall approach taken to the regulatory perimeter, which is consistent with both principle and international practice.

For the reasons given under Question 3.C, we do not think the proposal to include a prescribed size threshold for the wholesale exclusion is well-supported and would require further analysis and policy development by reference to the broader reform objectives if it were to proceed.

3.B Do you support the proposed exclusion for wholesale-only funded lenders? If not, what approach would you suggest?

Yes, we agree with the exclusion for wholesale-only funded NBLIs. We gave our detailed reasoning for this in our submission on the first Consultation Document, attached for reference. We stand behind those submissions, and here will focus on the additional questions in the third Consultation Document, following the further policy development that has taken place since the original consultation.

3.C Do you support a maximum size threshold for the wholesale exclusion? If so, what would be an appropriate measure of size?

We do not support the inclusion of a maximum size threshold for the wholesale exclusion:

- Wholesale funded entities (either taken individually or in aggregate) do not pose even a small risk to financial stability, given their relative scale and that they are funded by wholesale investors rather than retail depositors.

- Any numerical threshold will be, by nature, arbitrary – particularly if it is a dollar sum rather than a specified percentage of financial system assets.

- In the absence of market failures (moral hazard, information asymmetry), it is not clear why there should be a negative correlation between size and stability.

- No basis is advanced in the paper for how an NBLI would be regulated if it is brought within the perimeter, or how prudential regulation premised on, and designed for, deposit-taking would be superior to the bond market discipline to which the NBLIs are subject.

It is suggested in the Consultation Document that differences could be addressed through tailored standard-setting or exemptions, but the basis for that is not set out. This proposal, as a result, lacks a sufficient level of certainty and transparency that is required to meet the policy criteria for standard-setting described in chapter 4. In particular, no parameters are given for how a prudential framework designed to address market failures in the deposit-taking credit intermediation model would be appropriately designed and calibrated to address wholesale, and predominantly securitisation-based, funding models.

Financial stability and market failures

Prudential regulation is premised on a deposit-taking model; NBLIs by definition do not take deposits. As a result, in order to adjust to the current prudential framework, a called-in NBLI would have little choice but to either restrain its loan origination or to change its business model to that of a bank/LDT. Each of these adversely impacts the lending market by reducing credit access and diversity for consumers, and impairing the depth of New Zealand's financial markets through reduced securitisation activity. Requiring a change in business model additionally compromises a called-in NBLI's level of dynamism, which in turn undermines its contribution to efficiency and diversity in the lending market.

The Consultation Document does not make a case for how in principle this would benefit financial stability. To the extent that NBLIs need to substitute deposit for wholesale funding, this would increase the exposure of the deposit insurance scheme and in any case it would raise questions about implicit guarantee that are associated with prudentially regulated entities. In either case, this may introduce an element of moral hazard that would otherwise be absent.[2]

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[2] Franklin Allen, Elena Carletti and Agnese Leonello "Deposit insurance and risk taking" (Oxford Review of Economic Policy, Volume 27, October 2010), pp. 464-478; Kevin Hoskin and Naomi Javier "Open Bank Resolution – the New Zealand Response to a Global Challenge" (Reserve Bank of New Zealand Bulletin, Vol 76 No. 1, March 2013). In light of the widely-perceived implicit guarantee of regulated banks, a formal deposit insurance scheme likely only has a muted effect on moral hazard.

As we noted in our first submission, NBLIs are funded:

- By banks during the loan origination phase; and
- By the institutional capital markets once a marketable tranche of loans has been originated.

In the first instance, this is governed by prudential regulation within the perimeter (through the application of prudential rules applying to bank's exposures – e.g. LVR restrictions under BS19); and in the second, there is no suggestion that institutional investors (who deeply analyse and scrutinise the securitisation structure and underlying loan assets prior to investing) would be bailed out by taxpayers any more than managed funds would be.[3] On the contrary, as noted in our first submission:

- NBLIs are subject to substantial market discipline – their institutional investors have both the capability and incentives to monitor NBLIs' credit, something which is not true of retail depositors; and
- a transfer of risk to the institutional capital markets involves a diversification away from the risk of taxpayer bail-out.[4]

Similarly, we agree with the comment that wholesale investors are better placed to address information asymmetry (C3, pg 29) – for example, the Information Memorandum required for a securitisation contains very granular detail as to all aspects of the credit quality of a portfolio. This is supported by credit-responsive contractual provisions, including eligibility criteria – a set of detailed rules about the credit characteristics of loans that can be funded – performance and/or portfolio parameters, which provide for automatic adjustments to address any changes in the credit quality of the loan book through time (for example, requiring reserves or equity to be built up through restricting cashflows to the originator), and ultimately amortisation events, which put the structure into run-down, in which case first losses are assigned to the originating NBLI.

Furthermore, an independent credit review and analysis is carried out by the rating agencies according to published rating criteria, with published ratings assigned to the capital markets issuance.

Level of a threshold

For the reasons given above, we do not think a case for a maximum size threshold has been made, nor do we think it is appropriate or consistent with the objectives outlined in chapter 2. The submissions set out in this section are provided on an 'in the alternative' basis – i.e. in the event that the Reserve Bank still considers that a maximum size threshold is necessary, then it should (a) be subject to further consultation so as to meet prescribed transparency policy criteria for standard-setting (b) be set no lower than is necessary to maintain the desired level of financial stability, and (c) maintain a degree of flexibility to ensure it does not arbitrarily capture any NBLI in such a way that does not meaningfully contribute to financial stability.

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3 The first Consultation Document rejected the suggestion that managed funds should be subject to prudential regulation in any circumstances, despite forming a far higher portion of financial system assets (approximately 19%). A similar rationale should apply to the securitisation funding model employed by NBLIs, since it involves matching assets with liabilities and transferring the risk and return of those to sophisticated capital markets investors.

4 Members of ASF and FSF received letters from Minister Robertson setting out that providing taxpayer funds as financial support for members and other securitisation-funded lenders during the first Covid lockdown was not within the government's fiscal remit.

As to the size threshold, a range is given of **$20 or $60 million** – based on definitions of "large" in other statutory contexts, to **$15 billion**[5] – the level at which the Reserve Bank defines banks to be "systemically significant". Only the second of these is connected with the central concept of financial stability.

At the first end of this range, NBLIs would be prudentially regulated at the point they constitute **0.01%** of bank and non-bank system assets ($60 million/$584 billion). This would plainly contradict the policy decisions taken with respect to the regulatory perimeter.

The other end of the range is $15 billion, or a little under 3% of system assets. This amounts to less than half the portion of the NBLI sector in Australia, which, by comparison, is not subject to prudential regulation or similar call-in.[6] In addition, part of the rationale for this threshold is the inter-connectedness of banks, through their involvement in the payment system and related inter-bank flows ('too connected to fail'). By contrast, there is very limited scope for contagion in relation to NBLIs, which are not materially involved in the payments system or transactional banking, and by definition do not take retail deposits.[7] The extent of inter-connectedness through bank warehouse lending is already capped through sector and entity exposure limits within the conventional regulatory perimeter. As a result, any growth beyond this must come from the local and international wholesale capital markets, which creates no greater risk to financial stability than do managed funds (which comprise 19% of financial system assets).

If any threshold is set, (again, we do not think this is necessary nor justified) in principle and to be 'future proofed' for changes in the size of the financial system, it should be set at a percentage of bank and non-bank system assets, and at a level at which failure of the entity would adversely impact financial system stability. On this basis, the threshold should be not less than 2% of system assets. However, if this threshold is reached, we submit that it should trigger a discretionary (rather than automatic) 'call-in' process as proposed in the previous Consultation Documents (we say more about this below).

The need for further details about how the maximum size threshold would work

Despite the potential impact of the proposed maximum size threshold on the NBLI sector, and more broadly on diversity, competition and customer coverage within the financial system, the Consultation Document contains only a brief analysis of this proposal.

There is also little information given to enable assessment of the proposal. For example, in previous consultations it was proposed that any emerging stability risks would be managed through a designation or call-in power. The proposal (in Proposed Approach 3.1) does not indicate whether this will be the case, and the implication in the discussion on pg 30 is that it may be automatic through some mechanism. If that is the case, it is a very significant policy shift from the previous consultations, which (given its potential gravity) ought to be subject to separate consultation to address this issue in its own right.

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5 This would be similar to the level for the UK Prudential Regulatory Authority's call-in power (on a proportional basis), which applies to entities with gross assets exceeding £15 billion. As noted below, this power applies only to investment firms and does not extend to securitisation-funded entities.

6 'Non-ADIs' (i.e. non-deposit-taking lenders) in Australia comprise approximately 7% of aggregate financial system assets (excluding insurance and fund managers).

7 The fact that NBLIs by definition do not provide retail liquidity services (i.e. deposit or transactional accounts) is very significant in reducing moral hazard, since access to funds that are relied on to do basic transactions is a major impetus for bail-out – Toby Fiennes (2016) 'New Zealand's evolving approach to prudential supervision', speech to the New Zealand Bankers' Association, September.

The challenges of creating Standards for securitisation-funded entities

The Consultation Document comments (pg 30) that:

> "The Reserve Bank could use the flexibility of the regime to set requirements for these entities that appropriately reflect the lower level of financial stability risk presented by wholesale funded lenders."

We submit that, as discussed above, NBLIs funded by bank warehouse lending at first instance, and through the debt capital markets at second instance, are subject to an appropriate and sufficient level of scrutiny in the form of (respectively) 'bank discipline' (i.e. prudential supervision of warehouse lenders constituting indirect supervision of securitisation structures by the Reserve Bank), and 'bond market discipline' (i.e. in the form of investor and rating agency scrutiny).

In our view, calibration of appropriate Standards for wholesale-funded NBLIs would be a very significant project, which would have uncertain benefits compared to the market-based supervision which currently applies to this sector.

If the proposal is that NBLIs are required to become licensed as LDTs automatically on meeting or exceeding a size threshold, then we submit this would be unfeasible without pre-positioning of the framework of Standards that would apply to them in that event. It is acknowledged in the passage just quoted that Standards may need to be altered for the lower level of financial stability risk. However, the bigger issue is the absence of models locally or internationally for prudential regulation of non-deposit-taking/securitisation funded entities which pass the credit and other risks through to investors in a manner that is more similar to the position for managed funds than it is to entities operating under the deposit-funded credit intermediation model. This factor is exacerbated by (a) the broad range of wholesale financing structures and the bespoke nature of securitisations, not only from issuer to issuer but also among asset classes (RMBS, CMBS, ABS etc) from the same issuer, and (b) the complex interplay between asset composition and structural credit enhancement and other protections, including as a result of credit rating criteria.

To give some sense of the challenges involved, construction of an efficient licensing and prudential regime applying to a securitisation-funding model itself – as opposed to the engagement in securitisation by entities within the regulatory perimeter – would, to our knowledge, be a world-first.[8] While details around the international regulatory position are beyond the scope of this submission, we note for example that the UK Prudential Regulatory Authority's designation powers do not extend in this direction but apply only to *investment firms* (money market funds, private equity funds, hedge funds etc which have "permission to deal in investments as principal"), which have gross assets exceeding £15 billion.[9] Indeed, regulation of securitisation funding is a peripheral issue in key policy papers concerning the financial stability impacts of non-bank financial institutions.[10] We would be happy to discuss these complex issues with you in person.

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[8] There are complex regimes relating to the capital treatment, due diligence and other expectations, but these apply only to the involvement in securitisation of prudentially regulated entities within the perimeter (banks and insurance companies), as either originators or investors – refer for example European Union Directive 2013/36/EU (CRD). These are extremely complex, but in any event they do not purport to apply prudential style regulation to securitisation structures as such.

[9] Refer Financial Services and Markets Act 2000 (PRA-regulated Activities) Order 2013, BOE/PRA *Statement of Policy Designation of investment firms for prudential supervision by the Prudential Regulation Authority* (March 2013).

[10] Refer for example European Commission *Non-bank financial institutions: Assessment of their impact on the stability of the financial system* (Economic Papers 472, November 2012) talks about securitisation as a "cross-cutting issue" but has no entry in respect of it in its regulatory overview.

Process issues in relation to the proposed maximum size threshold

The extension to wholesale-funded NBLIs of the core licensing and prudential regime under the DTA would be a significant intervention that would have a material business impact on the subject entities and sector, and on their institutional investors, in addition to potential flow-on impacts on the credit and capital markets. Consistent with the policy decisions taken with respect to Standards in chapter 4 and the decision-making principles in chapter 2, we submit that any such power should be given effect:

- through secondary legislation, under the procedures set out in section 4.4 of the Consultation Document;[11] and

- after giving due consideration to the decision-making principles, including regulatory efficiency, proportionality and competition.

In undertaking this process, it would be imperative to give reasonable indication of the proposed licensing and prudential framework which would apply to the relevant entities after their designation as LDTs, including for the purposes of assessing the costs and benefits of the proposal as part of the regulatory impact analysis. Analysing the case for a call in power is not simply a matter of assessing the costs and benefits of *when* there might be a regulatory justification for its exercise as addressing a regulatory gap or risk, but must also involve showing *how* the regulatory tool that is proposed to be applied would resolve that issue. This would also enable a full assessment of the effect on financial system stability and (we argue under Question 2.A) effectiveness, as well as appropriate engagement from wider stakeholders, including customers and investors.

3.S Do you support the proposed approach to perimeter monitoring? If not, what approach would you suggest?

Yes, we support in concept the Reserve Bank having the mandate and powers to obtain information from specified wholesale-funded NBLIs along the lines of the Australian RFC regime. Members of this sector have reported financial and credit data to the Reserve Bank for some time on a voluntary basis, which was expanded during the initial Covid-19 crisis through detailed information provided by the sector periodically via the Financial Services Federation (FSF). This information also flows through warehouse lenders (which are invariably registered banks) reporting to the Reserve Bank as part of their prudential reporting obligations. Bespoke information gathering and reporting is costly, so it would be important to design the requirements in a way that would meet the Reserve Bank's needs most efficiently. We would be happy to discuss this further with you directly through ASF or via the FSF.

3.T Do you support the proposed designation power? If not, what approach would you suggest?

Yes, we support the designation power outlined under Proposed Approach 3.7, which is crucial in preserving the integrity of the regulatory perimeter, on the basis that this is to address products offered to the public that are deposits in disguise (i.e. is an 'anti-

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11 In this respect we agree with the discussion in the Consultation Document under Proposed Approach 3.7 on pg 50, and submit that the extension of the DTA to wholesale-funded NBLIs is more significant than the 'anti-avoidance' circumstances referred to there.

avoidance' provision). In relation to the proposal that changes to the prescribed size threshold for wholesale-funded NBLIs, we refer to our submissions above.

4.F Do you support the proposed approach to allowing the Reserve Bank to set reporting standards and lending standards in relation to categories of non-deposit-taking lenders that have been prescribed via regulations? Why or why not?

As to reporting standards, for the reasons given under Question 3.T, we support such a proposal in principle and would be happy to discuss with you an efficient design for such requirements.

In relation to lending standards, taking this to mean the application of macro-prudential tools such as high LVR restrictions (refer Section 3.4 on pg 48), we have no significant objections to this in principle, though we note this is unnecessary (and has no material benefit) as follows:

- Under the normal funding model, origination is undertaken via warehouse funding and the NBLI's equity and other funding resources. As such, LVR and similar rules are applied to NBLIs via the bank funding channel.

- Securitisations feature very granular credit parameters, responding to bank or investor requirements and credit rating criteria (i.e. by way of both bank and bond market discipline as above). These include, but are not limited to, LVR and similar criteria, contributing to the overall risk assessment by sophisticated wholesale investors. Rating agency methodology requires higher levels of equity and other credit support for receivables that are perceived to be riskier, thereby increasing the cost of capital. Securitisation structures therefore contain in-built restraint mechanisms by pricing for risk and disincentivising risky lending practices

- There is a risk, depending on the extent of the lending standards, that the NBLIs are homogenised with banks, with the effect that consumers who currently access NBLI lending (either by choice or due to not being accepted under bank criteria) losing access to credit and/or their desired level of borrowing flexibility adversely affecting their microfinancial and general macroeconomic outcomes.

It is proposed in Proposed Approach 4.2 that macro-prudential powers will be subject to the general Standard-setting powers, and therefore to the procedures set out under Section 4.4. On that basis (which we support), and bearing in mind the comments that this would be a 'reserve power' for circumstances in which lending in a particular sector is identified as contributing to financial instability, we consider that there are adequate safeguards and procedures to address these circumstances – including, for example, by taking into account the considerations noted above.