



FINANCIAL SERVICES FEDERATION

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Consultation Document: Review of the Credit Rating Exemption Threshold for Non-Bank Deposit Takers

Thank you for the opportunity for the Financial Services Federation (“FSF”) to comment on the review of the Credit Rating Exemption Threshold for Non-Bank Deposit Takers (“NBDTs”).

By way of background, the FSF is the industry body for the responsible and ethical finance and leasing providers of New Zealand. The FSF has over forty members and associates providing first-class financing, leasing, investment, banking and insurance products and services to over 1 million New Zealand consumers and businesses. The FSF’s affiliate members include internationally recognised legal and consulting partners. A list of FSF’s current members is attached as Appendix A.

You will see from this list that the FSF currently only has 5 members that still take deposits and of these only 2 are eligible to take advantage of the current exemption and remain unrated. The FSF is very concerned that the number of NBDTs operating in the New Zealand market has reduced significantly since the Global Financial Crisis and continues to do so as entities find other means to fund their lending activities in a way other than to raise deposits from the New Zealand public.

The FSF strongly believes that, whilst more robust regulation of the NBDT sector was obviously required following the GFC, it is important not to lose sight of the fact that those of the FSF’s memberships that still raise deposit funds from the public survived the crisis and did so arguably because they had strong systems and processes in place.

The FSF points out that it is not necessarily in the interests of the investing public of New Zealand to limit their range of choice as lack of diversification is not compatible with efficient and transparent financial markets.

It must be remembered that those of the FSF’s members who are still NBDTs are now subject to an unprecedented amount of scrutiny and regulatory oversight. These include among other things the provisions of the Non-Bank Deposit Takers Act 2013, the NBDT licensing regime, the requirement for NBDTs to undergo semi-annual audit, the supervisory regime under the Anti-Money Laundering/ Countering Financing of Terrorism Act 2009, monthly reporting requirements to Trustees and Trustee oversight, mechanisms to ensure good governance and that NBDTs are managed and governed by suitable persons, the requirement for the NBDT to have a Risk Management Plan to identify and manage key risks, capital ratio requirements, related party restrictions and liquidity regulations.

With all these requirements in place and being met by FSF’s NBDT members, the FSF would question what value a credit rating would add to a potential investor in terms of providing a better understanding of an NBDT’s creditworthiness. The fact that the NBDT is supervised by a robust licensing and prudential regime is, in the FSF’s view, of more comfort to a potential investor than a credit rating particularly when the credit rating system is not widely understood by the investing public.

The FSF’s 2 NBDT members who are exempt from the requirement to have a credit rating are appreciative of this but both report that the threshold has become a barrier to growth for them. Both entities report that they have investigated the possibility of obtaining a credit rating but that the costs are prohibitive (more detail will be provided on the costs later in this submission). They also report that their enquiries of

credit ratings agencies have revealed that, simply because of the size of their operation, it is likely that the rating that would be applied could be as low as a “D”.

The FSF’s NBDT members also report a very high rate of reinvestment amongst their depositor base (upwards of 90%) regardless of whether or not they have a credit rating. This suggests that depositors who are familiar with the NBDT in which they are investing are not as sensitive to credit ratings as you might think.

A further point to consider is that, because of the cost of obtaining and maintaining a credit rating, NBDTs whose growth puts them over the threshold (whatever that might be) need to continue to raise capital to fund the increased cost of the credit rating. The actual cost of raising capital is also onerous and burdensome.

The FSF therefore believes that leaving the threshold at the current level is inhibiting well-managed and compliant NBDTs from being able to grow both their deposit and lending books but the catch 22 situation is that, by obtaining a credit rating which in all likelihood will be low by default because of their small size, it could potentially deter those investors who do understand what credit ratings mean, from investing.

On this basis the FSF’s strong preference would be for the credit rating exemption threshold to be increased.

With regard to the specific questions raised on the Consultation Document, the FSF provides the following answers:

1. Do you agree that the direct and indirect costs to an NBDT of obtaining a credit rating are typically around \$100,000 per year?

FSF’s NBDT members who currently take advantage of the credit rating exemption threshold advise that their enquiries of credit rating agencies suggest that the direct cost of obtaining a rating are in the vicinity of \$65,000-\$75,000. Including the indirect costs of preparing the information required to obtain a rating, the provision of information to maintain the rating, the costs of reprinting investment statements and other material to reflect the credit rating etc, would easily result in a cost of \$100,000 per year.

2. Do you consider that the costs of obtaining a credit rating creates a material disincentive for smaller NBDTs to grow their business?

FSF’s NBDT members who are not required to obtain a credit rating under the current exemption threshold report that they have consciously avoided doing so because the costs are prohibitive and they do not believe the rating would add sufficient value for either their business or for their current and potential investors to justify the cost. This has definitely been a barrier to growth for these businesses.

3. Do you consider that the size of an entity creates a ceiling around the maximum level of credit rating an NBDT is able to obtain? If so, do you consider that this is a reasonable reflection of the impact that the size of an entity may have on its financial resilience?

FSF’s NBDT members report direct feedback from credit ratings agencies suggesting that their size will definitely create a ceiling around the maximum level of credit rating they are able to obtain and that, as a direct result of their small size, they can expect their rating to be at the level of a “D” regardless of any other factors. Ratings agencies deal on a global scale so size matters and they take a “one size fits all” approach in regards to the size of entities they are rating that does not necessarily take into account other factors such as the fact that, because of the size of the market in New Zealand, it can be relatively efficient so investors have a good understanding of the investment and the company that is offering it. Those NBDTs still operating in the market today survived the GFC regardless of their small size whilst much larger organisations who did have credit ratings did not. Indeed as was demonstrated during the fallout from the GFC, investors relied on credit ratings as indicators of all the risks involved. Size alone therefore is not an indicator of an entity’s financial resilience or otherwise, rather this is a product of how the organisation is structured, how it is managed and governed, how it manages its liquidity, etc.

4. Are there other matters that you consider we should be taking into account when considering whether the exemption threshold is set at a level that is consistent with the maintenance of a sound and efficient financial system and covers entities for whom compliance would be unduly onerous or burdensome? If so, what are these matters?

The FSF would reiterate that in the years since the GFC New Zealand has put in place a world-class regulatory regime to ensure that a sound and efficient financial system is maintained. In particular for NBDTs the supervisory structure now in place including the licensing and prudential regime is such that the New Zealand public can have strong faith and confidence in our financial markets. The FSF fully supports this regime and clearly understands the need for it to have been put in place whilst at the same time pointing out that the cost and compliance burden that this has caused has been borne largely by those entities who arguably were operating well prior to taking on this compliance burden. On this basis the FSF would strongly suggest that New Zealand already has a sound and efficient financial system and the need for smaller NBDTs to obtain a credit rating does not add anything of value to this. As already stated, the value of a credit rating in and of itself will probably not add any value to an investor's knowledge of a deposit-taker purely and simply because by default the rating for a small entity will be low and will not reflect the true position with regard to that entity's creditworthiness.

5. Do you agree with our analysis of the status quo? Are there any additional costs or benefits of the status quo that we should be considering?

The FSF believes that it is unduly onerous or burdensome to expect entities slightly over the \$20 million threshold to comply with the credit rating requirement because the cost to obtain and maintain a credit rating is the same for an entity of \$21 million as it is for an entity of \$100 million. Clearly the cost is more onerous or burdensome the smaller the entity is. For this reason and for the reasons already stated that the cost of obtaining and maintaining a credit rating is inhibiting growth for entities just under the \$20 million threshold, and that the FSF does not believe that having a credit rating provides the investing public with any more protection than if an entity does not have one given the nature of New Zealand's robust regulatory regime, the FSF would not support maintaining the status quo with regard to the credit rating exemption.

6. Do you agree with our analysis of this option? Are there other costs or benefits of this option we should be considering?

The FSF members who are currently able to take advantage of the credit rating exemption prefer this option of the three presented but would suggest that the small increase suggested to possibly up to \$25 million is insufficient for several reasons. Firstly, as previously stated, the supervision of NBDTs is now providing the framework to ensure a sound and efficient financial system that the obtaining of a credit rating will add nothing to. Secondly, in the FSF's opinion having a sound and efficient financial markets system also includes ensuring that investors have access to sufficient opportunities to appropriately diversify their portfolios. The situation currently is that the numbers of NBDTs is small and shrinking as entities find alternative means to fund their lending activities rather than raise deposits and the barriers to entry for any new entities are such that few if any entities would consider setting up business as an NBDT in New Zealand. The FSF believes that any further barriers to either growth or entry such as the requirement for small entities to obtain a credit rating are unnecessary to ensure the maintenance of the sound financial markets system. Finally, as previously stated, the FSF does not believe that the obtaining of a credit rating provides any further protection to investors than the current very effective regime does not. Because of the size of the entities in the global scale, the rating will necessarily be low and therefore not necessarily indicative of the entity's robustness. Given that there are only two NBDTs left in the \$20-\$30 million size band and none in the bands between \$30-\$60 million according to the Consultation Document it would seem to the FSF to be eminently sensible to increase the credit rating exemption threshold to \$30 or even \$35 million without the need for the entities to maintain a higher capital ratio than the current 10%.

7. Do you agree with our analysis of this option? Are there other costs or benefits of this option we should be considering?

The FSF believes that, while increasing the exemption to \$30 or even \$40 million would be preferable and sensible, the corresponding requirement to hold more capital would be very undesirable for small NBDT entities. The more cash an NBDT is required have on hand the more this inhibits their ability to grow. With the increased focus the regulatory regime has placed on appropriate levels of supervision of NBDTs and their governance, the FSF does not believe that holding more capital is necessary.

8. Which of the four options for the credit rating exemption threshold do you prefer? Are there other options you think we should consider?

Please refer to the answers provided for question numbers 6 and 7 above. It is the FSF's preference for the second of the three options to be adopted – that of an increase in the threshold to a level that would include the 2 NBDT entities currently between \$20 - \$ 30 million in size, but without the need for a higher level of capital to be held for the reasons stated above.

Thank you again for the opportunity for the FSF to submit on this matter of importance to some of our NBDT members. Please do not hesitate to make contact if there is anything further you wish to discuss.



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A National Federation of Financial Institutions

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APPENDIX A
Membership List as at 1 October 2014

| Debt Issuers - (NBDT) Non-Bank Deposit Takers | Vehicle Lenders | Finance Company Diversified Lenders | Credit Reporting | Insurance | Affiliate Members |
|--|--|--|---|--|---|
| <p><u>Rated</u></p> <ul style="list-style-type: none"> • Asset Finance (B) • Avanti Finance (BB) • Fisher & Paykel Finance (BB+) • Medical Securities (BBB+) <p><u>Non-Rated</u></p> <ul style="list-style-type: none"> • Mutual Credit Finance • Prometheus Finance | <ul style="list-style-type: none"> • Aqua Group Ltd • BMW Financial Services • Branded Financial Services • Community Financial Services Limited • European Financial Services • Fleet Partners NZ Ltd • Mercedes-Benz Financial Services • Motor Trade Finances • Nissan Financial Services NZ Pty Ltd • ORIX NZ • SG Fleet • Toyota Finance NZ • Yamaha Motor Finance | <ul style="list-style-type: none"> • Advaro Ltd • Centracorp Finance 2000 • Dorchester Finance • Finance Now • Future Finance • GE Capital • Geneva Finance • Home Direct • Instant Finance • John Deere Financial • Oxford Finance Ltd • DTR Thorn Rentals • South Pacific Loans • The Warehouse Financial Services Group | <ul style="list-style-type: none"> • VEDA Advantage <p><u>Debt Collection Agency</u></p> <ul style="list-style-type: none"> • Baycorp (NZ) | <ul style="list-style-type: none"> • Autosure • Protecta Insurance • Provident Insurance Corporation Ltd <p><u>Associate Members</u></p> <ul style="list-style-type: none"> • Southsure Assurance | <ul style="list-style-type: none"> • American Express International (NZ) Ltd • Buddle Findlay • Chapman Tripp • Deloitte • Ernst & Young • Finzsoft • KPMG • PriceWaterhouseCoopers • SimpsonWestern |

Total: 48 Members