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JUNE 2024 UPDATE

The banking industry: A look ahead

What to do with the shadows?

The mesh of challenges confronting the major banks in New Zealand – including the impending final report from the Commerce Commission's market study and the upcoming select committee inquiry into banking – will continue to create growth opportunities through 2024 for the shadow banking sector.

This trend was evident last year but we expect it to continue to gain momentum over the next 12 months.

All five of the change drivers we identified in our April 2023 report – the structural reform project of the Reserve Bank of New Zealand (RBNZ); the disruptive influence of technology; the pressure on bank balance sheets; the increasing focus on social licence and the expansion of bank obligations – will continue to exert pull.

But we think the trends that will demand most in-house attention, time and resource this year are:

- **A tougher business environment for traditional regulated entities**, as deposit takers respond to more restrictive regulations in a market that is already under stress from elevated interest rates, and
- **New opportunities and threats arising out of the technological innovation juggernaut.**

Together, these factors will create an opportune environment for private credit, mortgage/loan financing, and other largely unregulated providers of financial services traditionally provided by banks (often referred to as 'shadow banking').

In our view:

- Opportunities for alternative providers will be created as the RBNZ tightens its grip on the regulated banking sector to maintain financial stability in an economy that continues to face headwinds. As the role of the traditional bank is redefined, the door will open to more private investment and new tech solutions. This is already occurring internationally, alongside a rising concern that regulatory responses may have lagged.
- New Zealand's comparatively small lending transactions remain an issue for the creation of a large private credit market but, time and again, when conditions are favourable we have developed local and unique solutions to the size problem – e.g., our thriving public debt markets, effectively combining wholesale and retail demand into a single offer structure, and the development of consumer and SME-sized sustainable finance products across the industry (as we discussed in last year's Investing for Impact publication).
- New Zealand's nascent fintech sector may be about to enter a growth spurt as open banking becomes a reality and technological innovation moves up a gear.

Implications for the traditional banking sector

Key focus points for the mainstream banks will be:

Cementing customer loyalty ahead of the emergence of new competitors.

Building a strong relationship with the new-look RBNZ.

Managing expected bottlenecks in the implementation of new regulations and system change.

Continuing to find ways to attract deposits.

Developing alternative income streams.

01/

A tougher business environment for traditional regulated entities

More supervision and enforcement

New Zealand's banking regulation was a proud outlier from international norms with the RBNZ preferring a hands-off regime focused on inducing banks to build strong internal governance.

But a 2017 report from the International Monetary Fund (IMF) Financial Sector Assessment Program recommending "more intensive" supervision marked a turning point after which change has been radical and sustained.

The Deposit Takers Act 2023 will introduce a range of new supervisory and enforcement powers over the next four to five years together with the $100,000 Depositor Compensation Scheme (DCS) in mid-2025. The Act ushers in a new mandate to promote the "safety and soundness" of every deposit taker individually – not just the stability of the wider financial system.

The RBNZ views this change as "a profound paradigm shift in the approach to regulating and supervising entities… built on being proactive, sceptical and challenging of our regulated population".

Banks and non-bank deposit takers would be wise to take notice. The RBNZ has almost doubled its staff since 2017 to 510 as at June 2023. Although this growth had begun to taper off, even before the change of government, we do not expect a reduction in the RBNZ's appetite to supervise and enforce.

Heavier regulatory requirements

Most of the Deposit Takers Act reforms are yet to come into force, including on-site inspections and director due diligence requirements.

Regulated entities, however, already have an intimation of the future in the hard line RBNZ has taken to the New Zealand branches of overseas banks; prohibiting them from engaging in retail lending, retail payments and foreign exchange - activities still available to a similarly placed non-bank.

As we observed in our December 2023 commentary:

> "[S]tartups, fintechs and other unregulated (or less regulated) entities may eye up some of the opportunities created by the new constraints on NZ Branches but, where they are unable to provide the service efficiently, the gaps will remain unfilled".

The RBNZ is also casting a longer shadow through a range of policy changes across the sector, from implementation of the increased capital requirements set in 2019 (and currently proposed updates to capital frameworks), to new cyber breach reporting obligations, to the signalled further tightening of bank liquidity requirements. Non-bank deposit takers are also set to become subject to increased capital requirements, as well as a range of liquidity and other requirements for the first time.

These prudential changes coincide with an increasing conduct presence from the Financial Markets Authority (FMA), including:

- The Conduct of Financial Institutions (CoFI) legislation, still slated for March 2025 but subject to another policy refresh,
- The Government's intention to transfer oversight of the Credit Contracts and Consumer Finance Act (CCCFA) to the FMA from the Commerce Commission (although this will have the welcome effect of moving the sector from three primary regulators to two). The FMA's 'fair outcomes' consultation in late 2023/early 2024 provides a guide to its likely approach, and
- Increasing coordination between the RBNZ and FMA, including through the Council of Financial Regulators (CoFR) and legislative proposals to allow each regulator to rely on an assessment made by the other when appropriate.

This cross-pollination is also evident in other areas – e.g., the RBNZ talking of outcomes-based regulation and the FMA is eyeing up the possibility of without notice on-site inspection powers similar to those the RBNZ has under the Deposit Takers Act.

Higher business costs and risks

- >> Bank non-performing loans are on the increase as the recession and the costs associated with climate volatility take their toll across the economy. The quantum exceeded the Covid peak in January this year and has continued to climb – although it remains well below GFC era figures.

- >> Commercial property has been hit particularly hard, experiencing a spike in February 2024 that almost quadrupled the February 2023 total.

- >> Banks will be facing difficult decisions as they work with borrowers under stress and continue to factor in social licence priorities.

More broadly:

- Litigation risk will be front of mind, including potential class actions arising from a range of matters, such as de-banking, consumer lending, scams and climate change,
- The burden of regulatory compliance will be a constant line item for the next few years with implementation of the Deposit Takers Act, new banking standards and the DCS all taking up considerable resource, and
- The cost of capital and funding will continue to increase as regulatory capital requirements head toward their 2028 'steady state', bank liquidity settings become more extensive, and competition for deposits heats up - including the introduction of the DCS, the repayment of cheap Covid-era funding lines and the technology innovations discussed below. The current review of capital requirements does not propose to review the relative cost of loans between different sectors.

Non - performing loans by sector

(share of lending by value, seasonally adjusted)

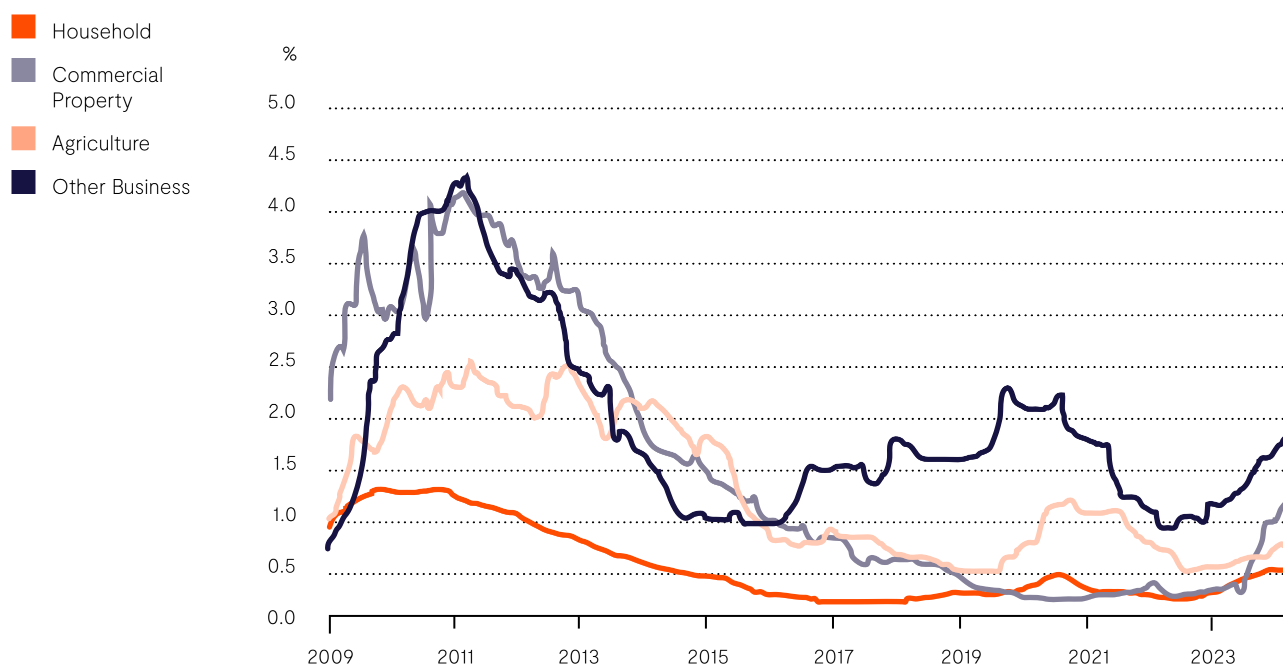

Figure 1.2 of the RBNZ Financial Stability Report

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New opportunities arising out of the technological innovation juggernaut

Although technological advances have already had a profound effect on the banking and financial services available to New Zealanders, the legislation governing the sector remains largely technology neutral.

This is about to change – creating opportunity for some providers to introduce or expand their offering, and restricting others – as global tech developments continue to accelerate.

Open banking

The Customer and Product Data Bill (CPD Bill), was introduced to Parliament in May of this year, opening the door to open banking.

The effect of the Bill as it applies to the banking sector will be to require banks to allow external providers to directly access customer information and/or initiate instructions.

Open banking will make it easier for customers to change banks or to engage with a new financial service provider. It will also enable symbiotic partnerships through which a tech provider that can attract customers with a slick user experience could outsource the regulated banking elements of the transaction to an established bank. A high profile (but potentially short-lived) example of this symbiosis was the Apple Card, created by Apple Inc. but issued by Goldman Sachs. Monzo and Revolut are both examples of overseas fintechs who started in this way before scaling to become fully-licensed neobanks and challenging existing banking norms. Revolut launched a narrower (non banking) offering in New Zealand in 2023.

Even without legislation, private initiatives are advancing. Under the Payments NZ Minimum Open Banking Implementation Programme, the four largest banks have been required since May 2024 to have standardised APIs ready for use by third parties in initiating payments, with account information sharing required by November. Regular progress reports are available here.

Payments NZ has also applied to the Commerce Commission for authorisation to develop an accreditation scheme and default contractual terms and conditions to apply between banks, as API providers, and accredited third parties. The Commission's decision is due in July.

Meantime, the Commission is pursuing an initiative of its own. It is consulting on a proposal to designate the interbank network, allowing it to impose regulations or standards on network participants if the industry fails to deliver an API-enabling payment ecosystem in a timely way. As we have previously stated:

> "We believe [designation, rather than stepping in and regulating] is preferable given the existing initiatives already underway. Industry should be given the space to demonstrate progress on those initiatives without adding the additional complexity of substantive regulation by the Commission to a landscape that already includes regulatory involvement by the Reserve Bank of New Zealand and the Financial Markets Authority as well as proposed oversight by MBIE and the Privacy Commission under the CPD Bill."

Submissions on the Commission's proposal closed on 10 May.

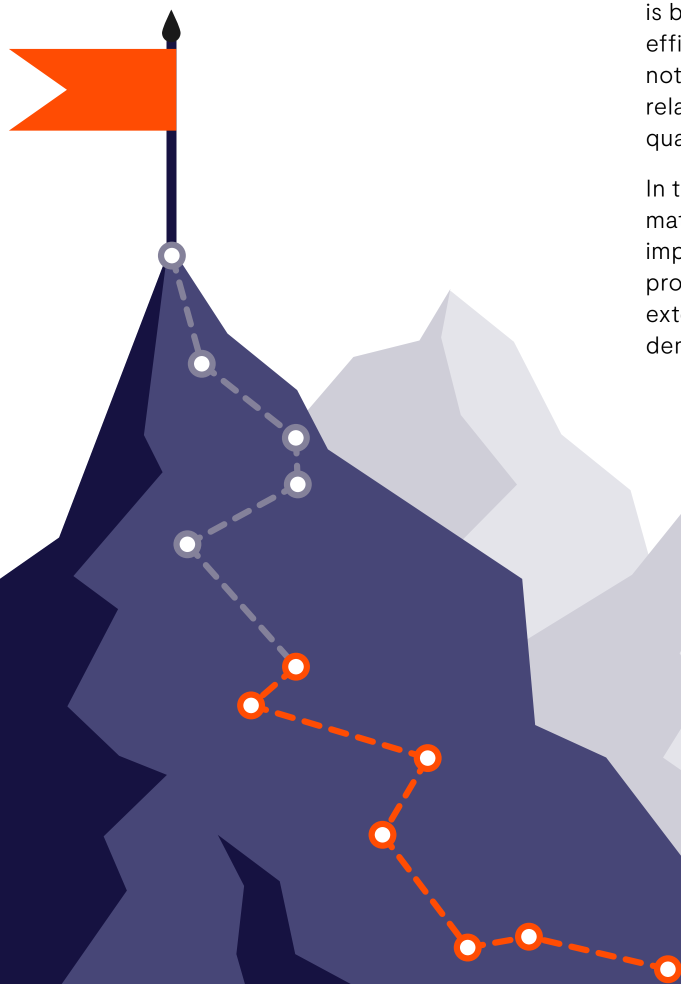
Central bank digital currency

The RBNZ is consulting on "high level design options" for a central bank digital currency (CBDC), see our commentary here. The consultation is the second stage in a four-stage process to run until around 2030.

Prototypes will be offered at stage three, which is expected to be completed in 2028-29, and if the decision is made to proceed, implementation will be at stage four.

We support RBNZ's commitment to ensuring New Zealand has reliable and efficient money and payments systems that support digital innovation, financial inclusion and resilience. There will, however, be significant potential costs – a reality acknowledged by the Treasury Committee of the UK Parliament which, while supportive of the work the Bank of England and HM Treasury are doing on a retail digital currency, has emphasised the need for a clear cost-benefit analysis.

CBDCs also remain largely untested and the benefits they offer can in many cases be delivered by other means – a well-functioning open banking system, for example, or instant payment solutions – both of which may mean low take-up rates for a CBDC and limited return on the policy investment.



Artificial Intelligence (AI)

AI is affected by existing statute – including the Privacy Act and the Harmful Communications Act in New Zealand's case – but there are a range of views among lawmakers internationally on whether it requires specific legislation.

The European Union has passed an AI Act that is expected to come into force mid-year and is likely to become the model for other jurisdictions. Canada is also proposing amendments to its Artificial Intelligence and Data Act (Bill C-27) to capture AI.

The Conservative UK Government, after a White Paper consultation, decided against legislating on the basis that it might inhibit innovation, but has created a regulatory framework aimed at affected regulators and guiding their decision making in this space. The US Congress also seems disinclined to legislate, although President Biden last year issued a wide-ranging Executive Order on AI, focusing largely on high-level safety, transparency and algorithmic concerns.

New Zealand has also so far taken a hands-off approach, although the FMA has been explicit that if firms want to avoid regulation, they need to be diligent in their management of AI risk, in particular Gen-AI, "through appropriate governance structures, risk management, remaining vigilant over operational resilience implications and addressing data risks".

As the technology becomes more entrenched and the uses of it expand, the public mood may change. While AI is becoming increasingly useful in lifting productivity and efficiency, so also are the risks becoming more obvious – not only the privacy and security aspects but the issues related to algorithmic bias and reliance on inaccurate or low quality data.

In the banking context, incomplete or skewed source material or bias in AI models could have significant implications for lending and other practices. AI policies and procedures may also come under increased scrutiny to the extent that banks are required to explain their AI use and to demonstrate an awareness of the potential consequences.

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A developing sector

The forces now preoccupying the mainstream banks – an increasingly unpredictable business environment and an onslaught of technological innovation – are not peculiar to New Zealand and seem likely to gather pace.

New Zealand – baby steps

Credit intermediation by non-bank lenders has always been fairly niche in New Zealand with RBNZ data indicating that they account for less than 5% of the banking sector.

At the macro-level, lending growth in New Zealand remains close to historical lows and annual mortgage lending is at its lowest point since 2012. This suppressed demand has limited opportunities for banks and non-bank lenders alike over the last year.

However, new non-bank lending businesses have already taken root and we expect this to continue as the wider market rebounds.

We have noticed a clear increase over the last five years in the number of private credit fund establishments – including Private Credit Group, Aotea Asset Management, Peninsula Credit and specific offerings from Australian fund managers Revolution Asset Management and Metrics.

More generally post-Covid, we have seen local fund managers build presence, starting with securitisation participations and building into direct lending with a New Zealand focus. As Quin Casey, Portfolio Manager – Fixed Interest at Fisher Funds states:

> "We expect private capital will capture an increasing share of domestic debt funding demand in the future. Fisher Funds is committed to being a reliable source of debt capital for medium to large New Zealand businesses, and we ready to support that market growth for the benefit of local companies and ultimately, our clients' savings.
>
> Rather than a 'one size fits all' approach, private credit can accommodate different debt structures that are a logical fit for the asset and cash flow profile of the borrower. This is the advantage of working with a private debt investor – a partnership approach that seeks mutually beneficial outcomes."

Non-bank lenders featured in several of New Zealand's largest recent finance deals including:[1]

- The sale of HSBC's NZ$1.4b retail mortgage loan portfolio to Pepper Money, a non-bank residential home lender,
- The capital raise by New Zealand Green Investment Finance (NZGIF) from offshore institutional funds through its Solar Finance programme to support solarZero,
- The New Zealand Local Government Funding Agency (LGFA) $1.1b bond offer in the New Zealand market – exceeding the largest single domestic bond issuance ever by a New Zealand bank. Since then, LGFA has issued circa NZ$3.75b of bonds domestically and A$1.65b in the Australian market. On the lending side, LGFA's total lending increased to $16b in 2023 – more than TSB and SBS combined,
- An ever-increasing variety of New Zealand securitisation term outs, under which institutional investors fund loan portfolios rather than banks. These now regularly top $1.5b per year, with a notably increased participation from NZ-based funds.

This rise spans consumer mortgage financing, typically through securitisation, and corporate lending, often through a credit fund, and is in line with global trends.

Overall, New Zealand's comparatively small lending transactions remain an issue for the creation of a large private credit market. However, issues relating to scale are common across the New Zealand economy and our markets are well-versed in solving them – whether by adapting best practices from offshore markets or creating new technologies.

1. Chapman Tripp acted on the HSBC/Pepper Money and solarZero/NZGIF transactions, and the majority of securitisation term outs in the market.

According to Simon Petris, Co-Founder & Senior Portfolio Manager at Revolution Asset Management:

"In the Australian market we have seen ongoing growth in private credit, including strong direct relationships with private equity sponsors. Where a bank might have otherwise been involved private credit now commonly provides the cornerstone investment – something Revolution Asset Management is well suited to do.

New Zealand has typically had smaller deal sizes and comparatively less activity, but when transactions arise in that meet our scale and investment requirements we are pleased to be able to support them. We continue to see the potential for growth in New Zealand, particularly once the lending market and system growth recovers, and we aim to bring our exposure to New Zealand companies up to about 20% of our flagship Fund II."

Global trends

The United States is ahead of the pack with a long-established private credit market that has grown exponentially since the GFC to nearly US$1.7 trillion (according to Federal Reserve data). The two largest mortgage lenders in the US are also non-banks - Rocket Mortgage and United Wholesale Mortgage, each with a loan book in 2022 more than 1.5 times that of the closest bank competitor.

In Europe, Deloitte's Private Debt Deal Tracker recorded the fourth highest number of private credit deals on record in the last quarter of last year, bouncing back from a lull as market interest rates rose with increased geographic diversity.

The UK is also seeing new mortgage financing models, such as the 30-year fixed mortgages funded by covered bonds that are now being offered in the UK by mortgage lender Perenna.

And the Reserve Bank of Australia produced an abstract in 2023 noting that non-bank lending had "grown strongly in recent years", but that there was limited data covering non-bank credit intermediation more broadly. EY has estimated that the developing Australian private credit market stood at AU$188b assets under management in 2023, up from AU$109b three years earlier.

Timeline

The banking sector is facing a multi-faceted regulatory reform programme which will require substantial adjustment and will change the dynamics of the market, encouraging technological innovation and creating opportunities for new entrants.

Near term certainties

Next 12 months

- Banks will be in the final stages of preparing for conduct licensing (CoFI), which comes into effect on 31 March 2025 and will continue to soak up considerable resources for core system development.
- Implementation of the depositor compensation scheme (DCS) is expected in mid-2025, potentially increasing the attractiveness of non-bank deposit takers offering higher yields.
- There will be continued significant progress in open banking developments, including enactment of the Customer and Product Data Bill and progress with the API Centre milestones.
- All relevant banks will be required to complete their first mandatory climate risk reports.

Medium term probabilities

Next 5 years

- We are likely to see significant central bank digital currency (CBDC) testing over the next five years. This has remained a priority of the RBNZ since the change of government.
- Competition for deposit bases will increase, and capital requirements will continue to ratchet towards the new 16-18% maximums. With non-bank deposit takers also likely to become subject to increased capital requirements, the market size for regulatory capital instruments will be tested.
- Significant open banking infrastructure and more specialised providers of new fintech solutions, diversifying the industry. To compete, larger players will continue to develop their own products or acquire start-ups.
- We are likely to see the emergence of legislation, or clearer regulatory expectation, on banks' use of artificial intelligence, in matters such as governance, risk management and operation resilience.

Long term possibilities

Next 10 or more years

Similar to last year, we see:

- Completion of key modernisation projects, including introduction of a CBDC and 24/7 real time payments.
- Deposit bases may become considerably less static, compounding the need for banks to obtain wholesale funding and develop products that keep money within the bank ecosystem.
- A long-term consolidation may occur as scale and breadth of product offering widens to attract customers. A possible by-product of this may be that participants beyond the traditional banks (e.g., financial market infrastructures) become "too big to fail", increasing the moral hazard attached to the sector.

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Our thanks to Patricia Herbert for helping us write this publication.

Every effort has been made to ensure accuracy in this publication. However, the items are necessarily generalised and readers are urged to seek specific advice on particular matters and not rely solely on this text.
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