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Adrian Orr
Governor
Reserve Bank of New Zealand
Wellington

Dear Governor Orr

We write to bring your attention to an aspect of the Reserve Bank of New Zealand (RBNZ) capital adequacy proposal that has had limited airtime: the issue of how the proposal will affect competition in respect of financial services, particularly regarding the expansion of non-banks. This issue has been raised in our report (NERA Economic Consulting, dated 17 May 2019), and as a key point by the external expert Professor Ross Levine. This letter points out empirical evidence that is germane to a final position on the proposal.

In our report, we explained that raising the costs of registered banks would be unlikely to increase competition among them, but it would facilitate the expansion of other financial institutions – near or shadow banks. This latter point is also emphasised by the external expert Professor Levine, who states (at [65]) that the RBNZ "should evaluate the degree to which legal, regulatory, and tax systems are well-prepared for the emergence and expansion of non-bank forms of finance".

We draw your attention to recent empirical work (Buchak et al, 2018)[1] on exactly this point. We have not seen it referenced in the submissions on the RBNZ proposal or the external reviews and it is most relevant.

Buchak et al estimate that US shadow banks experienced a near doubling of market share in mortgage lending from 2007 to 2015, and that some 60% of this growth is explained by increased regulation of traditional banks (including stricter capital requirements). Approximately 30% was explained by improved and disruptive lending technology (with the balance coming from other sources). The RBNZ proposal is an impost on New Zealand registered banks that will, as we have argued in our report, not increase competition among registered banks but will increase competition between registered and shadow banks. This is an issue that is not necessarily "solved" by additional regulation of shadow banks, for regulation has a cost that is likely to include inhibiting welfare-enhancing competition from new technology, for example.

When this empirical evidence is conjoined with the evidence that it is shadow banks – not registered banks – that have a history of failures in New Zealand, we consider that the point should be taken most seriously. In saying so, we recognise that the externalities that arise from the failure of shadow banks relate more from loss of deposits than from disruption to payments systems; and that both

[1] Greg Buchak, Gregor Matvos, Tomasz Piskorski, and Amit Seru (2018), "Fintech, regulatory arbitrage, and the rise of shadow banks", *Journal of Financial Economics*, 130(3), 453-483.

effects would be present with the failure of critical registered banks. The RBNZ proposal discussion treats these externalities jointly.

We wish you well in your deliberation. We intend to publish this letter on the NERA website, www.nera.com.

Yours sincerely

Kevin Counsell, Prof. Lewis Evans, James Mellsop

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