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Economic Policy Centre

Pensions and Intergenerational Equity

PIE Commentary

When will we ever learn?

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PIE highlights intergenerational equity issues and welcomes the attention to how we pay for social goods provision at local and national levels in New Zealand. We are very aware of outright frauds and con artists who can cause much pain to those with money to invest, but there are many pitfalls for the unwary in our established financial system as history teaches us. We republish this opinion piece about the danger of shadow banking by Susan St John Hon Associate Professor of Economics, University of Auckland with acknowledgement to the Daily Blog.[2]

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When will we ever learn?

Worrying signs of the recession are all around for those who look. Martyn Bradbury wrote last week about how *"Kiwis are spending more on their credit cards to keep up with the rising cost of living"*

As well, suggesting a repeat of history, the signs are again emerging of third tier lending:

> *Homeowners at risk of having their properties repossessed by their lender are turning to third-tier finance companies to avert a mortgagee sale, OneRoof has been told.*

[1] PIE Commentaries are opinion pieces published as contributions to public debate, and do not necessarily reflect the view of the Pensions and Intergenerational Equity Hub.
[2] see St John, S (2023), When will we ever learn? Daily Blog 31th July 2023

Mortgage adviser Jonathan Battersby, whose company, SOS Non-Bank, specialises in finding private lending solutions for clients who have been refused finance by the banks, has noticed a big uptick in inquiries from stressed homeowners.

Here's how it goes: rising interest rates and recessionary forces catch out the over-leveraged who can't service their mortgages; the banks become more choosey as to who can borrow as credit risks increase; those turned away by the official banks turn to the 'non-banks'.

In the meantime, depositors at the banks try to protect themselves from inflation but find the return after tax on their term deposits woeful. Clever marketing by finance companies lure Mum and Dad depositors with promises of marginally higher rates that under-play the risks. A finance company gives the investor an IOU which is not itself money in exchange the ownership of their bank deposit.

In the process known as shadow banking, finance companies or 'non-banks' then on-lend these deposits at high interest rates to the overleveraged, desperate homeowners.

The numbers of outstanding IOUs held by Mum and Dad investors as well as hard-pressed property developers grow rapidly as shadow banking takes off in a fragile housing market. Inevitably depositors try to get their money back. For a while they can be serviced as finance companies attract new deposits to repay loans. But when the source of new deposits dries up and finance companies have to call in loans, bankruptcy and defaults may rapidly take hold.

Investors discover their IOUs are not real money at all and are next to valueless.

After the last explosion in shadow banking 2006-2012, 67 finance companies went under, with losses for investors of over $3 billion, including the well-known and trusted names of South Canterbury Finance, Hanover Finance and Bridgecorp Holdings

Recall the voiceover of Richard Long at news time on TV even when the company was actually in trouble? "You can't rely on the weather but you can rely on Hanover Finance."

***Hanover Finance** was a New Zealand non-bank finance company that focused on lending for high-risk property development that failed in 2010 under the leadership of Mark Hotchin.*

Following this collapse, there were wide changes made to regulations of finance companies. There is now a list of registered finance companies with Reserve Bank oversight. And, it was announced last week, that by 1 March 2025 about 100 registered banks, licensed insurers, and licensed non-bank deposit takers such as credit unions, will need to be licensed by the Financial Markets Authority (FMA)

…the Financial Markets Authority (FMA) –will begin accepting licensing applications for financial institution licenses under the Conduct of

> *Financial Institutions (CoFI) regime….which comes into force on March 31 2025, requires these institutions to put fair treatment at the heart of their business. Each institution must treat consumers fairly – the "fair conduct principle" – through the requirement to establish, maintain and implement a fair conduct programme. They must take all reasonable steps to comply with the programme and with regulations that ban target-based sales incentives and regulate other types of incentives.*

Will the 'fair conduct principle' in 2025 really prevent another debacle emerging with the shadow banking sector?

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