TE TAI ŌHANGA
THE TREASURY

Reference: 20220263

05 October 2022

[redacted]

Dear [redacted]

Thank you for your Official Information Act request, received on 13 July 2022. You requested the following:

> *I would like to request copies of documents which relate to reforms to prudential regulation introduced in the Reserve Bank of New Zealand Act 2008. In particular, I would like to obtain any terms of reference, reports to Ministers and others, cabinet decisions and public consultation papers which relate to the regulatory framework for prudential regulation of banks and non-bank institutions in the period 2004 to 2008.*

This request was transferred to the Treasury from the Ministry of Business, Innovation and Employment (MBIE) and was extended for 35 working days.

Information being released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	22 August 2006	Cabinet paper – EDC (06) 92 – Review of Financial Products and Providers: Discussion Papers	Release in full
2.	22 August 2006	Cabinet paper – EDC (06) 87 – Review of Financial Products and Providers: Release of Discussion Papers	Release in part
3.	23 August 2006	EDC Min (06) 13/7 – Review of Financial Products and Providers: Release of Discussion Papers	Release in part
4.	September 2006	Discussion paper – Review of Financial Products and Providers: Non-Bank Deposit-Takers	Release in full

1 The Terrace
PO Box 3724
Wellington 6140
New Zealand
tel. +64-4-472-2733

https://treasury.govt.nz

5.	September 2006	Excerpt of discussion paper – Review of Financial Products and Providers: Supervision of Issuers	Release in full
6.	12 June 2007	Cabinet paper – EDC (07) 89 – Review of Financial Products and Providers and Financial Intermediaries – Overview Paper	Release in part
7.	13 June 2007	EDC Min (07) 11/11 – Review of Financial Products and Providers and Financial Intermediaries – Overview Paper	Release in part
8.	13 June 2007	EDC Min (07) 11/15 – Review of Financial Products and Providers and Financial Intermediaries: Regulation of Non-Bank Deposit Takers	Release in part
9.	15 June 2007	Cabinet paper – CAB (07) 249 – Review of Financial Products and Providers and Financial Intermediaries: Regulation of Non-Bank Deposit Takers	Release in part
10.	18 June 2007	CAB Min (07) 21/10 – Review of Financial Products and Providers and Financial Intermediaries: Regulation of Non-Bank Deposit Takers	Release in part
11.	4 September 2007	Cabinet paper – EDC (07) 160 – Review of Financial Products and Providers: Regulation of Non-Bank Deposit-Takers – Further Details	Release in part
12.	5 September 2007	EDC Min (07) 19/1 – Review of Financial Products and Providers: Regulation of Non-Bank Deposit-Takers – Further Details	Release in part
13.	8 November 2007	LEG Min (07) 23/1 – Reserve Bank of New Zealand Amendment Bill: Approval for Introduction	Release in part

I have decided to release the relevant parts of the documents listed above, subject to information being withheld under the following sections of the Official Information Act, as applicable:

- Section 9(2)(k) – to prevent the disclosure of information for improper gain or improper advantage.

Direct dial phone numbers of officials have been redacted under section 9(2)(k) in order to reduce the possibility of staff being exposed to phishing and other scams. This is because information released under the OIA may end up in the public domain, for example, on websites including the Treasury's website.

Please note that information deemed out of scope has also been removed.

Information publicly available

The following information is also covered by your request and is publicly available on the Treasury's website:

Item	Date	Document Description	Website Address
1.	13 June 2007	Cabinet paper: Institutional Arrangements for Prudential Regulation	www.treasury.govt.nz/sites/default/files/2007-10/edcmem-13jun07.pdf

Accordingly, I have refused your request for the documents listed in the above table under section 18(d) of the Official Information Act as the information requested is publicly available.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This reply addresses the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Mary Llewellyn-Fowler
Acting Manager, Financial Markets

20220263 TOIA Binder
Table Of Contents

55/MED

Cabinet Economic Development Committee

EDC (06) 92

22 August 2006

Copy No: 27

Title

Review of Financial Products and Providers: Discussion Papers

This paper should be read in conjunction with the covering paper for this item distributed separately under EDC (06) 87.

Attached for Ministers' consideration are the following discussion papers:

- Review of Financial Products and Providers: Overview of the Review and Registration of Financial Institutions;
- Review of Financial Products and Providers: Securities Offerings;
- Review of Financial Products and Providers: Supervision of Issuers;
- Review of Financial Products and Providers: Collective Investment Schemes;
- Review of Financial Products and Providers: Non-Bank Deposit-Takers;
- Review of Financial Products and Providers: Insurance;
- Review of Financial Products and Providers: Mutuals' Governance;
- Review of Financial Products and Providers: ; Consumer Dispute Resolution and Redress
- Review of Financial Products and Providers: Platforms and Portfolio Management Services;

An overview paper seeking approval for the release of the discussion papers is under EDC (06) 87.

Gerrard Carter
for Secretary of the Cabinet

Copies to:
Cabinet Economic Development Committee
31 Chief Executive, DPMC
32 Rosemary Cook, DPMC
33-34 Secretary to the Treasury
35 Geoff Dangerfield, Ministry of Economic Development
36 Minister of Justice
37 Secretary for Justice
38 Chief Executive, Ministry of Social Development
39 Chief Executive, Ministry of Economic Development (Commerce)
40 Head, Ministry of Consumer Affairs
41 Minister of Revenue
42 Commissioner of Inland Revenue
45 Reserve Bank

55/HE1

Cabinet Economic Development Committee

EDC (06) 87

22 August 2006

Copy No: 27

Title

Review of Financial Products and Providers: Release of Discussion Papers

Purpose

This paper seeks approval for the release of nine discussion documents relating to the Review of Financial Products and Providers (RFPP).

Executive summaries of the discussion papers are attached to this paper. Copies of the full discussion papers have been distributed separately under EDC (06) 92.

Previous Consideration

None indicated.

Summary

The RFPP, which commenced in March 2005, is a cross-agency review being led by MED, in conjunction with the Reserve Bank, Treasury, Securities Commission, Justice, and Consumer Affairs. It covers the regulation of insurance, superannuation, collective investment schemes, platforms and portfolio management services, non-bank financial institutions, the offerings of securities, mutuals' corporate governance, and consumer dispute resolution and redress in the financial sector.

The RFPP is seeking to develop an effective and consistent framework for the regulation of non-bank financial institutions and financial products which promotes confidence and participation in financial markets by investors and institutions, and results in a sound and efficient financial sector.

Specific drivers for reform and problems identified are discussed for each discussion document on pages 6-16. Executive summaries of the nine discussion documents are attached. Copies of the full discussion papers have been distributed separately under EDC (06) 92.

Once submissions on the discussion documents have been received, decisions on proposals for reform arising from the review will be submitted for approval in April 2007.

The paper also outlines other reviews being undertaken in the financial sector, and seeks agreement to defer until April 2007 a report to the

Cabinet Economic Development Committee on the Review of Domestic Institutional Arrangements for Financial Sector Regulation, as that review is affected by the findings of the RFPP.

Baseline Implications	None from this paper.
Legislative Implications	None from this paper. Legislation to implement the decisions on the proposals will be drafted in 2007.
Timing Issues	None indicated.
Announcement	The discussion documents will be released at the beginning of September 2006 for a consultation period of three months. A press release will be issued public announcing the release of the documents. The documents will be sent to interested stakeholders, and will be made available on the MED web-site. Officials will meet with stakeholders to discuss the proposals and to seek specific feedback.
Consultation	Treasury, Reserve Bank, Consumer Affairs, and the Securities Commission assisted in writing the discussion documents, and were consulted on this paper. Justice was consulted on the discussion documents and this paper. DPMC, IRD and MSD were consulted on the discussion documents. Advisory groups consisting of representatives of key industry organisations, industry participants, professional organisations and government agencies assisted in developing the options in the discussion documents. The Minister of Commerce indicates that the government caucuses will be consulted and that consultation is not required with other parties represented in Parliament.

The Minister of Commerce recommends that the Committee:

1 note that the discussion documents attached to the paper under EDC (06) 92 containing proposals for reform follow from an initial problem identification process and have been developed with input from stakeholder advisory groups;

2 note that the Minister of Commerce intends to release the following discussion documents attached to the paper under EDC (06) 92 for the Review of Financial Products and Providers (RFPP):

2.1 Review of Financial Products and Providers: Overview of the Review and Registration of Financial Institutions;

2.2 Review of Financial Products and Providers: Securities Offerings;

2.3 Review of Financial Products and Providers: Supervision of Issuers;

2.4 Review of Financial Products and Providers: Collective Investment Schemes;

2.5 Review of Financial Products and Providers: Non-Bank Deposit-Takers;

2.6 Review of Financial Products and Providers: Insurance;

2.7 Review of Financial Products and Providers: Mutuals' Governance;

2.8 Review of Financial Products and Providers: Consumer Dispute Resolution and Redress;

2.9 Review of Financial Products and Providers: Platforms and Portfolio Management Services;

3 invite the Minister of Commerce to submit a further paper to the Cabinet Economic Development Committee by April 2007 seeking approval for policy decisions on the RFPP;

4 note that, in December 2005, Cabinet:

4.1 directed the interdepartmental working group (Chair, Treasury) to report to the Cabinet Economic Development Committee on detailed institutional arrangements for the prudential regulator by 30 November 2006;

4.2 noted that final decisions on institutional arrangements will be dependent on the report referred to in paragraph 4.1 and on final proposals relating to additional prudential regulation which will be presented to Cabinet as part of a report on the Review of Financial Products and Providers in November 2006;

[CBC Min (05) 18/28]

5 note that the report referred to in paragraph 4.2 is contingent in part on the report date of the RFPP;

6 agree to defer the report to the Cabinet Economic Development Committee referred to in paragraph 4.2 on the Review of Domestic Institutional Arrangements until April 2007;

7 note that the Minister of Commerce indicates that the government caucuses will be consulted and that consultation is not required with other parties represented in Parliament.

Gerrard Carter
for Secretary of the Cabinet

EDC (06) 87

Copies to:

Cabinet Economic Development Committee
31 Chief Executive, DPMC
32 Rosemary Cook, DPMC
34 - 33 Secretary to the Treasury
35 Geoff Dangerfield, Ministry of Economic Development
36 Minister of Justice
37 Secretary for Justice
38 Chief Executive, Ministry of Social Development
39 Chief Executive, Ministry of Economic Development (Commerce)
40 Head, Ministry of Consumer Affairs
41 Minister of Revenue
42 Commissioner of Inland Revenue
47. Reserve Bank

OFFICE OF THE MINISTER OF COMMERCE

The Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS: RELEASE OF DISCUSSION PAPERS

PROPOSAL

1 I am seeking the Committee's agreement to the release by the Ministry of Economic Development (MED) of the following discussion papers relating to the Review of Financial Products and Providers (RFPP):

- Review of Financial Products and Providers: Overview of the Review and Registration of Financial Institutions;
- Review of Financial Products and Providers: Securities Offerings;
- Review of Financial Products and Providers: Supervision of Issuers;
- Review of Financial Products and Providers: Collective Investment Schemes;
- Review of Financial Products and Providers: Non-Bank Deposit-Takers;
- Review of Financial Products and Providers: Insurance;
- Review of Financial Products and Providers: Mutuals' Governance
- Review of Financial Products and Providers: Consumer Dispute Resolution and Redress;
- Review of Financial Products and Providers: Platforms and Portfolio Management Services

EXECUTIVE SUMMARY

2 The RFPP covers the regulation of insurance, superannuation, collective investment schemes, platforms[1] and portfolio management services, non-bank financial institutions, the offerings of securities, mutuals' corporate governance and consumer dispute resolution and redress in the financial sector. The RFPP is a cross-agency review being led by the Ministry of Economic Development, in conjunction with the Reserve Bank, the Treasury, the Securities Commission, the Ministry of Justice and the Ministry of Consumer Affairs.

3 The review represents that fourth and final part of the government's reform programme for the financial sector which has been operating since 1999 and has been designed to create an environment where domestic and overseas investors

[1] A platform is a computerised administration service which is designed to hold, trade and report on investments.

and market participants can operate with confidence. Previous parts of the reform programme included: the Takeovers Code, the demutualisation of the stock exchange and exchange supervision, changes to improve securities trading law, a continuous disclosure regime and enhanced powers and functions for the Securities Commission.

4 The RFPP commenced in March 2005 and has already had significant industry input into the problem identification and (through a number of advisory groups) the options for reform outlined in the attached discussion documents. The purpose of releasing the attached discussion documents is to test proposals with a wider audience to ensure that everyone in the market has the opportunity to contribute to the review.

5 There are a number of reasons why the review is necessary and why it is being undertaken now. At a general level, there is a myriad of legislation in the non-bank financial sector that has been developed at different times with confusing or conflicting objectives. This creates the potential for gaps in coverage, inconsistencies in the regulatory treatment of similar products and regulatory arbitrage. It also leads to unnecessary compliance costs and inefficient regulation that impedes business innovation. In some areas there are also concerns about inadequate consumer protections (for example, issues with governance and accountability), the overall effectiveness of the regulation in achieving its objectives and that New Zealand is failing to comply not only with international principles but also international agreements. For these reasons, many of the proposals in the attached discussion documents are supported by businesses and consumer groups alike.

6 The review is seeking to develop an effective and consistent framework for the regulation of non-bank financial institutions and financial products that promotes confidence and participation in financial markets by investors and institutions and results in a sound and efficient financial sector.

7 The proposals in the documents relating to application and disclosure; trustee supervision; collective investment schemes and superannuation; and mutuals' governance; are generally designed to consolidate and simplify current regulatory requirements to make regimes more effective and in some areas to reduce costs on business.

8 The proposals for change for non-bank financial institutions, registration, consumer redress and insurance are either substantive or create relatively new regimes. The insurance paper seeks to build on the base of current industry self-regulation to develop a credible regime that effectively addresses risks posed by insurance companies while not imposing unnecessary costs on those companies. The non-bank deposit takers paper creates a new opt-in regime for some financial institutions which comply with prudential requirements similar to banks and would be regulated by the prudential regulator, which Cabinet has agreed in principle would be the Reserve Bank. The overview/registration paper proposes a new registration regime for financial institutions to identify providers of financial services and assist with monitoring, accessibility of information for market participants and compliance with international obligations. The consumer dispute resolutions and redress paper proposes some options for ensuring more effective access to consumer redress in the financial sector.

9 As stated above, many of the proposals in the papers are supported and developed in conjunction with the financial sector and there are limited risks in their release. However, as with any review of this size, some areas will get a negative reaction from some stakeholder groups. Consistent with the Review of Regulatory Frameworks the documents have made every endeavour to ensure that any proposals which impose costs are proportionate to the risks posed and do not impose unnecessary burdens on business. Feedback is being sought through the discussion documents on the actual costs of the proposals and how objectives of the regime can be met in the most cost-effective way. The stakeholder advisory groups for the review have also been useful in assisting officials in identifying the costs and impacts of proposals and how best to achieve the objectives without imposing unnecessary costs.

10 The paper seeks agreement for the discussion documents to be released at the beginning of September 2006 for a consultation period of three months. I intend to seek Cabinet decisions on proposals for reform arising out of the review in April 2007. The legislation to implement these decisions will be drafted in 2007, with the intention of introducing the legislation into the House in late 2007/early 2008.

BACKGROUND: PROCESS FOR THE REVIEW

11 The RFPP considers the regulation of insurance (health, life and general), superannuation, collective investment schemes, platforms and portfolio management services, non-bank financial institutions (friendly societies, credit unions, building societies, finance companies, industrial and provident societies), and the offering of securities. It also covers mutuals' corporate governance and consumer redress in the financial sector.

12 The review began in March 2005 with a problem identification stage. Problem identification was undertaken in conjunction with market participants, consumer groups, and self-regulatory organisations. Phase One of the review was agreed by Ministers in July 2005 and resulted in:

- the development of a framework for the RFPP which included: The outcomes the government wanted to obtain from the non-bank financial sector, the reasons for government intervention in the sector and objectives of any regulatory regime;
- an assessment of the current regulatory regime for the non-bank financial sector against the framework for the RFPP, including identifying any problems; and
- some general directions for reform of the non-bank financial sector.

13 The second stage of the review has been the development of options for reform. These were developed in conjunction with advisory groups based in Auckland and Wellington made up of people from key industry organisations, industry participants, professional organisations and government bodies. The advisory groups provided industry expertise and knowledge to inform options development, the costs and benefits of various proposals and implementation. This work has fed into the next stage of the review, which is the release of the attached discussion documents.

14 As there was involvement by stakeholders in both the problem identification and the development of options for reform, many of the discussion papers represent fairly detailed regulatory proposals which already have a substantial degree of stakeholder input and buy-in. The purpose of the release of the discussion documents is to ensure that there is consultation with a wider audience on the proposals developed.

COMMENT

Why the review is needed and why it is being undertaken now

15 The key objective for the RFPP is to develop an effective and consistent framework for the regulation of non-bank financial institutions, and financial products that promotes confidence and participation in financial markets by investors and institutions, and results in a sound and efficient financial sector.

16 The problem definition work on the RFPP undertaken last year concluded that the objectives behind regulation of the non-bank financial sector in many areas were fundamentally sound, however, there is a range of areas where the regulation could be improved in order to meet the objectives of the Review. The general drivers for the review are:

- There is a myriad of different pieces of legislation in the non-bank financial sector that has been developed in different decades and sometimes different centuries, with confusing or conflicting objectives. This has led to gaps in coverage of the regulation, inconsistencies in the regulatory treatment of similar financial products and consequent regulatory arbitrage.

- Some unnecessary compliance costs are being imposed on business and inefficiencies or inflexibility in the regulation has the potential to impede business innovation. In particular, some of the legislation is very out-dated (in the case of insurance around 100 years old), which has resulted not only in costs but also regimes which are not appropriate for current New Zealand conditions.

- In some areas there are concerns about inadequate consumer protections and the overall effectiveness of the regulation in achieving its objectives (for example, in some areas governance, accountability or supervision could be enhanced).

- Out of scope

- For all of the reasons above there is wide industry consensus and drive for the need for change to the regulatory regime in a number of areas.

17 More specific drivers for reform and problems identified are discussed under each of the documents below.

18 The Review considers all of the non-bank financial products and providers together so that any new regulatory regime developed will avoid the problems identified above of inconsistencies, gaps, and regulatory arbitrage, which can occur when parts are considered in a piece-meal fashion and in isolation, as has been done in the past.

The Discussion Documents

General Comment

19 Under the Review of Regulatory Frameworks, the government is focusing on the removal of unnecessary regulatory constraints on economic growth as well as the continuous quality improvement of regulatory frameworks and processes. An important component of this is ensuring a quality process in regulatory design. The RFPP meets all of these objectives. It is intended that the review:

- removes unnecessary costs on business and makes the regulatory regime more flexible in some areas;
- makes regulation more transparent and effective;
- ensures that where it imposes costs on business that they be proportionate to the risks posed and do not impose unnecessary burdens on business;
- leads to regulatory design which is responsive to business, based on sound analysis and actually achieves our objective of encouraging investment in New Zealand's financial markets by promoting a sound and efficient financial system in which the public has confidence; and
- achieve the above goals more effectively through consulting with business and consumer groups early in the process on both the problem identification and options development.

20 The documents propose a range of regulatory measures to address issues raised. The documents attempt to leverage off industry standards and practice where possible by proposing options for public/private supervision and legislative backing for self-regulation.

21 The papers have also taken into account trans-Tasman coordination in the design of the proposals. In some areas it has been less relevant (for example, where institutions are not operating on a trans-Tasman basis). In other areas, proposals are directed at achieving similar regulatory outcomes to those in Australia, but using slightly different regulatory frameworks. Some proposals suggest co-ordinated regulation and supervision where appropriate or the provision of exemptions from some requirements for Australian subsidiaries and branches in recognition of the quality of the Australian regime or to reduce costs for those operating trans-Tasman.

22 Many of the proposals in the papers would also bring New Zealand closer in line with international principles, in particular the International Organisation of Securities Commissions' principles, and the International Association of Insurance Supervisors' principles. They also ensure that New Zealand complies

with international obligations it is a signatory to, in particular, the Financial Action Task Force Recommendations on Anti-Money Laundering and Countering the Financing of Terrorism (FATF Recommendations). Any movement towards international principles has only been proposed where this is also appropriate for NZ conditions.

23 There are 9 documents that I am seeking agreement to release. Outlined below for each document is the need for reform, key proposals and comments/risks likely in release. These are entitled: Overview of the Review and Registration of Financial Institutions, Insurance, Supervision of Issuers, Consumer Dispute Resolution and Redress, Non-Bank Deposit Takers, Collective Investment Schemes, Mutuals' Governance, Securities Offerings, Platforms and Portfolio Management Services.

Out of scope

Pages 7-10 of this document contain information outside the scope of your request and so have been removed

Out of scope

Non-Bank Deposit Takers (NBDTs)

53 This discussion document puts forward the proposition that there is a separate category of financial institution (Non-Bank Deposit Takers) which are in the business of borrowing money from the public to lend to others, are different from other debt issuers and whose consumers need more protections. This category would include entities like finance companies, credit unions, and building societies.

54 The particular characteristics of deposit-takers that require a higher level of supervision include:

- Deposit-takers hold assets across a wide range of borrowers, whereas other debt issuers generally invest within the same company or a group of related companies. It is therefore more difficult for depositors to understand the level of risk associated with their deposits than in the case of investing funds with a debt-issuer that lends only to itself or a group of related companies.
- Deposit-takers generally issue relatively short-term deposits that investors are more inclined to rely on for transaction or near-term purposes than in the case of other debt securities.
- Deposit-takers tend to be highly geared relative to most other forms of debt issuers.
- There is a potentially substantial level of contagion risk with deposit-takers, both because of their funding nature and because they tend to be viewed as like entities.

55 The discussion document proposes that there be two tiers of NBDTs:

- Tier One (Opt-In): Authorised Deposit Takers (ADTs): Any deposit-taker could elect to become an ADT provided that they meet the licensing and ongoing supervisory requirements imposed by the prudential supervisor – proposed to be the Reserve Bank (the current supervisor of registered banks). These requirements would include a minimum level of capital, a minimum capital adequacy ratio, a minimum credit rating, a limit of related party exposures, and some governance and disclosure requirements.
- Tier Two Deposit Takers (Enhanced Trustee Model): these entities would come under the improvements above for other issuers (i.e. enhanced disclosure, trustee/Securities Commission supervision model, enhanced trust deeds) and would be regulated by the Securities Commission and trustees. It is proposed that they may also have to meet other requirements proposed in the discussion document (i.e. a minimum capital requirement, possibly a mandatory credit rating, enhanced disclosure, capital adequacy measurement framework, more fit and proper person requirements). They would be required to disclose prominently that they are not an ADT.

56 It is proposed that credit unions and building societies would also be regulated by the prudential regulator as a special class of financial institution. This reflects a view that it would be more efficient for credit unions and building societies to be regulated by the prudential regulator in order to ensure consistency of regulatory approach and because, for reasons of scale, it may not be commercially viable for trustees to supervise these entities if some become ADTs. Consistent with agreement with industry, credit unions would still given be given the option of keeping restrictions/remaining small or having their restrictions removed and transitioning to the ADT category.

57 The purpose of the two-tier regime is to provide a clear means of distinguishing between risks of institutions, without imposing unnecessary impediments to raising capital. It is intended that the proposed approach will assist in creating a clear differentiation between ADTs, that are all required to meet the same minimum standards and are supervised on a consistent basis, from other deposit takers. Given that ADTs would be required to meet a uniform set of

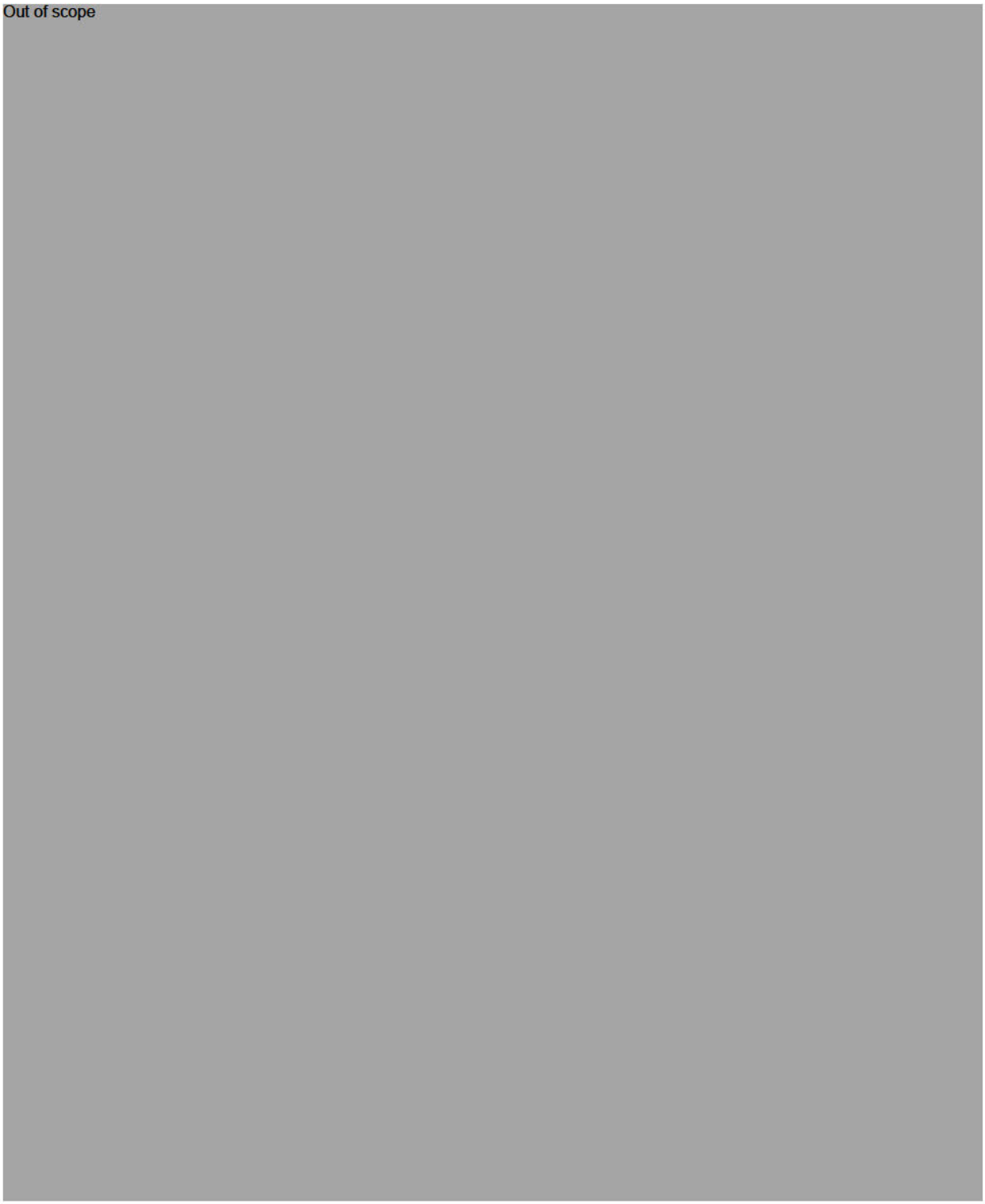
requirements similar to those for banks, and to be supervised on a fully consistent basis, the paper indicates that this can most effectively be done through one government agency, the prudential regulator (there is a Cabinet in principle agreement that this would be the Reserve Bank). This would facilitate a consistent approach and enable economies of scale and scope to be derived in the supervision process. It would also facilitate more effective management of distress in the ADT sector.

58 Many of the larger non-bank deposit takers will support this approach as a way of distinguishing themselves from what they perceive are higher risk institutions. Others in the industry will support the improvements to the Tier Two NBDT category (including potentially credit ratings and capital requirements)

59 On the other hand, there will be some in the market that oppose the Tier Two additional requirements as being unnecessary barriers to entry. In addition, some of the trustee corporations will lose some of their clients. They and others in the industry see the approach as providing greater confusion for investors as they predict that ADTs will move to within 20-30 basis points from banks, and market themselves as being close to banks which may in turn give consumers a misleading impression of the risks involved in these institutions and further mis-pricing of debt. As ADTs would be required to have credit ratings these will make the distinctions between ADTs and banks clear, however, financial education may also be needed.

Out of scope

Pages 14 and 15 of this document contain information that is outside the scope of your request and so have been removed



Links to other reviews

75 There are currently a number of different reviews being undertaken in the financial sector. Officials are endeavouring to ensure that these reviews are being coordinated, inter-linkages are being made, any outcomes are consistent and impacts or implementation issues relating to these reviews are aligned in order to impose the least costs on the sector.

Review of Domestic Institutional Arrangements

76 A review of Domestic Institutional Arrangements is being undertaken at the same time as the RFPP and aims to ensure that any regulatory framework developed will have skilled regulators with the appropriate powers and checks and balances to effectively implement, monitor and enforce the regime.

77 At the end of last year Cabinet agreed that there were not currently any significant coordination problems in the New Zealand market and that the costs of making large changes to the regulatory structures would outweigh any perceived benefits. Cabinet also agreed that there should be a dual regulator model like that used in Australia (i.e. a market conduct regulator and prudential regulator). In particular, that the Securities Commission maintain its role as the market conduct regulator and that there be one prudential regulator, and agreed in principle that this should be the Reserve Bank.

78 The review of domestic institutional arrangements is now looking at the governance and accountability provisions surrounding the Reserve Bank to ensure adequate checks and balances are in place to balance the new responsibilities the Reserve Bank will take on. The review of domestic institutional arrangements will also consider issues the Reserve Bank will face in taking on the new functions, such as how the functions will be funded and which agency should have responsibility for providing policy advice on prudential regulation.

Review of Financial Intermediaries

81 The Review of Financial Intermediaries also has many links with the RFPP. This work is currently progressing on a slightly quicker timeframe, because the work of the Financial Intermediaries Task Force has meant it has advanced further. Officials will, however, ensure that any links are made between the reviews, for example, between disclosure of financial intermediaries and disclosure in relation to financial products.

Timing of the release and the remainder of the review

82 It is proposed that the papers be released at the beginning of September for a consultation period of three months. This is to enable industry to have sufficient time to read, digest and respond to the papers.

83 Once feedback has been received on the discussion documents policy proposals will be developed for Cabinet consideration. I intend to seek Cabinet decisions on proposals for reform arising out of the review in April 2007. The legislation to implement these decisions will be drafted in 2007, with introduction of legislation anticipated in late 2007/early 2008.

84 As the work on Domestic Institutional Arrangements outlined above in paragraphs 75 to 78 is contingent in part on the design of the regulatory regime, the timeframe for this review will also need to be moved from the original date agreed with Cabinet of November 2006 to April 2007.

CONSULTATION

85 The options for reform proposed in the discussion papers were developed in conjunction with advisory groups made up of people from key industry organisations, industry participants, professional organisations and government bodies. Where possible, the advisory groups' views are reflected in the discussion documents. While there was consensus on many issues, not all members of the advisory groups agreed with all of the proposals in the discussion documents.

86 The following government agencies assisted in the writing of the discussion documents: The Treasury, the Reserve Bank, the Ministry of Consumer Affairs and the Securities Commission. In addition, the Department of Prime Minister and Cabinet, the Ministry of Justice, the Inland Revenue Department and Ministry of Social Development, were consulted on all or some of the content of the discussion documents.

87 The following government agencies were consulted on this Cabinet paper and agree with its recommendations: the Treasury, the Reserve Bank, the Ministry of Consumer Affairs, the Securities Commission, and the Ministry of Justice.

FISCAL IMPLICATIONS

88 There are no fiscal implications associated with the release of the discussion papers. The fiscal implications arising from any recommendations for reform arising out of the papers will be addressed at the time that policy recommendations are made to Cabinet.

HUMAN RIGHTS

89 There are no Human Rights implications arising from the release of the discussion documents.

LEGISLATIVE IMPLICATIONS

90 There are no legislative implications arising from the release of the discussion documents.

REGULATORY IMPACT AND COMPLIANCE COST STATEMENT

91 There are no regulatory impacts associated with the release of the discussion documents.

PUBLICITY

92 The release of the discussion documents will be publicly announced through a press release. Documents will also be sent to interested stakeholders and will be available on the MED website. After the release of the discussion documents, officials intend to meet with interested stakeholders to discuss the proposals in the paper and seek specific feedback on the issues raised.

RECOMMENDATIONS

93 It is recommended that the Committee:

1 **Note** that the attached discussion documents containing proposals for reform follow from an initial problem identification process and have been developed with input from stakeholder advisory groups;

2 **Agree** to the release by MED of the following attached discussion documents for the Review of Financial Products and Providers (RFPP) for a consultation period of three months:

2.1 Review of Financial Products and Providers: Overview of the Review and Registration of Financial Institutions;

2.2 Review of Financial Products and Providers: Insurance;

2.3 Review of Financial Products and Providers: Supervision of Issuers;

2.4 Review of Financial Products and Providers: Consumer Dispute Resolution and Redress;

2.5 Review of Financial Products and Providers: Non-Bank Deposit-Takers;

2.6 Review of Financial Products and Providers: Collective Investment Schemes;

2.7 Review of Financial Products and Providers: Mutuals' Governance

2.8 Review of Financial Products and Providers: Securities Offerings; and

2.9 Review of Financial Products and Providers: Platforms and Portfolio Management Services.

3 **Agree** that policy decisions on the RFPP be sought by April 2007 and legislation implementing the decisions be introduced in late 2007/early 2008.

4 **Agree** to rescind the previous Cabinet decision that the Review of Domestic Institutional Arrangements (CAB Min(05) 41/1 refers) be reported back to Cabinet in November 2006, as this review is contingent in part on the report back date of the Review of Financial Products and Providers; and

5 **Agree** that policy decisions on the Review of Domestic Institutional Arrangements be sought by April 2007.

s9(2)(k)

Hon Lianne Dalziel
Minister of Commerce

CAB 100/2002/1

Consultation on Cabinet and Cabinet Committee Submissions

Certification by Department

Departments consulted: The attached submission has implications for the following departments whose views have been sought and are accurately reflected in the submission:

The Treasury, the Reserve Bank, the Ministry of Justice

Departments informed: In addition, the following departments have an interest in the submission and have been informed:

The Department of Prime Minister + Cabinet

Others consulted: Other interested groups have been consulted as follows:

The Securities Comission has been consulted on the discussion papers + the Cabinet paper.
The Ministry of Social Development + Inland Revenue Department have been consulted on some aspects of the discussion papers.

Signature	Name: Title: Department:	Date
s9(2)(k)	Kirstie Hewlett, Manager, Ministry of Economic Development	14/08/2006

Certification by Minister

Ministers should be prepared to update and amplify the advice below when the submission is discussed at Cabinet/Cabinet committee. The attached submission:

Consultation at Ministerial level	☐ did not need consultation with other Ministers ☑ has been the subject of consultation with the Minister of Finance *[required for all submissions seeking new funding]* ☐ has been the subject of consultation with the following Minister(s)
Consultation with Government MPs	☐ does not need consultation with the government caucuses ☑ ~~has been~~ or **will be** *[specify which]* the subject of consultation with the following government caucuses: ☐ Labour caucus ☐ Progressive Coalition caucus
Consultation at Parliamentary level	☑ does not need consultation at parliamentary level ☐ **has been** or **will be** *[specify which]* the subject of consultation with the following other parties represented in Parliament:

s9(2)(k)	Portfolio	Date
	Commerce	14/8/06

Annex 1

Review of Financial Products and Providers: Executive Summaries of Discussion Documents

Pages 30-60 contains information that is outside the scope of your request and so have been removed

Non-Bank Deposit Takers

3. EXECUTIVE SUMMARY

3. The Non-Bank Deposit-Takers (NBDT) sector comprises financial institutions whose core business involves the borrowing of money from the public (mainly in the form of deposits or debentures – whether secured or unsecured), and the lending of money or provision of other financial services.

4. Although the NBDT sector is a relatively small part of the total financial system, it performs important functions and has been growing in market share over recent years. It is a significant channel for saving and investment and provides credit to a wide range of sectors in the New Zealand economy. It is therefore important that the NBDT sector is sound and efficient so it can make an effective contribution to economic performance and meet the needs of depositors and borrowers.

5. There are several reasons to justify regulation of the NBDT sector, including those listed below.

   - The information that potential depositors would need to compare the risk/return trade-off of deposits is complex and beyond the capacity of most to analyse. There is evidence of mispricing of risk in the NBDT sector, suggesting that returns offered to depositors may not adequately compensate them for the risks they are taking in some cases.

   - Information failures can lead to resource allocation inefficiencies in the market for deposits, which can contribute to instability in the NBDT sector.

   - Confidence in the deposit-taking sector is an important element in the sustained stability and vibrancy of that sector. Appropriate regulation can assist in underpinning that confidence.

   - There is a potential contagion risk in the NBDT sector, where the distress or failure in some NBDTs can spread to others. This risk can be lessened through appropriate regulation to address information asymmetry.

   - Significant problems in the NBDT sector could potentially weaken the reputation of the New Zealand financial sector.

6. The overall objective of regulating NBDTs should be to promote a sound and efficient financial system, with specific objectives being to:

   - Ensure that all NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs, and promote depositor confidence;

   - Provide depositors with a clearer basis for distinguishing between lower risk and higher risk NBDTs; and

   - Resolve NBDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.

7. Existing regulation of the NBDT sector does not adequately meet these objectives. There is no requirement for NBDTs to meet a consistent set of entry standards. Although trustees supervise NBDTs, there is a lack of consistency in supervisory

requirements and no substantive oversight of trustees in the performance of their duties. In some cases, there is a lack of sufficient prudential regulation. There are also inadequacies in the public disclosure requirements, leading to disclosures which are in many cases insufficiently comprehensive or timely, and not user-friendly. A lack of credit ratings from approved rating agencies means there is no simple way of assessing financial soundness and comparing the risk profiles of NBDTs.

8. This discussion paper proposes a strengthening of regulation across the NBDT sector. Some of this strengthening will come from proposed enhancements to the generic trustee supervisory framework for debt issuers (see *Supervision of Issuers* discussion paper for further information), while some will come from new requirements which are specific to the NBDT sector. The proposals involve enhancements to self discipline, market discipline, and supervisory discipline, while also seeking to preserve efficiencies. The proposals place emphasis on enhancements to governance and risk management processes, and on disclosure. This includes the possible introduction of a mandatory credit rating requirement. It is also proposed that licensing and supervision requirements will be strengthened for all NBDTs.

9. It is proposed that two tiers of NBDT will be created: Authorised Deposit-Takers (ADTs) and Other Depositor Takers (Tier 2 NBDTs).

10. The ADTs would be licensed and supervised by the Reserve Bank using a framework similar to that applied to registered banks. ADTs would have to meet minimum prudential requirements, including a minimum credit rating and capital adequacy requirements. Entry into the ADT category would generally be on a voluntary basis, provided that the deposit-taker could meet the requirements at entry and on an ongoing basis. The Reserve Bank would also have the capacity to require deposit-takers to become ADTs. This power could be used when the size or nature of a deposit-taker's business was such that the failure of the institution could pose a risk to the soundness of the financial system.

11. Deposit-takers that do not seek to be ADTs, or that cannot meet the requirements, would be supervised by trustees overseen by the Securities Commission. Existing generic trustee-based supervision would be strengthened in a number of ways (see *Supervision of Issuers* discussion paper for additional information). In addition there will be enhancements which will apply only to deposit takers that are not ADTs. These enhancements will include the implementation of minimum requirements in trust deeds, including a standard framework for measuring capital adequacy. An option being considered is to require all deposit-takers in this category to maintain and disclose a credit rating from an approved rating agency.

12. It is proposed that building societies and credit unions that do not become ADTs would be licensed and supervised by the Reserve Bank on terms similar to those applicable to ADTs, but modified to reflect the small size and mutual form of these entities.

55/ME
1117/EDC

Cabinet Economic Development Committee

EDC Min (06) 13/7

Minute of Decision

Copy Number: 23

Review of Financial Products and Providers: Release of Discussion Papers

On 23 August 2006, the Cabinet Economic Development Committee (EDC):

1 **noted** that the discussion documents attached to the paper under EDC (06) 92 containing proposals for reform follow from an initial problem identification process and have been developed with input from stakeholder advisory groups;

2 **noted** that the Minister of Commerce intends to release the following discussion documents attached to the paper under EDC (06) 92 for the Review of Financial Products and Providers (RFPP):

2.1 Review of Financial Products and Providers: Overview of the Review and Registration of Financial Institutions;

2.2 Review of Financial Products and Providers: Review of Securities Offerings;

2.3 Review of Financial Products and Providers: Supervision of Issuers;

2.4 Review of Financial Products and Providers: Collective Investment Schemes;

2.5 Review of Financial Products and Providers: Non-Bank Deposit-Takers;

2.6 Review of Financial Products and Providers: Insurance;

2.7 Review of Financial Products and Providers: Mutuals' Governance;

2.8 Review of Financial Products and Providers: Consumer Dispute Resolution and Redress;

2.9 Review of Financial Products and Providers: Platforms and Portfolio Management Services;

3 **invited** the Minister of Commerce to submit a further paper to EDC by April 2007 seeking approval for policy decisions on the RFPP;

4 **noted** that, in December 2005, Cabinet:

4.1 directed an interdepartmental working group (Chair, Treasury) to report to EDC on detailed institutional arrangements for the financial sector prudential regulator by 30 November 2006;

4.2 noted that final decisions on institutional arrangements will be dependent on the report referred to in paragraph 4.1 and on final proposals relating to additional prudential regulation which will be presented to Cabinet as part of a report on the Review of Financial Products and Providers in November 2006;

[CBC Min (05) 18/28]

5 **noted** that the report referred to in paragraph 4.2 is contingent in part on the report date of the RFPP;

6 **agreed** to defer the report to EDC referred to in paragraph 4 until April 2007;

7 **noted** that the Minister of Commerce indicates that the government caucuses will be consulted and that consultation is not required with other parties represented in Parliament.

s9(2)(k)

Gerrard Carter
Secretary

Reference: EDC (06) 87; EDC (06) 92

Present:
Hon Dr Michael Cullen (Chair)
Hon Jim Anderton
Hon Annette King
Hon Trevor Mallard
Hon Parekura Horomia
Hon Mark Burton
Hon Ruth Dyson
Hon David Benson-Pope
Hon Lianne Dalziel
Hon David Cunliffe
Hon David Parker
Hon Clayton Cosgrove
Hon Judith Tizard
Hon Harry Duynhoven

Officials present from:
Department of the Prime Minister and Cabinet
Treasury
Ministry of Economic Development

Copies to:
Cabinet Economic Development Committee
Chief Executive, DPMC
Rosemary Cook, DPMC
Secretary to the Treasury
Geoff Dangerfield, Ministry of Economic Development
Minister of Justice
Secretary for Justice
Chief Executive, Ministry of Social Development
Chief Executive, Ministry of Economic Development (Commerce)
Head, Ministry of Consumer Affairs
Minister of Revenue
Commissioner of Inland Revenue

Ministry of Economic Development

Manatū Ōhanga

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS:
NON-BANK DEPOSIT-TAKERS

Discussion Document

September 2006

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Regulatory and Competition Policy Branch
Ministry of Economic Development
PO Box 1473
Wellington
New Zealand
http://www.med.govt.nz

1. TABLE OF CONTENTS

2. INTRODUCTION

1. This discussion paper sets out proposed changes to the regulation of Non-Bank Deposit-Takers (NBDTs).

2. The Discussion paper has the following structure.

- Executive Summary.
- Section 4 sets out background information about NBDTs, the importance of their functions, the outcomes being sought in this sector, the reasons for regulatory intervention and the proposed regulatory objectives.
- Sections 5, 6 & 7 discusses the current regulatory arrangements for NBDTs and the problems associated with those arrangements, and sets out proposed licensing and supervision arrangements for NBDTs.
- Section 8 summarises the review of the Friendly Societies and Credit Unions Act and the implications of the NBDT reforms for the credit union reforms.
- Appendix 2 sets out the questions on which we are seeking comment.

3. EXECUTIVE SUMMARY

3. The Non-Bank Deposit-Takers (NBDT) sector comprises financial institutions whose core business involves the borrowing of money from the public (mainly in the form of deposits or debentures – whether secured or unsecured), and the lending of money or provision of other financial services.

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requirements and no substantive oversight of trustees in the performance of their duties. In some cases, there is a lack of sufficient prudential regulation. There are also inadequacies in the public disclosure requirements, leading to disclosures which are in many cases insufficiently comprehensive or timely, and not user-friendly. A lack of credit ratings from approved rating agencies means there is no simple way of assessing financial soundness and comparing the risk profiles of NBDTs.

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9. It is proposed that two tiers of NBDT will be created: Authorised Deposit-Takers (ADTs) and Other Depositor Takers (Tier 2 NBDTs).

10. The ADTs would be licensed and supervised by the Reserve Bank using a framework similar to that applied to registered banks. ADTs would have to meet minimum prudential requirements, including a minimum credit rating and capital adequacy requirements. Entry into the ADT category would generally be on a voluntary basis, provided that the deposit-taker could meet the requirements at entry and on an ongoing basis. The Reserve Bank would also have the capacity to require deposit-takers to become ADTs. This power could be used when the size or nature of a deposit-taker's business was such that the failure of the institution could pose a risk to the soundness of the financial system.

11. Deposit-takers that do not seek to be ADTs, or that cannot meet the requirements, would be supervised by trustees overseen by the Securities Commission. Existing generic trustee-based supervision would be strengthened in a number of ways (see *Supervision of Issuers* discussion paper for additional information). In addition there will be enhancements which will apply only to deposit takers that are not ADTs. These enhancements will include the implementation of minimum requirements in trust deeds, including a standard framework for measuring capital adequacy. An option being considered is to require all deposit-takers in this category to maintain and disclose a credit rating from an approved rating agency.

12. It is proposed that building societies and credit unions that do not become ADTs would be licensed and supervised by the Reserve Bank on terms similar to those applicable to ADTs, but modified to reflect the small size and mutual form of these entities.

4. BACKGROUND

4.1 FINDINGS IN REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS PAPER TO MINISTER OF COMMERCE – JULY 2005

13. In July 2005, the Ministry of Economic Development submitted a paper to the Minister of Commerce on the *Review of Financial Products and Providers* (RFPP). The paper set out the framework for reviewing financial sector regulation and provided preliminary comment on existing regulatory arrangements and possible areas for change.

14. The paper noted that NBDTs are not subject to a consistent set of licensing and supervision arrangements. Moreover, the objectives of existing regulation and supervision of NBDTs are unclear and insufficiently anchored to the outcomes being sought by government in this area. Although NBDTs are subject to prudential oversight by trustees under the Securities Act 1978, the prudential requirements in trust deeds and the standards of supervisory practices of trustees vary considerably.

15. The paper argued that, in order to maintain a sound and efficient financial system, in which depositors have confidence and which is resilient in times of stress, a more standardised, consistent and formalised licensing and prudential supervision regime for NBDTs should be explored.

4.2 WHAT IS THE NON-BANK DEPOSIT-TAKERS (NBDT) SECTOR IN NEW ZEALAND?

16. For the purpose of this Discussion Paper, the NBDT sector comprises financial institutions whose core business involves the borrowing of money from the public (mainly in the form of deposits or debentures – whether secured or unsecured), and the lending of money or provision of other financial services. The NBDT sector comprises a wide range of financial institutions in terms of functions, size, corporate form, ownership, and funding base. It currently comprises around 50 very small credit unions, 11 building societies, the PSIS, and around 70 finance companies that fund via deposits or debentures issued to the public (with most being of small to moderate size). Most NBDTs are domestically owned, but a few of the larger finance companies are owned by foreign banks or corporations.

17. The NBDT sector is currently a relatively small part of the financial system, holding around 7 percent of total financial system assets and around 16 percent of household deposits[1] as at 31 December 2005. However, the sector has been growing strongly in recent years, and its market share (relative to registered banks) has been steadily increasing. If that rate of growth continues over the next few years, the NBDT sector will become a relatively substantive part of the total financial system.

18. The NBDT sector performs important functions in the financial system. In particular, NBDTs are significant:

[1] Excluding household assets under management.

- Channels for retail savings;
- Providers of credit, including to niche sectors of the economy not as readily serviced by registered banks, particularly consumer finance, property sector finance, motor vehicle and industrial equipment finance, and finance to small and medium-sized enterprises; and
- In some cases, providers of transaction services – an increasing feature of some NBDTs.

19. The above functions are important elements in the financial system, given that they relate to the role of money as a store of value and medium of exchange, and to the intermediation of funds. To a significant extent, these functions distinguish NBDTs from other non-bank issuers of debt securities to the public, such as corporations issuing bonds or debentures to the public to finance their (non-financial) activities. In particular, the main distinguishing features between NBDTs, as discussed in this paper, and other non-bank debt issuers to the public, are those outlined below.

- NBDTs generally raise money via deposits or debentures and lend these funds to many different entities. This makes it difficult for depositors in NBDTs to assess the safety of their funds. In contrast, non-financial entities, such as industrial companies, that issue debt securities are doing so to fund their own operations.
- NBDTs are generally significantly more highly leveraged than other companies, making them potentially vulnerable to adverse events.
- NBDTs generally issue debt securities to specific investors (depositors) under their name and in a form that is not readily transferable on a secondary market. Depositors are therefore directly reliant on the NBDT in order to liquefy their deposits. Debentures or notes issued by non-financial corporations tend to be in a form that can be readily sold on a secondary market.
- The business of some NBDTs, like that of banks, involves a significant maturity mismatch between assets and liabilities, with a higher proportion of assets (loans) being of a longer term maturity than liabilities (mainly deposits or debentures). This gives rise to a potential liquidity risk which, in extreme circumstances, can create solvency pressures. It also creates a potential vulnerability to contagion between NBDTs if depositors lose confidence in the sector. The contagion risk is exacerbated by the "look-alike" nature of some NBDTs. These considerations are less problematic for non-financial entities that issue debt securities to the public.

20. In this discussion paper, the focus is therefore on the case for regulating NBDTs, and the proposed objectives and nature of NBDT regulation, as opposed to the regulation of other types of debt security issuers.

4.3 PROPOSED DEFINITION OF NON-BANK DEPOSIT-TAKERS (NBDT)

21. For the purpose of this paper, a broad definition of NBDT has been adopted. This definition is generally consistent with the definition of deposit-taker and deposit in many

countries with which New Zealand typically compares itself, such as the United Kingdom, Australia and Canada.

22. In this paper, NBDTs are defined as those entities (of any legal form) that offer debt securities to the public (as defined in the Securities Act 1978), where:

- The security is issued in the name of a person(s) or entity(ies);
- A sum of money is paid to the issuer on terms under which it will be repaid, with or without interest or a premium, either on demand or on a specific date;
- The security is not readily transferable;
- The security may be secured or senior unsecured;
- Repayment value is not contractually linked to the value of underlying assets;
- Payment or repayment is not referable to the provision of property (other than currency) or the provision of services; and
- The security is issued by an entity whose business involves the lending of money or the provision of financial services.

23. This definition would have the effect of including a wide range of NBDTs, including building societies, credit unions, the PSIS and those finance companies that issue debt securities to the public. It would exclude entities that lend money or provide other types of financial services, but which fund solely from non-public sources (i.e. wholesale markets or related parties). It would also exclude entities that fund by way of offering debt (or other) securities to the public, but where the entity is not in the business of lending money or providing financial services, such as industrial companies that raise funds through the issuance of bonds or debentures to the public.

24. There would be provision to exempt entities from the NBDT supervisory regime where the regulator considered that inclusion was not consistent with the purposes of the regime.

25. There are a number of advantages in adopting a broad definition of NBDT, as set out above, including those listed below.

- It captures the main elements of deposit-taking, without specifying institutional form. It is therefore consistent with the principle of applying a competitively neutral approach to regulation, based on the function of deposit-taking.
- It is broadly compatible with international convention, including, in most respects, Australian law.
- It captures the features of deposit-taking that, as discussed later in the paper, provide justification for the regulation of deposit-takers – such as:
  - the issuance of debt securities to non-expert investors who are not well placed to obtain or interpret complex information to understand the risks they are taking

- the debt securities are not readily transferable and hence liquidity relies on the issuer paying on demand (for on-call instruments) or on maturity
- the debt securities are issued by entities whose core functions are those of financial institutions, and which may give rise to public expectations of probity that do not apply to the same extent for other types of debt issuers.

26. The disadvantage of a broad approach to the definition of NBDT is that it would capture a wide range of financial institutions. This raises complications in the design of prudential supervision arrangements, given that the broader the supervisory net, the greater the potential efficiency costs are in imposing prudential regulation. This issue is considered in Sections 5, 6 & 7 of this paper.

Question for Submission

1. Do you agree with the proposed definition of NBDT? If not, please provide your reasons and any thoughts you may have on an alternative definition.

4.4 OUTCOMES SOUGHT

4.4.1 What Outcomes are Being Sought?

27. The overall outcomes being sought from the NBDT sector relate to the functions performed by NBDTs, as set out above, and their contribution to the wider economic and other policy objectives set by the Government. On this basis, the outcomes Government is seeking to achieve in the NBDT sector can be summarised as the promotion of:

- A sound and efficient financial system; and
- Confidence in the financial sector that encourages participation by providers and consumers.

28. A financial system can be said to be sound when all relevant risks in the financial system are adequately identified, priced, allocated and managed. These risks include credit risks, liquidity risks, market risks and operational risks. A sound financial system is resilient to economic and financial shocks when it can continue to perform its functions with minimum disruption in the face of a reasonable range of economic and financial shocks. This does not mean that individual financial institutions should be immune from failure or that investors and other participants should never lose money. Occasional institutional failures and losses by investors are inevitable and consistent with a sound financial system, provided that the system as a whole continues to function and that core services continue to be provided.

29. The Government seeks to promote a financial system that is efficient as well as sound. Efficiency has three main elements: productive efficiency (the capacity of the system to produce outputs); allocative efficiency (how well the system allocates funds, risks and services); and dynamic efficiency (the ability of the system to respond to change over time).

30. An important element of a sound and efficient system is public and financial market confidence in the system and its components. In this respect, confidence is a key *ingredient* in, and *outcome* from, a sound and efficient financial system.

Question for Submission:

2. Do you agree with the proposed outcomes being sought for regulatory intervention in the NBDT sector? Do you have suggestions for alternative outcomes for the NBDT sector?

4.5 REASONS FOR REGULATORY INTERVENTION

31. This section sets out the reasons why Government believes that some form of regulatory intervention is justified in the NBDT sector in order to achieve the desired outcomes. The analysis centres on the likely existence of *imperfect information* and of *externalities* in the sector.

32. The reasons cited below apply most particularly to the NBDT sector. To a much lesser degree, some of them also apply to the debt-issuance market generally. Please see the *Supervision of Issuers* discussion paper which covers proposed enhancements to the trustee framework more generally.

4.5.1 Imperfect Information

33. There is evidence of material information failure in the NBDT sector. In particular:

- ***Lack of comprehensive and timely information on NBDTs.*** Like all debt-issuers, NBDTs are required to issue prospectuses and investment statements. These contain a broad range of information on the financial position of the NBDT and its products. However, the information disclosed tends not to be sufficiently comprehensive, accessible, timely, or risk-focused to enable depositors (or their advisers) to effectively evaluate and compare NBDT risks.

- ***Complexity of information/difficulty of interpretation.*** Assessing the risk of a deposit in a NBDT involves the assimilation and understanding of complex information. Even if comprehensive and timely information were available, it is strongly arguable that retail depositors are unlikely to have the skills or knowledge to evaluate the risks they are taking. This is true for the NBDT sector to a much greater extent than for other debt-issuers, given the variety of financings and lendings undertaken by the typical NBDT.

- ***Search and transaction costs.*** It is costly for depositors to obtain reliable information on NBDTs. Although investment statements and prospectuses are readily available, other relevant information is much harder and more costly to locate – e.g. information on trust deeds, nature of trustee monitoring arrangements, etc. Investment advisers can assist in the risk assessment process and the proposed strengthening of the regulation of investment advisers will assist in enhancing this avenue for depositors. However, even investment advisers are unlikely to be well placed to meaningfully assess risks in NBDTs without some additional information.

- ***Mispricing.*** Although there is a spread of deposit interest rates across the NBDT sector, there is a significant clustering of interest rates even when risk profiles vary. Moreover, although the deposit interest rates offered by NBDTs are generally higher than those offered by banks, the margin above bank deposit rates is arguably narrower than it should be, given their risk profiles. Hence, there may be some basis to conclude that risks in the NBDT sector are not being adequately reflected in funding costs, and that depositors may be taking higher risks in some cases than the interest rate they receive would suggest.

- ***Contagion risk and public confidence.*** Lack of depositor understanding creates the potential for contagion risk. A period of acute distress in the NBDT sector could create a risk of contagion within the sector to the extent that depositors are unable to distinguish between sound and unsound NBDTs. In extreme situations, this could trigger distress or failure in essentially sound NBDTs, particularly if they are forced into asset sales at sub-market prices.

34. In summary, the above analysis suggests that information on NBDT risk is currently difficult for depositors to assess.

4.5.2 Externalities

35. The other main type of market failure that can be a justification for regulatory intervention is externalities. In the financial sector, externalities may include:

- ***Systemic instability.*** The failure of some financial institutions, particularly those which are large relative to the financial system, could have an adverse effect on the financial system and wider economy. The failure of such a financial institution could cause significant disruption to financial markets, payment systems, credit, liquidity and asset prices.

- ***International reputation.*** Episodes of severe financial instability, or protracted weakness in the financial system, can erode international confidence in the financial system, potentially leading to a higher-risk premium on funding, greater difficulty in accessing foreign capital markets and a higher propensity for destabilising shifts in investor sentiment.

36. We believe that the systemic instability reason for regulating financial institutions applies only weakly in relation to NBDTs, at least while individual NBDTs and the NBDT sector remain relatively small. The systemic instability argument for regulating NBDTs would become more compelling if NBDTs were to grow to become a substantial proportion of the financial system.

37. There may be an international reputation reason for ensuring appropriate regulation of the NBDT sector. Although foreign investors are likely to distinguish between NBDTs and banks, and hence not infer that NBDT sector instability implies instability in the broader financial system, there is the risk that instability in this sector could tarnish that of the financial system as a whole.

38. On balance, therefore, we believe that the only externality currently justifying regulation of the NBDT sector relates to the international reputation of the financial system.

4.5.3 Summary – Rationale for NBDT Regulation

39. The main elements of the rationale for regulatory intervention in the NBDT sector follow.

- The information that potential depositors would need to compare the risk/return trade-off of deposits is complex and beyond the capacity of most to analyse.
- Depositors may lack an awareness of the risks they are taking in placing funds with NBDTs. This may hinder the emergence of a market solution to the lack of information on NBDTs' risks, and exacerbate the difficulty depositors have in evaluating risks in the NBDT sector.
- Information failures lead to allocative inefficiencies in the market for deposits, which can contribute to instability in the NBDT sector and potentially broader financial instability.
- Confidence in the deposit-taking sector is an important element in the sustained stability and vibrancy of that sector. Appropriate regulation can assist in underpinning that confidence.
- There is a potential contagion risk in the NBDT sector. This risk can be lessened through appropriate regulation to address information asymmetry.
- Significant problems in the NBDT sector could potentially weaken the reputation of the New Zealand financial sector, particularly if the NBDT sector becomes a relatively substantial part of the financial system.

Question for Submission

3. Do you agree with the reasons for regulating NBDTs as set out in this discussion paper? We would be interested in hearing your perspectives on this issue, including any alternative views you might have on the reasons for regulating NBDTs.

4.6 OBJECTIVES OF REGULATION

40. The objectives for the regulation of NBDTs should address the reasons for regulation of NBDTs and anchor to the outcomes sought for the financial sector.

41. Based on the argumentation set out in this paper, the high-level objective of regulating and supervising NBDTs should appropriately be to promote a sound and efficient financial system, with specific objectives being to:

- Ensure that all NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs, and promote depositor confidence;
- Provide depositors with a clearer basis for distinguishing between lower-risk and higher-risk NBDTs; and
- Resolve NBDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.

42. These objectives are similar in substance to those applicable to the licensing and supervision of registered banks, as set out in the Reserve Bank of New Zealand Act 1989. They are also similar in most respects to the kinds of regulatory objectives for deposit-takers in other advanced economies, such as Australia and the United Kingdom, but with less explicit reference to depositor protection *per se*.

43. The proposed absence of an explicit depositor protection objective for NBDTs is consistent with the approach taken in the case of banking supervision in New Zealand. It reflects a desire to ensure that regulation does not create excessive moral hazard risks or unduly dilute market disciplines on NBDTs, and thereby weaken the incentives for strong governance and risk management practices in NBDTs.

44. The avoidance of a reference to depositor protection also reflects the view taken by Government that NBDT regulation, like other regulation in the financial sector, should not seek to eliminate risks for investors. This could occur either by attempting to eliminate the risk of institutional failure, or by insulating depositors from loss when a financial institution does fail. It would neither be feasible nor desirable to regulate NBDTs to eliminate the probability of institutional failure – to do so would seriously undermine the efficiency of the financial system and, weaken its ability to service the economy and society. Similarly, it would be undesirable to seek to insulate depositors from loss in the event of a NBDT failure, given that this would excessively weaken depositors' incentives to monitor and exert discipline on NBDTs.

45. An outline of the regulatory instruments available to meet these objectives is set out in Appendix 1.

Question for Submission:

4. What are your views on the proposed objectives for the regulation and supervision of NBDTs?

5. PROPOSED SUPERVISORY ARRANGEMENTS

5.1 INTRODUCTION

46. This section of the discussion paper sets out proposals for changes to the regulation of NBDTs. Please note that there are two elements to this: enhancements to the trustee regime more generally, which are set out in a separate discussion paper (*Supervision of Issuers*); and enhancements specifically for the NBDT sector. For the sake of completeness, this section includes both elements, with links to the other paper where relevant.

47. It begins with a summary of existing regulatory requirements in the NBDT sector and the problems with current arrangements. It then sets out proposed changes.

5.2 CURRENT REGULATORY REGIME

48. Under the existing regulatory arrangements, NBDTs are not required to be licensed to undertake the business of deposit-taking. NBDTs are registered under various statutes depending on what corporate form they take. For example, finance companies are registered under the Companies Act 1993, building societies are registered under the Building Societies Act 1965 and credit unions are registered under the Friendly Societies and Credit Unions Act 1982 (FSCU Act). The Companies Office performs the registration function in each case.

49. The registration function is not an equivalent to licensing – it does not involve fit and proper assessments, nor an assessment of whether the NBDT is "fit for purpose", or the application of minimum prudential requirements to NBDTs. Registration merely requires NBDTs to meet the requirements of the respective legal-form legislation, both at the time of registration and on an ongoing basis, and establishes some minimum governance requirements. Credit unions are an exception to this, given that the FSCU Act imposes prudential restrictions on credit unions and empowers the Registrar to perform some functions similar to those of a prudential supervisor.

50. Although NBDTs are not subject to a licensing requirement, they are subject to prudential supervision if they issue securities to the public (as defined in the Securities Act). Under the Securities Act, NBDTs, like other non-bank entities that issue debt securities to the public, are required to have a trust deed administered by a trustee (either a trustee corporation or a trustee authorised by the Securities Commission).

51. The Securities Act specifies some minimum requirements for trust deeds. However, most of the content of a trust deed is determined by negotiation between the trustee and the issuer, including the covenants contained in the trust deed and the powers and functions of the trustee. See *Supervision of Issuers* discussion paper for more detail of the enhancements proposed to the trustee regime. In the case of finance companies, the content of trust deeds and the nature of trustee monitoring vary considerably from company to company. This is also the case with the building societies, but to a lesser extent. In the case of credit unions, there is a greater degree of standardisation of trust deeds and trustee monitoring, with most credit unions adopting one of two standard formats for their trust deed.

52. Under the trust deed arrangements, there is no central authority overseeing NBDTs. Supervisory requirements and actions are therefore taken by each trustee on an individual basis, in much the same way as occurs with other non-bank issuers of debt securities. There is therefore no distinction between NBDTs and other non-bank debt security issuers.

53. NBDTs are required to comply with other requirements in the Securities Act, such as the requirements relating to prospectuses, investment statements and advertising. Again, there is no distinction in these arrangements between NBDTs and other issuers of debt securities to the public.

5.3 PROBLEMS IDENTIFIED

54. The current structure of regulatory arrangements for NBDTs has a number of deficiencies that impede the ability to achieve the desired outcomes and objectives set out in this discussion paper. In particular, the existing arrangements do not provide a sufficient or consistent basis for:

- Promoting sound governance and risk management in NBDTs, or underpinning public confidence in the NBDT sector;
- Providing depositors and others with a reliable means of distinguishing between lower and higher risk NBDTs and making well-informed risk/return decisions; or
- Responding promptly and effectively to emerging distress or deterioration in financial condition or dealing with sector-wide distress.

55. Some of these problems are inherent in the current trustee regime and are dealt with in *Supervision of Issuers* discussion paper.

56. The main problems with existing arrangements in relation to the NBDT sector are outlined below.

- There is no licensing requirement to be a deposit-taker. This means that NBDTs are not subject to assessment by a regulatory authority upon entry to the deposit-taking sector. Thus there is no fit and proper assessment of shareholders with significant influence or control over a NBDT, or of the directors and senior management of a NBDT. There is also no evaluation of a NBDT's risk management capacity and internal controls. This means there is a risk that a NBDT may be controlled or managed by persons with insufficient capacity to manage the NBDT in a sound manner, or by persons with significant conflicts of interest.
- There are no minimum requirements for ongoing supervision, including prudential requirements relating to capital, constraints on lending to related parties, limits on exposure concentration or standardised triggers for prompt corrective action. The absence of these requirements reduces the capacity to promote a minimum level of prudential soundness in the NBDT sector and creates a risk of excessive or non-commercial lending to related parties. It also weakens the capacity for a consistent approach to prompt corrective action in situations of emerging distress.

- There is an inconsistency in supervisory arrangements across the NBDT sector, both in terms of prudential requirements and supervisory practices. This creates a competitively non-neutral regulatory environment and gives rise to a potentially counter-productive regulatory arbitrage risk. It also makes it difficult for depositors and others to ascertain the reliability of the supervisory arrangements across the NBDT sector.

- As noted in the *Supervision of Issuers* discussion paper, there is currently insufficient scrutiny by a central regulatory authority of trustees in the performance of their role. This creates a risk of unsatisfactory supervisory practices and has the potential to weaken the accountability of trustees in the performance of their responsibilities.

- Disclosures made by NBDTs are not sufficiently comprehensive, frequent, timely or user-friendly to enable depositors and financial advisers to assess the financial strength of NBDTs and compare risk profiles of NBDTs. This impedes the ability of depositors to make well-informed risk/return decisions, and can lead to a misallocation of resources and inadequate risk management. Although prospectuses do contain considerable information on the financial position and performance of NBDTs, they do not always present key indicators in user-friendly formats readily accessible by non-expert investors. Moreover, there is no uniform measurement framework for the calculation and presentation of NBDTs' capital relative to their risk positions.

- Unlike in the case of some other parts of the financial system – such as registered banks and general insurance – there is no mandatory credit rating requirement in the NBDT sector. Some NBDTs have obtained ratings from internationally reputable rating agencies, but most have not. This reduces the ability of depositors and others to assess the financial strength of a NBDT or compare one NBDT with another. The use by NBDTs of ratings from domestic financial agencies has the potential to confuse, rather than inform, depositors and their advisers, given the inconsistency across different rating approaches and the questionable reliability of some rating systems. Thus current regulatory arrangements do not promote particularly effective market discipline on the NBDT sector, and have limited influence on risk management within NBDTs.

- Market discipline in the NBDT sector is also likely to be less effective than in the banking sector (for example), given the nature of the funding base of many NBDTs compared to registered banks. In the case of banks, wholesale creditors and other banks provide an effective channel for market discipline, with the capacity and incentives to exert discipline on banks through pricing and access to funding. Many NBDTs have little or no wholesale funding and limited funding from banks; most funding is from the retail sector. In the absence of a relatively simple metric, such as a credit rating, non-expert creditors have little capacity to exert discipline on NBDTs.

- The trustee-based supervision framework is arguably not well placed to deal with potential contagion situations within the NBDT sector, given the lack of a central supervisory authority with a sound overview of the NBDT sector as a whole and the capacity to respond to contagion situations (see *Supervision of Issuers* discussion paper).

Question for Submission

5. Do you agree with the problems identified with the existing regulatory framework for NBDTs, as assessed in this discussion paper? If not, please provide your views on this issue.

5.4 INTERNATIONAL PERSPECTIVE

57. The existing supervision arrangements for NBDTs in New Zealand are unusual by international standards. In most OECD countries, deposit-taking financial institutions are licensed and prudentially supervised on a broadly consistent basis by a central government agency.

58. Although the definitions of deposit-taking vary considerably from country to country, the core features of deposit-taking are similar to those defined earlier in this paper – in essence, most countries require an entity that raises deposits from the public, where deposit-taking is part of the provision of financial services, to be licensed and supervised by a central government agency.

59. Licensing and supervision requirements vary from country to country, but typically include a common set of features, generally similar to those applicable to banks:

- Licensing criteria, applied by the prudential supervision authority, and generally including fit and proper requirements applied to shareholders able to exercise significant influence or control over a deposit-taker, directors and senior management, general "fit for purpose" requirements (designed to ensure that deposit-takers can conduct their business prudently), and minimum entry capital requirements designed to ensure an acceptable level of shareholder commitment;

- Requirements relating to governance, often including board composition requirements (e.g. as to a minimum number of independent directors, non-executive chair of the board, etc), board committees and internal audit arrangements;

- Prudential requirements, often relating to minimum capital adequacy ratios, limits on exposure concentration, limits on lending to connected parties, guidelines or requirements for risk management systems and internal controls, and liquidity requirements. In many countries, the capital adequacy requirements are based on the Capital Accord promulgated by the Basel Committee on Banking Supervision;

- Off-site monitoring by the supervisory authority, covering a broad range of indicators, including an assessment of the NBDT's compliance with prudential and other regulatory requirements and a general assessment of its financial condition. Supervisory authorities generally maintain procedures for varying the intensity of the supervision depending on the size, complexity and riskiness of the NBDT, and have procedures for escalating supervisory actions where there is a basis for concern;

- Most prudential supervisors either conduct periodic on-site examinations to evaluate the financial condition of a NBDT and its compliance with regulatory requirements, or contract out such a role to independent assessors. Again, this is typically done on the basis of the size, complexity or riskiness of a NBDT;

- Supervisory authorities generally have wide-ranging powers to intervene where a deposit-taker gets into difficulty or breaches prudential requirements. These powers often include the capacity to give directions to a deposit-taker, remove senior management, de-license a deposit-taker or have it placed in liquidation or statutory management.

60. The Australian and British regulatory arrangements provide reasonably typical examples of the supervision arrangements applied in many OECD countries.

5.4.1 Australia

61. In Australia, any entity that conducts "banking business" (defined in the Australian Banking Act as both the taking of deposits, other than as part payment for identified goods and services, and the making of advances) is required to be licensed and supervised by the Australian Prudential Regulation Authority (APRA) as an Authorised Deposit-taking Institution (ADI). ADIs are sub-divided into three categories: banks; building societies and credit unions. Although each category has its own particular requirements, a common set of licensing and supervisory requirements apply across all ADIs. These supervisory requirements are similar to the generic supervision measures highlighted above. Finance companies are exempted from APRA's supervisory requirements, but are subject to ASIC-based supervisory requirements.

5.4.2 United Kingdom

62. In the United Kingdom, any entity seeking to raise deposits from the public is required to be licensed and supervised by the Financial Services Authority (FSA). The FSA applies a definition of deposit-taking similar to that proposed in this discussion paper and includes banks, building societies and credit unions, and the equivalent of finance companies. Again, although specific supervisory requirements, including the nature of prudential rules and level of supervisory monitoring, vary depending on the type and nature of the financial institution, a broadly common set of licensing and supervisory requirements is applied by the FSA to all deposit-takers, much along the lines referred to above.

6. PROPOSAL FOR LICENSING AND SUPERVISION OF NBTDS IN NEW ZEALAND

63. This section of the discussion paper sets out proposals for the licensing and supervision of NBDTs in New Zealand.

64. Before discussing the proposed prudential supervision requirements, it is important to note that non-prudential regulation will apply to all NBDTs, just as is currently the case, but with some proposed enhancements. These non-prudential supervision regulatory arrangements are discussed briefly below.

65. Also, there are important proposed enhancements to the trustee/trust deed regime (these are set out in full in *Supervision of Issuers* discussion paper). These enhancements will apply to all NBDTs to the extent that they continue to fall under trustee-based supervision. Because of the special characteristics of NBDTs (see discussion in paragraphs 21-30 above), we propose some additional requirements on NBDTs, over and above other debt issuers. These are covered below.

6.1 NON-PRUDENTIAL REGULATION – APPLICABLE TO ALL NBDTS

66. Under existing regulatory arrangements, all NBDTs are subject to some non-prudential regulation, including the need to comply with product and issuer disclosure requirements, basic governance requirements (set out in legal-form legislation), financial disclosure and audit requirements (set out mainly in the Financial Reporting Act 1993, but also in some legal-form legislation), and basic consumer protection law (including the Fair Trading Act 1986, Consumer Guarantees Act 1993, Commerce Act 1986).

67. Under any new arrangements, non-prudential regulation will continue to apply to all NBDTs. However, enhancements are proposed for some of the non-prudential regulatory requirements, including the following.

- ***Financial service registration.*** As explained in the *Overview of the Review and Registration of Financial Institutions* discussion paper, it is proposed that all providers of defined financial services will be required to be registered with the Companies Office. The purpose of the registration function would be to identify which entities are providing financial services within defined categories, to enable financial service providers to be allocated to their respective regulatory categories and to enable basic criminal checks to be performed on significant shareholders, directors and senior management of all financial service providers. Financial service registration would not certify a provider as being "fit for purpose" – it would not be a merit licensing function.

  It is proposed that all NBDTs would be subject to this financial service registration requirement. Although the financial service registration function would be separate from any prudential licensing requirement, the two functions would be integrated to the extent practicable, with a view to eliminating any unnecessary duplication and minimising compliance costs.

- ***Governance requirements.*** All NBDTs will continue to be subject to basic governance requirements (including director duties and accountability,

obligations to maintain records, etc.) under their legal-form legislation. However, it is proposed that the governance requirements for mutual organisations (building societies, credit unions, friendly societies, etc.) will be strengthened and standardised, bringing them closer into alignment with the governance arrangements applicable to companies (see *Mutuals' Governance* discussion paper).

- ***Product disclosure.*** All NBDTs will continue to be subject to product disclosure requirements under the Securities Act. As noted in the *Securities Offerings* discussion paper, it is proposed that product disclosure requirements will be enhanced and made more focused and user-friendly.

- ***Issuer disclosure.*** All NBDTs will continue to be subject to an issuer disclosure requirement – i.e. an obligation to issue financial statements and other information. Currently, issuer disclosure is achieved via the Securities Act in the form of prospectus requirements. NBDTs that continue to be supervised by trustees, pursuant to the Securities Act, will remain subject to issuer disclosure under that Act. NBDTs that are supervised by the Reserve Bank will cease to be subject to Securities Act issuer disclosure requirements in respect of their debt securities, but will become subject to disclosure requirements administered by the Reserve Bank.

6.2 LICENSING AND PRUDENTIAL SUPERVISION OF NBDTS

68. In assessing possible licensing and supervision arrangements for the NBDT sector, officials had regard to a number of factors, including:

- Which arrangements would best address the objectives of regulation for the NBDT sector;
- Which arrangements would have least adverse impact on productive efficiency (including compliance costs and regulatory administration costs), and on dynamic efficiency within the financial sector;
- The importance of trying to minimise moral hazard risks;
- The importance of preserving, and enhancing where appropriate, self and market discipline in the NBDT sector;
- Maintaining a competitively neutral regulatory framework;
- trans-Tasman supervisory coordination and integration where relevant; and
- International principles and practice in relation to the licensing and supervision of deposit-taking financial institutions.

6.2.1 Authorised Deposit-Takers (ADT)

69. Taking into account these factors, officials considered that the best option was to create two tiers of NBDTs – Authorised Deposit-Takers (Tier 1) and other deposit-takers (Tier 2):

- The second tier would be supervised by trustees, as at present, with enhancements as proposed in the paper on trustees and trust deeds (see *Supervision of Issuers* discussion paper). There would also be some further requirements to recognise the issues peculiar to the NBDT sector (see paragraphs 21-30 above). Proposed requirements on Tier 2 institutions are discussed later.

70. Authorised Deposit-Takers (ADTs), on the other hand, would be supervised by a single supervisory authority to a level designed to ensure a relatively lower-risk category of financial institution. ADTs would cease to be subject to trust deed requirements and trustees would be replaced by a single government agency as supervisory authority for all ADTs. As discussed later, any deposit-taker could seek to become an ADT, provided it meets the licensing and supervisory requirements. Deposit-takers would not be forced to become ADTs unless they are of a size or nature that their failure could pose a risk to the soundness of the financial system.

71. ADTs would be supervised on a uniform basis by one supervisory authority, similar to the arrangements applicable to registered banks. It is proposed that the Reserve Bank would be the supervisor, given the similarities between the supervisory requirements of registered banks and ADTs, and the efficiencies of locating the supervision function in one government agency. This will help to realise economies of scale in the supervisory task and the benefits of deeper industry knowledge on the part of the supervisor.

72. ADTs would be a middle tier of deposit-taker – generally higher-risk and smaller than registered banks, but generally somewhat lower-risk than in the case of Tier 2 NBDTs. The aim of creating an ADT category would be to provide some assurance to depositors and others that NBDTs in this category meet minimum supervisory requirements consistent with being lower-risk in nature and being supervised to a consistent minimum standard.

73. Tier 2 NBDTs would comprise all non-bank deposit-takers that are not in the ADT category. Tier 2 NBDTs would continue to be subject to the trust deed requirements of the Securities Act and to be supervised by trustees, with trustees being overseen by the Securities Commission. As discussed later, existing supervisory arrangements applicable to non-bank deposit-takers would be strengthened under the proposed arrangements.

74. Requiring all NBDTs to be licensed and supervised to a uniform level would impose substantial efficiency costs on the financial system. If the supervisory arrangements were designed to ensure that all NBDTs are of an acceptable maximum risk, then this would effectively prevent many finance companies from offering higher-risk deposits and therefore constrain investor choice. It would also reduce the capacity of the NBDT sector to meet the needs of the economy to the extent it is currently doing, particularly in niche markets not readily serviced by banks or lower risk NBDTs. In order to avoid these efficiency costs, the supervisory requirements would need to be pitched at a very basic level, which would then be inconsistent with the objective of promoting depositor confidence and creating a deposit-taking sector that is reliably lower-risk in nature.

75. Only ADTs could use the term "Authorised Deposit-Taker". All other deposit-takers (in Tier 2) would be required to disclose prominently the fact that they are not Authorised Deposit-Takers.

6.2.2 Building Societies and Credit Unions

76. It might not be possible for some of the small building societies and probably most of the credit unions to meet the requirements of the ADT category, due to their small size and nature of operations. For those building societies and credit unions that do not seek to be ADTs or are unable to meet the requirements for ADTs, it is proposed that they would be separately subject to prudential supervision by the Reserve Bank as a distinct category of NBDT. This is discussed later.

6.2.3 Registered Bank Arrangements

77. It is proposed that registered banks would remain a separate category of financial institution; they would continue to be the only financial institutions legally able to use "bank" or a derivative of that word in their name. However, just as is currently the case, any entity may provide banking services without the need to be a registered bank.

78. No changes are proposed to the existing requirements for registered banks. Registered banks would continue to be licensed and supervised by the Reserve Bank and the existing minimum requirements would continue to apply – i.e. a minimum capital of $15 million, a minimum ongoing capital ratio (assessed using the Basel capital arrangements) of not less than 8 percent, an acceptable credit rating (which would normally be not less than BBB- or its equivalent from an approved international rating agency), and an acceptable degree of standing, shareholder support, governance and risk management capacity.

79. There is no proposal to lower these requirements to accommodate NBDTs unable to meet the registered bank requirements. However, just as is currently the case, any NBDT would be eligible to seek registration as a registered bank provided they can meet registered bank requirements, both at the time of application for a licence and on an ongoing basis.

7. PROPOSED LICENSING AND SUPERVISORY ARRANGMENTS

7.1 TIER 1 – AUTHORISED DEPOSIT TAKERS (ADT)

80. The prudential requirements for ADTs would be pitched at a level that seeks to ensure that they are relatively lower-risk in nature so that depositors can have a reasonable basis for confidence that their deposits are highly likely to be repaid on call or upon maturity. The licensing and supervisory requirements would be similar to those currently applicable to registered banks, but pitched at a somewhat lower level. As noted earlier, however, the supervisory arrangements would not provide any kind of guarantee to depositors that their funds are necessarily safe.

7.1.1 Who May be an Authorised Deposit-Taker

81. Any entity that meets the generic definition of a NBDT (i.e. essentially an entity that issues deposits or deposit-like debt securities to the public) could seek to be an ADT provided that they meet the licensing and ongoing supervisory requirements set out below.

82. However, it is proposed that the Reserve Bank, as the supervisor of ADTs, would have the statutory power to require a non-bank deposit-taker to become an ADT in circumstances where the deposit-taker is of a size or nature where its failure or distress could pose a significant risk to the soundness of the financial system. Under this arrangement, the Reserve Bank would be required by legislation to issue a policy statement from time to time setting out the considerations to which it would be required to have regard when determining whether an entity's size or nature of business could cause that entity to pose a significant risk to the soundness of the financial system in the event of the entity's distress or failure.

83. It is proposed that the Reserve Bank would be empowered by legislation to specify by notice to the entity in question that it is required to be licensed and supervised as an ADT, giving the reasons for that decision. It is proposed that the entity would have a right to appeal that decision in the courts.

84. It is not envisaged that the power to require an entity to be an ADT would be used frequently. It is only likely to be invoked where a deposit-taker grows to a substantial size, becomes a significant participant in the payment system, or performs other core financial service functions on a scale such that its distress or failure could pose a significant risk to the soundness of the financial system.

85. In the case of entities that voluntarily seek to be an ADT, they would be required to meet all ADT licensing and supervisory requirements from the point of licensing unless transition arrangements are agreed to by the Reserve Bank.

86. In the case of an entity that is required by the Reserve Bank to be an ADT, the Bank would agree to a transition path to enable the entity to meet the ADT requirements within a specified period of time.

87. The proposed features of the ADT supervision regime are set out below.

7.1.2 Licensing Requirements

- ***Fit and proper requirements for shareholders, directors and managers.*** These would be similar to those for registered banks, but pitched at a level more suitable for small deposit-taking financial institutions. The requirements would comprise both negative assurance requirements (e.g. criminal background and bankruptcy checks) and some positive assurance that the board as a whole has the competency to perform its role and that the senior management team individually and collectively has the expertise and experience to manage the NBDT prudently. It would include a check on shareholders with the ability to exercise significant influence or control over an ADT to ensure they have appropriate standing to be a shareholder in that position.

- ***Minimum capital level.*** Given the desire to ensure that shareholders in ADTs have made a significant financial commitment to the NBDT, and to ensure a minimum critical mass, it is proposed that a minimum capital level would apply to ADTs – possibly $5 million. In addition, newly established entities seeking to become ADTs would need to satisfy the supervisor that they have sufficient capital to absorb establishment costs and projected net costs until the NBDT becomes profitable.

- ***Fit for purpose.*** An entity wishing to be an ADT would have to demonstrate that it is "fit for purpose" in the sense that it has governance arrangements, staffing expertise, and risk management systems and controls sufficient to manage the proposed business of the ADT to a prudent level.

- ***Minimum credit rating.*** It is proposed that an ADT would need to have a credit rating from a rating agency approved by the Reserve Bank of not lower than BB (or its equivalent).

  A mandatory credit rating from an approved rating agency, with a minimum acceptable rating of BB, would provide a number of benefits, including:

  - providing depositors with a meaningful, relatively simple and consistent basis for identifying the financial strength of an ADT and comparing the financial strength of an ADT with other deposit-takers
  - ensuring that all ADTs meet a minimum level of financial strength that takes into account size, risk diversification, asset quality, capital adequacy, shareholder support, governance and risk management capacity. Officials believe that a BB rating is the lowest that could be regarded as consistent with the notion that ADTs must be relatively low-risk financial institutions
  - providing a more effective channel for market discipline on ADTs than other mechanisms are likely to provide. Enhanced market discipline is likely to reinforce the incentives for sound governance and risk management.

7.1.3 Prudential and governance requirements

- ***Minimum capital adequacy ratio.*** It is proposed that an ADT would be required to comply with a minimum capital adequacy ratio measured using the

standardised Basel II model framework. This framework provides a consistent basis for measuring an ADT's capital adequacy by applying an internationally recognised definition of capital and by requiring capital ratios to be calculated against both on- and off-balance sheet risk-weighted credit exposures.

Consistent with the notion that ADTs must be lower-risk entities, officials believe they should be subject to a capital ratio at least equivalent to that applicable to registered banks (i.e. 8 percent in relation to risk-weighted credit exposures). However, there is an argument that the minimum ratio should be higher in the case of ADTs, given their relatively small size, their lower level of risk diversification and generally lower level of shareholder support. Therefore, a minimum capital ratio in the range of 10 – 15 percent could be considered appropriate for the ADT category. This is one of many issues that will need to be discussed with prospective ADTs at the time the framework is being developed.

- ***A limit on credit exposures to related parties***. It is proposed that an ADT would be subject to a limit on credit exposures to related parties set in relation to its tier 1 capital. Current thinking is that the limit would be set at 15 percent of capital, with a higher limit being permitted in situations where the ADT has a relatively high credit rating. The limit would be designed to prevent an ADT's capital from being effectively diluted by lending back to shareholders.

- ***Limit on exposure concentration.*** An option that would be considered in designing the supervisory requirements for ADTs is a limit (relative to tier one capital) on credit exposures to individual counterparties or groups of related counterparties. This would be designed to avoid excessive exposure concentrations within ADTs and therefore to reduce their vulnerability to counterparty default.

- ***A local incorporation requirement for NBDTs with foreign ownership.*** It is proposed that, in the case of an ADT incorporated in a foreign country, where there is a depositor preference in the home jurisdiction or where the supervisory, governance or disclosure requirements in the home jurisdiction are significantly less than those in New Zealand, the ADT would be required to incorporate in New Zealand.

7.1.4 Supervision

- ***Off-site monitoring.*** ADTs would be monitored off-site by the supervisory authority on a regular basis – probably quarterly, as is the case with registered banks. Monitoring would include assessments of compliance with prudential requirements and general financial condition. Monitoring would be primarily based on public disclosure statements (see below), but with scope for the supervisor to obtain additional information privately from ADTs. There would be scope for the supervisory authority to contract out some aspects of this monitoring where it is cost-effective to do so.

- ***Periodic consultations with ADT management.*** The supervisory authority would periodically consult with the senior management team of each ADT to discuss the ADT's financial position and performance, compliance with supervisory requirements, risk management issues and other matters. The

frequency and nature of consultations would depend on the size, complexity, functions and risk of each ADT, but would generally be on annual basis.

- ***No routine on-site examinations.*** Consistent with the approach taken to the supervision of registered banks in New Zealand, it is proposed that there would be no routine on-site examinations of ADTs by the supervisory authority. However, the supervisory authority would have the power to either conduct an on-site examination or to require an ADT to undergo review by an approved independent party, where warranted.

- ***Escalation of supervision in situations of uncertainty or concern.*** The supervisory authority would have the powers to escalate supervision or take other actions where, for example, the supervisory authority has reason to believe that an ADT may be in breach of requirements or at financial risk. The powers would include the ability to appoint an investigator, to give directions to the ADT, to remove and replace directors and senior management, to de-license the ADT and to either have the ADT liquidated or placed into statutory management. Once in statutory management, the Reserve Bank would have the power to direct the statutory manager on the conduct of the statutory management. This is the same arrangement that applies in respect of registered banks.

7.1.5 Measures to Enhance Self and Market Discipline in ADTs

- ***Governance requirements.*** It is proposed that all ADTs would be required to meet minimum governance requirements set by the Reserve Bank. These would be similar to those applicable to registered banks and could include: a requirement for a minimum number of directors on the board, a minimum number of independent directors, and a non-executive or independent chairman of the board. These requirements would be designed to reinforce sound corporate governance practices within ADTs and provider a stronger base for prudent risk management.

- ***Constraint on directors acting in interests of parent.*** Where an ADT is wholly owned by another party, the ADT would be required to ensure its constitution does not allow directors, when exercising powers or performing duties as a director, to act other than in what he or she believes is the best interests of the ADT.

- ***Financial and risk-related disclosure requirements.*** It is proposed that all ADTs would be brought under financial disclosure requirements administered by the supervisory authority, replacing the prospectus requirements currently applicable under the Securities Act. (ADTs would remain subject to product disclosure and advertising requirements under the Securities Act.) It is likely that the disclosure requirements would be modelled on those currently applicable to registered banks, but would be somewhat simpler in nature. The key features would probably include:

  - disclosure statements, probably issued on a quarterly basis, covering financial statements, capital adequacy information (using the Basel II basic requirements), exposure concentration, exposures to connected persons, asset quality, liquidity information and key risk-related data

- a short Key Information Summary setting out prescribed information in a standardised format and aimed at the non-expert investor. One option would be for this to be attached to, or part of, an ADT investment statement. Information required to be disclosed would include the rating of the ADT, recent changes to the rating, where that rating sits on the rating scale, the capital ratio of the ADT and other key financial and risk-related information

- a requirement for an ADT's directors and CEO to sign the disclosure statement, attesting that it is not false or misleading

- attestations signed by the directors and CEO, including as to whether the ADT is in compliance with licensing requirements, that it has systems and controls to identify, monitor and manage all of its material business risks to a prudent level, and that the systems and controls have been adequately applied in the period to which the disclosure statement applies

- year-end disclosures subjected to external audit, while the half-year disclosure statement would be subject to limited (negative assurance) audit review. The appointment of the auditor would be subject to dis-approval by the supervisor.

7.2 TIER 2: OTHER NBDTs

88. Tier 2 NBDTs would be subject to enhanced trustee-based supervision, overseen by the Securities Commission. The enhancements to trustee-based supervision would be the same as those set out in the *Supervision of Issuers* discussion paper, but with some specific requirements relevant to NBDTs.

89. It is recognised that there are many benefits to the current trustee supervision model, such as the flexibility of trustee-based supervision which provides issuers with tailored risk-based supervision. However, some issues have been raised with the current supervision model and trust deeds. The Financial Sector Assessment Programme (FSAP) found there were insufficient checks and balances and accountability in how trustees were performing their role. Other issues have also been raised regarding whether there are sufficient entry requirements for trustees (New Zealand is non-compliant with AML/CFT Recommendations in this regard); that trustees may need more powers in some areas to effectively carry out their role; and that there is currently no effective way for government to gather whole of sector data and monitor the sector. Currently, there are minimal trust deeds requirements so trust deeds can be inconsistent and/or may lack minimum protections making it difficult for people to compare products; or may mean that consumers may be lacking important protections. These are discussed in more detail in the *Supervision of Issuers* discussion paper.

90. The *Supervision of Issuers* discussion paper also proposes some solutions to address these issues. These are:

- The implementation of a trustee supervision model, for the supervision of debt issuers (and collective investment scheme issuers). Under this model trustees will continue to operate as the front-line supervisors and will be subject to entry and ongoing requirements that will be monitored and enforced by the Securities Commission;

- Additional powers may be given to trustees to enable them to carry out their role more effectively, for example: obtaining information from issuers on a periodic basis; obtaining information from auditors on matters likely to be relevant to the exercise of the powers or duties of the trustee; amending the trust deed in circumstances where the issuer does not agree to the amendment; engaging, at the issuer's expense, a third party expert to review specified aspects of the NBDT's systems, controls and governance; giving directions to the issuer where it is in breach of regulatory requirements or in distress, including to remove and replace directors or senior management. Trustees would continue to have the duties and powers accorded under the Corporations (Investigations and Management) Act 1989;

- The Commission will also be given greater ability to hold the trustees accountable for the performance of their duties. For example, it will be able to take a range of actions to require a trustee to comply with the terms of the trust deed and to apply for civil pecuniary penalty orders and compensatory orders; and

- That there should be minimum requirements for debt trust deeds. These requirements would include prescribed matters that must be addressed and disclosed (rather than how they must be addressed) by the trustee in every trust deed. For example: corporate governance, terms of the securities, financial covenants, minimum capital, exposures (both related party and concentration exposures), reporting, trustee duties and powers, meetings, and appointment and removal of trustees.

91. Against this background, the main elements proposed for Tier 2 NBDTs comprise:

7.2.1 Licensing of Tier 2 NBDTs

- ***NBDT must be licensed to conduct deposit-taking.*** It is proposed that any entity wishing to take retail deposits and not licensed as an Authorised Deposit-Taker (or otherwise subject to licensing and supervision by the Reserve Bank) must be licensed as a deposit-taker. Licensing would be approved by the Securities Commission, on the recommendation of the trustee with which the NBDT applicant has negotiated a trust deed.

- ***Fit and proper requirements.*** The shareholders (with control or significant influence), directors and senior management of NBDTs would be subject to fit and proper assessments to evaluate their suitability to control or influence the NBDT. These tests would comprise both negative and positive assurance as to suitability and competency, and would apply both at the time of licensing and at the time of any change in significant shareholding, directors or senior management. The negative assurance would be applied by the Companies Office as part of the financial service registration process. The positive assurance element of the fit and proper test would be applied by the trustees, in liaison with the Securities Commission, in accordance with any legislative requirements or guidelines developed. The tests would be pitched at a lower level than required for Authorised Deposit-Takers, but would be designed to seek to ensure that the board and senior management team have the necessary skills and experience to manage the NBDT prudently.

- ***Systems and controls.*** Part of the fit and proper requirements would include whether the NBDT has the systems and controls to manage the proposed business prudently and in accordance with supervisory objectives.

- ***Governance requirements.*** It is proposed that Tier 2 NBDTs would be required to meet some minimum corporate governance requirements, in accordance with any legislative requirements or guidelines developed, both at the time of licensing and on an ongoing basis. These requirements may include a minimum number of directors on the board of a NBDT, a minimum number of independent directors and an independent or non-executive chair of the board.

- ***Minimum capital.*** It is proposed that, for an entity to be licensed as a Tier 2 NBDT, it must have a monetary minimum capital of an amount to be determined, but likely to be in the region of $500,000 to $2 million. This proposal seeks to ensure that the shareholders of an NBDT have made a significant minimum financial commitment to the proposed NBDT. In addition, trustees would be required to assess, at the time of licensing and thereafter, whether the NBDT has sufficient capital given the risks of the business it is conducting and to ensure that the trust deed includes a minimum capital ratio that is suitable for the NBDT's nature of business. We would welcome views on this proposal and on the minimum amount.

7.2.2 Supervision of Tier 2 NBDTs

- ***Trustee-based supervision – prudential requirements and supervision.*** Tier 2 NBDTs will be subject to the new proposed regime for trustee supervision of debt issuers. First, a trustee supervisory model is proposed whereby trustees continue to monitor debt issues but with trustees themselves subject to approval and oversight by the Securities Commission.

  Second, trust deeds would continue to be negotiated between the NBDT and the appointed trustee, subject to proposed minimum requirements laid out in legislation and or regulations. The proposed minimum requirements would include prescribed matters that must be addressed and disclosed (rather than how they must be addressed) by the trustee in every trust deed, for example: corporate governance, terms of the securities, financial covenants, minimum capital, exposures (both related party and concentration exposures), reporting, trustee duties and powers, meetings, and appointment and removal of trustees.

  Third, it is proposed that trustees have additional powers, for example powers relating to: obtaining information from issuers on a periodic basis; obtaining information from auditors on matters likely to be relevant to the exercise of the powers or duties of the trustee; amending the trust deed in circumstances where the issuer does not agree to the amendment; engaging, at the issuer's expense, a third party expert to review specified aspects of the NBDT's systems, controls and governance; giving directions to the issuer where it is in breach of regulatory requirements or in distress, including to remove and replace directors or senior management. Trustees would continue to have the duties and powers accorded under the Corporations (Investigations and Management) Act 1989. These proposals are discussed in detail in the *Supervision of Issuers* discussion paper.

- It is proposed that NBDT may have to meet some additional requirements for their trust deeds, over and above those proposed for all debt issuers. These are discussed below. Subject to all trust deeds meeting these minimum requirements, the trust deed terms and conditions could vary according to the particular nature of the NBDT. The requirements would be kept to a minimum so as to avoid compromising the efficiency of the sector, but might include:

  - *use of a standardised capital adequacy measurement framework.* This would most probably be Basel II standardised – as the framework for measuring a NBDT's capital adequacy relative to on- and off-balance sheet exposures. It would facilitate comparison of NBDTs' capital ratios by applying a consistent measurement framework. It would also provide a relatively comprehensive basis for assessing NBDTs' credit exposures and other relevant risk positions, and for defining the attributes required of an NBDT's capital instruments

  - *a minimum capital ratio.* It is proposed that all trust deeds would be required to specify a minimum Tier 1 capital ratio, probably measured using the Basel II framework, as a trigger for intervention by the trustee.

    One option would be for the trustee to negotiate the minimum capital ratio with the NBDT, with no regulated minimum ratio. This would provide for greater flexibility and reduce the efficiency costs associated with setting a uniform minimum ratio. However, it would reduce the reliance that depositors could place on the supervisory framework and give rise to the possibility of inadequate minimum capital ratios.

    The other option would be a requirement for a minimum capital ratio below which no trust deed can go, as a basic trigger for intervention by trustees. Trustees would still be able to negotiate a capital ratio higher than this level. One possibility would be for the minimum ratio to be a Tier 1 capital ratio of 4 percent of risk weighted exposures, with a minimum total capital ratio of 8 percent. This would provide greater certainty of a meaningful trigger for intervention by trustees, but could impose efficiency costs on the NBDT sector.

7.2.3 Ongoing Public disclosure

- ***Financial and risk-related disclosures.*** Tier 2 NBDTs will be subject to the new proposed regime for ongoing disclosure by debt issuers. First, as is currently required, all debt issuers would be required to produce both annual reports and annual audited financial statements. Second, as is currently required, all debt issuers would be required to both register and communicate to investors in a timely fashion, all material changes to both the offer document and trust deed. Third, it is proposed that a continuous disclosure regime be extended to all securities for which the issuer holds out that there is or may be an established secondary market. These proposals are discussed further in the *Securities Offerings* discussion paper.

- It is proposed that Tier 2 NBDTs would be required to comply with enhanced disclosure requirements. The disclosure arrangements would be administered by the Securities Commission and some additional proposals for disclosure include that:

- that financial statements be prepared and audited every six months, rather than the current annual requirement

- a Key Information Summary sets out, in very brief form key financial and risk-related information, including capital ratio, the credit rating of the NBDT and recent changes to the rating (if a mandatory rating option is implemented or the NBDT chooses to have a rating from an approved rating agency if ratings are not mandatory) or disclosure of the absence of a rating if there is no mandatory rating requirement

- the Key Information Summary would be subject to annual external audit by an auditor

- Tier 2 NBDTs would be required to disclose in any advertisement, offer document, investment statement or other disclosure that they are not an Authorised Deposit-Taker.

7.2.4 Credit rating

7.2.4.1 Mandatory Credit Rating

92. An option that is being proposed in this discussion paper for consideration is that all Tier 2 NBDTs be required to obtain and disclose a credit rating (applicable to senior unsecured liabilities of greater than 12 months maturity) by a rating agency approved by the Securities Commission. As noted above, under this option, NBDTs would be required to disclose the rating in their disclosure statements and Key Information Summaries, including recent changes to the rating (e.g. any change in the preceding 2 years) and where the rating sits on the rating scale.

Benefits of a Mandatory Rating Requirement

93. A requirement for all Tier 2 NBDTs to obtain, maintain and disclose a credit rating by an approved rating agency may have the following benefits:

- ***Inform depositors and facilitate comparisons of NBDTs' soundness.*** A mandatory credit rating from an approved rating agency would provide depositors with a relatively simple metric to enable them to compare the financial strength of one NBDT with that of others in a more consistent manner than is currently possible.

- ***Strengthen market disciplines.*** A mandatory rating requirement would strengthen market discipline on NBDTs by providing market participants with a more reliable means of making investment decisions and comparing one NBDT with another. The board and senior management of a NBDT would have strong incentives to manage the affairs of the NBDT in a manner consistent with avoiding a rating downgrade and maintaining a rating that compares favourably with peer NBDTs. A mandatory rating would thereby reinforce incentives for sound governance and risk management practices.

- ***Reduce moral hazard risks.*** A ratings requirement can reduce the moral hazard risks associated with government regulation and supervision. In the absence of ratings, depositors are more likely to be reliant on the supervisory authority to determine whether to place their funds, or conduct business, with a

NBDT. Such reliance on prudential supervision can create a moral hazard risk and impose contingent risks on the government's balance sheet, given that the government would come under greater pressure to bail-out an insolvent institution or insulate creditors from losses in the absence of a rating.

Costs of a Mandatory Rating Requirement

94. A requirement to have a credit rating from an approved rating agency has some costs and can be critiqued on some grounds.

- ***Costs.*** A requirement for NBDTs to obtain a mandatory rating from an approved rating agency would impose additional costs on most NBDTs. The costs would vary depending on the size and nature of the NBDT, but officials understand that the direct cost could be expected to range between $40,000 and $50,000 a year in most cases, plus the management time absorbed in the annual rating process. The cost of ratings would need to be offset against the cost saving flowing from a less comprehensive and intrusive supervisory regime that would otherwise probably apply in the absence of ratings.

  Moreover, it is important to note that the cost of rating would not be a particularly significant expense relative to the revenue of most NBDTs. For example, the cost for a typical medium-sized finance company would range between around 0.1 - 0.5 percent of annual revenue. The cost for very small NBDTs or insurers, such as credit unions and some of the minor friendly societies, would be a considerably larger proportion of their revenue.

  One option that could be considered to avoid excessive cost burdens for very small NBDTs would be to have an exemption from a rating requirement for NBDTs below a specified asset or deposit liability threshold. In this case, exempt NBDTs could be required to disclose the fact that they do not have a rating from an approved rating agency, and be prevented from advertising any other rating without making it clear that the rating is not from an approved rating agency.

- ***Disadvantage of ratings for small financial institutions.*** It has been argued that small financial institutions are unfairly disadvantaged by the standard international ratings frameworks. This argument tends to be based on the beliefs that:

  - the international rating agencies do not have the experience or competency to assess very small firms – i.e. they are geared to assessing large, multinational firms

  - the rating scales used are designed for large financial market participants

  - rating agencies attach more weight than is justified to factors such as an institution's small size, low level of risk diversification and lack of shareholder support.

  Although rating agencies mainly deal with large firms, they do rate small regional firms in many countries and are increasingly being drawn into that sphere of business. Moreover, the ratings methodologies are readily transferable from large to small firms, with appropriate adaptations.

To the extent that small firms with similar financial ratios to large firms do get lower ratings, this reflects the fact that financial ratios are largely based on accounting data and are generally a poor measure of economic capital. Lower ratings for small firms generally reflect the reality that, everything else being equal (e.g. capital ratio, asset quality, etc.), small firms are generally of higher risk than larger firms, for reasons such as:

- small firms typically do not have the risk diversification benefits from having a large balance sheet – they generally have larger exposure concentrations to individual or related counterparties, or to particular sectors of the economy

- operational risk tends to be larger with small firms due to increased key person risk, less capacity for diversification of operational risk shocks, and fewer resources devoted to operational risk management

- corporate governance and risk management systems tend to be weaker in small firms than in larger firms

- shareholder support tends to be weaker in small firms compared to many large firms; raising capital can be much harder for a small financial institution than a large one with institutional investors and standing. Moreover, small firms tend to be prone to connected exposure risks (to a greater extent than large firms).

- ***Ratings are not necessarily reliable indicators of risk.*** Arguments are sometimes made that ratings are not necessarily reliable indicators of risk and that rating agencies have a mixed track record in predicting defaults. We also understand the concern that they are not sufficiently responsive to fast-moving market conditions. We agree that ratings are not perfect predictors of default; nor can they be expected to be. Rather, they are intended merely to be broad indicators of the ex ante probability of default over a defined time period. In this regard, ratings agencies have established relatively creditable track records. They are arguably better than the alternatives, such as no rating at all, scoring systems of dubious pedigree, or relying solely on financial disclosures.

- ***Investors do not always understand ratings.*** Feedback from advisory groups indicates that investors do not always understand ratings. For example a sub investment grade B rating is interpreted by some as a good rating. Lack of consistency between the rating scales used by different agencies and the emergence of new rating agencies without a proven track record have added to investors' confusion.

- ***Different rating scales.*** A criticism sometimes made of credit ratings is that the rating agencies have different rating scales, and that this can make it difficult for depositors to compare the ratings across NBDTs. Although this is a valid issue, it can be addressed to a significant degree by limiting the number of approved rating agencies to just the major international agencies, whose rating scales are broadly similar. Moreover, there is scope for education of depositors by promoting material that maps one rating scale with others and by requiring disclosure of the description of the rating grade applied by a rating agency.

7.3 COMPARISON OF MAIN FEATURES OF PROPOSED SUPERVISORY REQUIREMENTS FOR AUTHORISED DEPOSIT-TAKERS AND TIER 2 DEPOSIT-TAKERS

95. Please note that in the case of Tier 2 Deposit-Takers, some of the features are common to all debt issuers under the proposed regime – this is highlighted where approporiate.

Proposed requirement	Authorised Deposit-Takers	Tier 2 Non-Bank Deposit-Takers
Supervisor	Reserve Bank	Trustees overseen by Securities Commission (all debt issuers)
Regulatory instruments	Conditions of licence imposed by Reserve Bank after consultation No trust deeds	Some requirements imposed by legislation, regulation or Securities Commission guidance notes Trust deeds negotiated by trustees subject to regulatory requirements imposed by Securities Commission (all debt issuers) Some requirements imposed by regulations administered by Securities Commission
Minimum capital	$5 million	To be determined but, if agreed in-principle, would probably be in the order of $500,000 - $2million
Fit and proper	Yes, similar to banks, applied to shareholders with control or significant influence, directors and senior management Administered by Reserve Bank	Yes, but lower than for ADTs, applied to shareholders with control or significant influence, directors and senior management Administered by trustees, overseen by Securities Commission
Governance requirements	Minimum number of directors Minimum number of independent directors Non-executive or independent chair Prohibition on ADT directors acting in other than the interests of the ADT	Requirements specified by Securities Commission: Minimum number of directors Minimum number of independent directors Non-executive or independent chair
Capital ratio	10 – 15 % of risk weighted exposures, measured by Basel II (standardised)	Trust deeds must include a minimum capital ratio requirement measured by Basel II

		(standardised) An option being considered is for regulations to specify a minimum capital ratio as a basic trigger for action by trustees
Connected lending	Limit, set at 15% of Tier 1 capital, ratings dependent	Trust deed must either specify limit or there must be clear disclosure of all related party disclosures (all debt issuers)
Large exposures	Probably a limit and disclosure	No limit; just disclosure
Credit rating	Minimum rating of BB (or its equivalent) from rating agency approved by Reserve Bank	An option is being proposed which would require NBDTs to be rated by an agency approved by the Securities Commission; no minimum rating required
Disclosure	Yes; quarterly, similar to banks, but simplified, administered by Reserve Bank ADTs would be subject to product disclosure under Securities Act	Yes, six-monthly, administered by Securities Commission under prospectus arrangements Tier 2 NBDTs would be subject to product disclosure under Securities Act
Distress and exit	Triggers for intervention	Triggers for intervention
Supervisor monitoring and supervision powers	Monitoring by Reserve Bank, based mainly on public disclosure statements, but with capacity to obtain additional information Powers to escalate monitoring, obtain information, have an ADT investigated Powers to give directions to an ADT in defined circumstances Power to recommend statutory management	Monitoring by trustees on the basis agreed in trust deeds, or where relevant on the basis specified in regulation (all debt issuers) Powers to escalate monitoring, obtain information, have an NBDT investigated Powers to give directions to NBDTs in defined circumstances Power to appoint receiver or liquidator, and to recommend to Securities Commission that an NBDT be placed in statutory management

7.4 TREATMENT OF BUILDING SOCIETIES AND CREDIT UNIONS

96. Under the proposed supervisory arrangements, building societies and credit unions could opt to become ADTs if they were able to meet the requirements. However, as things currently stand, some of the smaller building societies and all of the credit unions would probably be unable to meet these requirements – mainly because they would fall well below the proposed minimum capital level or the minimum rating requirement of BB (or its equivalent).

97. There are two ways to deal with this situation.

- Building societies and credit unions unable to meet ADT requirements, or not wishing to become an ADT, could be supervised as Tier 2 NBDTs; or

- Building societies and credit unions unable to meet ADT requirements, or not wishing to become an ADT, could be supervised as a special category of NBDT by the Reserve Bank.

98. On balance, the Government considers that the more practicable of the two options would be for all building societies and credit unions to be licensed and supervised as a special class of NBDT by the Reserve Bank. This would have a number of advantages, including:

- Given that building societies and credit unions, respectively, have their own identity and are viewed to some extent as like-entities within their respective groups, it could be confusing for the public if some building societies and credit unions are supervised by one supervisory authority and others by trustees, under different supervision and prudential requirements;

- The like-nature of their business suggests that all building societies and all credit unions, respectively, should be subject to a level playing field in terms of regulatory arrangements;

- There would be economies of scope and scale if the ADT supervisory authority also supervised building societies and credit unions;

- Direct supervision by the supervisory authority may help to facilitate transition to the ADT category for those that wish to enter this category of NBDT;

- Supervision by one authority would promote a more consistent approach to the supervision of building societies and credit unions than would be likely to occur if they are supervised under Tier 2;

- If some credit unions restructure their affairs to become eligible to be ADTs, leaving others under Tier 2, it may be difficult for remaining credit unions (and any new credit unions established) to implement trust deed arrangements given their very small size and the possibility that trustees would find it uneconomic to supervise them. A similar argument may apply in the case of the small building societies.

99. If building societies that do not become ADTs are supervised as a special category of NBDT, the supervisory requirements would be similar to those applied under the ADT

category, but with modifications. The modifications would be determined by the supervisory authority in consultation with the building societies, but may include the following possibilities.

- The minimum capital level would be set at a realistic level for small building societies.
- The capital adequacy ratio could be the same as or similar to that applied to ADTs, but this would need to be determined in consultation with affected entities.
- The minimum credit rating requirement would not apply, given that very few small building societies could meet the requirement. It is also possible that credit unions would be exempted from the need for a credit rating, given the costs of a rating relative to their income. However, if an exemption were granted, this may be on the condition that the absence of a rating would have to be disclosed and that some restrictions would apply to the disclosure of alternative ratings.
- Small building societies could be exempted from the need for quarterly disclosures (being brought under a six-monthly disclosure regime), given the cost of this relative to their income.

100. For credit unions that do not opt-in to become an ADT, they will be subject to prudential requirements determined by the supervisory authority in consultation with credit unions. There may need to be some restrictions on the nature of business able to be conducted by credit unions. Details are set out in the following section titled "Impact of the RFPP recommendations on credit union reforms".

101. The prudential requirements on credit unions, as set out in and pursuant to the Friendly Societies and Credit Unions Act, would be repealed once credit unions come under the new arrangements.

102. Building societies and credit unions that do not become ADTs would be required to disclose in their investment and disclosure statements, advertisements and marketing material that they are not ADTs.

7.5 COSTS AND BENEFITS OF THE PROPOSED REFORMS

103. We assess the benefits and costs of the proposals using the following criteria.

- Effectiveness in meeting objectives, specifically:
  - would it facilitate sound risk management in NBDTs and the promotion of depositor confidence?
  - would it assist depositors to differentiate between lower and higher risk NBDTs?
  - would it facilitate satisfactory exit of insolvent or distressed NBDTs?
- Credibility
- Impact on self and market discipline

- Competitive neutrality
- Certainty/clarity
- Impact on productive efficiency, dynamic efficiency and allocative efficiency
- Regulatory arbitrage.

104. Our conclusions are summarised below.

7.5.1 Benefits

105. The main benefits of creating two tiers of NBDTs follow.

- The proposed arrangements would assist in promoting a sound and efficient financial system and public confidence in the financial system. The combination of supervision, disclosure and ratings would assist in promoting effective identification, management and allocation of risks within the NBDT sector. Disclosure and ratings would assist depositors to better compare risks across the NBDT sector and reduce the probability of an incorrect pricing of investment risks.

- The proposals would facilitate the creation of a category of NBDTs (ADTs) that can be regulated in a way that promotes a relatively lower-risk category of deposit-taker without the efficiency costs of trying to achieve this outcome across all NBDTs. This would better align with depositor expectations and assist depositors to more clearly and easily differentiate between higher and lower risk NBDTs.

- If the ADT category is implemented on an elective basis, this would avoid imposing higher efficiency costs on NBDTs that do not wish to be in the ADT category. The self-selective nature of an elective approach would mean that those entities that wish to be ADTs (and that can meet the requirements for this category of NBDT) have assessed the costs of becoming an ADT and have concluded that the costs are outweighed by the benefits.

- The proposed arrangements would avoid the efficiency costs of applying standardised prudential measures across a wide range of disparate entities, thereby allowing Tier 2 NBDTs to continue providing higher-risk financial services and offering higher-risk returns to depositors.

- The enhanced disclosure requirements would assist depositors in making better-informed investment decisions and help to reinforce market discipline on, and sound risk management practices in, NBDTs.

- The enhanced trustee-based supervisory framework for Tier 2 NBDTs would be a major improvement on the existing supervisory arrangements, given that it would promote greater consistency and reliability in the measurement of capital adequacy across NBDTs, establish minimum requirements for trust deeds, enhance the transparency of trust deeds and trustee supervision, and strengthen the accountability of trustees.

- The proposed arrangements may assist in reducing contagion within the NBDT sector by more clearly differentiating between ADTs and Tier 2 NBDTs. A mandatory rating requirement would further assist in reducing contagion risk.

- The proposals would facilitate efficient and effective management of distress and failure in the ADT sector, particularly in a situation of wider crisis, given the greater resourcing and expertise available to a single supervisory authority and the scope for implementing streamlined distress response processes. Extended supervisory powers for trustees, supported by the intervention capacity of the overseeing regulatory authority, would assist in the management of distress and failure of Tier 2 NBDTs.

- Supervising those building societies and credit unions that are unable or do not seek to be ADTs as a special class of NBDT has several benefits, including: regulating like-entities on a consistent basis; deriving economies of scale and scope by having one supervisory authority; and avoiding the costs and difficulty of having a group of very small institutions supervised under trust deed arrangements.

- The proposed arrangements would be broadly compatible with those in Australia. ADTs, and building societies and credit unions, would be an equivalent to non-bank ADIs in Australia, while Tier 2 NBDTs would be the equivalent of finance companies under Australian requirements (i.e. exempted from being ADIs).

7.5.2 Costs and Risks

106. The costs and risks of the proposed arrangements are:

- There would be direct and indirect costs associated with being in the ADT category. The direct costs would include any possible supervision charges levied on ADTs by the supervisory authority, compliance costs, the costs of maintaining a rating and constraints on risk-taking. These costs would be offset to some degree by the removal of trustee-based supervision arrangements, including the costs of trustee fees and compliance burdens associated with trustee supervision. If the ADT category is implemented on an elective basis, then NBDTs have a choice as to whether they wish to incur the costs and constraints of being an ADT and whether the costs are outweighed by the benefits. A mandatory approach to the ADT category would have greater cost implications, given that some NBDTs would be obliged to be in the ADT category.

- There is a risk that investors may be misled into thinking that Authorised NBDTs are low-risk in nature or are necessarily safer than all of those in the Tier 2 NBDT category. In order to reduce this risk to an acceptable level, a public education programme would be important, making it clear that ADTs are not necessarily low risk entities, are not guaranteed by the government and are not necessarily lower risk than NBDTs in the Tier 2 category. Ratings and disclosure would assist in reinforcing these points and reducing the risk of misperceptions by depositors and others.

- The proposal for an ADT category could create a moral hazard risk, given the supervisor approval and oversight for this category of NBDT. A similar risk

currently applies in the case of registered banks. This risk can be reduced to a significant extent by the use of public education to correct misperceptions of what the ADT category means and by placing an appropriate emphasis on market disciplines through disclosure and ratings.

- The proposals would involve a competitively non-neutral approach to the regulation of like-functions, with some deposit-takers being in the ADT category and others in the Tier 2 category. This is contrary to the general principle that like-functions should be regulated in like-manner. However, if an elective approach is adopted for the ADT category, as is proposed, then this would reduce the need for a competitively neutral regulatory framework, given that NBDTs could determine whether the costs of being an ADT are justified by the benefits.

Questions for Submission

6. Do you agree that the proposed creation of two tiers of NBDTs, with ADTs being restricted to lower-risk NBDTs, and other NBDTs being supervised under enhanced trust deed arrangements, is a more cost-effective means of meeting the proposed regulatory objectives that the alternative options? If not, please suggest the alternative options you would prefer and why.

7. Do you agree with the proposal that the ADT category be elective? Please give your reasons?

8. Do you agree that the Reserve Bank should have the power to require a deposit-taker to become an ADT where the size and nature of the deposit-taker's business is such that its failure could pose a risk to the soundness of the financial system?

9. Do you consider that some types of deposit-taking should require the NBDT providing those types of deposits to be in the ADT category? Please give your reasons.

10. What are your reactions to the proposed requirements for the ADT category and Tier 2 NBDT category? Do you think that they are appropriately calibrated for the proposed regulatory objectives and outcomes? If not, please suggest alternatives.

11. Do you agree that building societies and credit unions that cannot or do not seek to be ADTs should be supervised as a special category of NBDT, rather than being supervised as Tier 2 NBDTs? If not, please suggest your preferred approach and the reasons for it.

8. REVIEW OF FRIENDLY SOCIETIES AND CREDIT UNIONS ACT

8.1 INTRODUCTION

107. This section of the discussion paper provides some background on the current review being undertaken of the legislation governing credit unions and the impact of the RFPP process on this.

8.1.1 Background and In-Principle Decisions

1. In April 2005, the Government agreed to progress legislative changes to the Friendly Societies and Credit Unions Act 1982 (FSCU Act) in two phases.

8.1.1.1 First Phase

108. The first phase initiates legislative changes that Cabinet agreed to in September 2004. These changes are to:

- Allow credit unions to determine their own common bond, provided it is an objectively verifiable characteristic;
- Allow charities and incorporated societies affiliated with the common bond to become credit union members;
- Allow each credit union to determine its own minimum deposit amount;
- Remove the requirement to specify service charges in credit union rules, provided that a mechanism for levying the charges is specified in the rules;
- Allow credit union associations to extend new services to members without Ministerial approval.

109. These changes are being progressed through a Business Law Reform Bill.

8.1.1.2 Second Phase

110. The Government has agreed to defer the following in-principle changes to the FSCU Act until the conclusion of RFPP.

- Amendments to current statutory restrictions by allowing credit unions more flexibility to borrow and invest surplus funds and to hold land if credit union rules allow and if trust deeds are amended accordingly.
- Specify matters that have to be included in trust deeds of credit unions that depart from the default provisions on borrowing and investment including:
  - giving trustee supervisors a first ranking security charge over the assets of the credit union
  - imposing specific requirements to monitor and address the risks posed by these new activities, including provisions to ensure that investments are

consistent with the credit union's objectives, rules and have regard to the need for diversification and balance in credit unions' investments.

- Require trustee supervisors to certify to the Registrar of Friendly Societies and Credit Unions they are satisfied that any amendments to trust deeds comply with the new provisions of the FSCU Act.

- Grant credit unions legal status so they have limited liability, can own property, have perpetual succession, can sue and be sued in their own name, and consequently remove the role of trustees as officers of credit unions.

- Provide a conversion mechanism that would allow credit unions to convert to limited liability companies, provided that credit union reserves are locked up for minimum of five years or applied for charitable purposes.

- Change the current restriction on credit unions issuing one class of shares (e.g. members' deposit shares) to a default provision to allow credit unions to issue additional securities to their members if their rules permit, provided that:

  - these securities are transferable among members
  - investing members have a reasonable exit mechanism
  - equality of voting among members is maintained
  - such securities rank behind members' deposits and creditors in the event of a winding up
  - offers of such securities are deemed offers to the public and are subject to the full disclosure requirements of the Securities Act.

- Specify directors' duties owed by members of the committee of management on a basis similar to those owed by the directors of companies, such as:

  - to act in good faith and in the interests of the credit union
  - to exercise a power for a proper purpose
  - to comply with the Act and the credit union's rules
  - not to engage in reckless trading
  - not to agree to the credit union incurring an obligation unless the director believes at that time on reasonable grounds that the credit union will be able to perform the obligation when it is required to do so
  - to exercise the care, diligence and skill that a reasonable director would exercise.

8.2 IMPACT OF THE RFPP RECOMMENDATIONS ON CREDIT UNION REFORMS

111. This discussion paper recommends that NBDTs be divided into two categories: ADTs, to be supervised by the Reserve Bank, and Tier 2 NBDTs, to be supervised by

trustees and overseen by the Securities Commission. In addition, it is proposed that building societies and credit unions be supervised by the Reserve Bank as a distinct category of NBDT. Credit unions and building societies may elect to become ADTs, provided they meet the ADT requirements, or to be supervised on an ongoing basis as a special category of NBDT.

112. The tenor of the in-principle changes which Cabinet has agreed to allows credit unions that wish to grow more aggressively to do so provided they adhere to stricter prudential risk management practices. Alternatively, credit unions can also choose to conduct business within the constraints of the prudential requirements in the FSCU Act. It is intended that these two options will still be available to credit unions. The main impact of the RFPP recommendation on the second phase of the credit union reforms is that the Reserve Bank would be replacing the trustees as the prudential supervisor of all credit unions. Trust deeds would no longer be the supervisory instrument; prudential requirements would be imposed by the Reserve Bank pursuant to empowering legislation. Consequently, while the substance of the decisions made in phase two of the credit union reforms will be retained, some of those decisions may need to be implemented in a slightly different way. Discussion will be held with the credit unions to ascertain the most effective way of achieving this.

APPENDIX 1: INSTRUMENTS AVAILABLE TO MEET THE PROPOSED OBJECTIVES

113. There is a wide range of regulatory instruments available to achieve the objectives set out in this paper. The choice of these instruments depends on their effectiveness in meeting the proposed objectives and on the impact on productive efficiency (including compliance and regulatory administration costs), allocative efficiency and dynamic efficiency. The choice of regulatory instrument also depends on how effective self and market discipline are in achieving the regulatory objectives. The more reliable self and market discipline (without regulatory intervention) are, the less reliance is needed on regulatory discipline and, in particular, on supervisory discipline.

114. The main regulatory instruments available can be classified into three broad categories.

- ***Self discipline regulatory instruments.*** These are designed to directly encourage strong corporate governance and risk management within financial institutions. They include:
  - corporate governance requirements (eg director duties, measures to avoid conflicts of interest and inappropriate related party dealings)
  - fit and proper requirements for shareholders, directors and senior management
  - board composition requirements (e.g. independent directors, non-executive chair of the board)
  - internal audit
  - director attestations (e.g. in relation to the veracity of publicly disclosed information and the adequacy of an NBDT's risk management systems and controls).
- ***Market discipline regulatory instruments.*** These are designed to strengthen external disciplines on financial institutions, including assisting depositors and other investors to better protect their own interests in dealing with financial institutions. The instruments can include:
  - Product and financial disclosures
  - Credit ratings requirements
  - External audit
  - Market or industry self-regulation.
- ***Supervisory discipline regulatory instruments.*** These are a supplement to self and market discipline. The regulatory instruments can include:
  - licensing of financial institutions (either to perform specified functions or to use protected words in their name)

- prudential requirements, such as minimum capital adequacy, limits on exposures to connected parties, limits on exposure concentration, liquidity requirements
- off-site monitoring by the regulator
- capacity for on-site examinations by the regulator or third-party reviews
- intervention by the regulator where a financial institution is in breach of requirements or is in serious financial distress.

115. A number of points are worth emphasising.

- An effective regulatory framework generally relies on a combination of all three discipline pillars – self, market and supervisory disciplines. In general, the more effective self and market disciplines are, through sound corporate governance and internal risk management, and through active monitoring and reaction by market participants, the less need there is for regulatory interventions to enhance self and market discipline.
- As a generalisation, the regulatory costs (relating to compliance costs, administrative costs and dynamic efficiency) and risks (moral hazard, and the dilution of market and self discipline) tend to be lower with those regulatory instruments that seek to reinforce self and market discipline relative to those that involve prudential supervision.
- Information asymmetry problems are generally most effectively addressed through regulatory instruments that directly address those problems, and tend to be in the market discipline pillar and, to a lesser extent, in the self discipline pillar – mainly disclosure, ratings and external audit. Investor education and the management of investor expectations are also important tools in addressing information asymmetry problems.
- Externalities (such as financial instability and reputation risk) generally require use of regulatory tools across all three pillars. The more material the risk and impact of an externality, the greater the case for use of more intensive prudential regulatory instruments.
- Investor/depositor protection issues are best addressed through a combination of regulatory instruments across all three pillars. In the case of financial functions where the impact (on individuals, the financial system and the economy) of financial losses by investors, or the costs associated with low investor confidence, are relatively low, then the main regulatory instruments are those within the self and market discipline pillars. If the impact of financial losses by investors or the costs associated with low investor confidence are relatively high, then a greater case can be made for using regulatory instruments in the prudential supervision pillar.

116. In the case of NBDTs, a case for more use of regulation – across all three pillars – can be made, due to the materiality of information asymmetry, the non-expert nature of the investor, the externalities associated with failure or poor risk management, and the impact of investor loss or the cost of low investor confidence. Some form of prudential supervision is justified because regulating for greater information disclosure is unlikely

to be sufficient to address the information asymmetry problem – i.e. due to the limitations of depositors being able to assimilate and understand the information in question.

APPENDIX 2: SUMMARY OF QUESTIONS FOR SUBMISSION

1. Do you agree with the proposed definition of NBDT? If not, please provide your reasons and any thoughts you may have on an alternative definition.

2. Do you agree with the proposed outcomes being sought for regulatory intervention in the NBDT sector? Do you have suggestions for alternative outcomes for the NBDT sector?

3. Do you agree with the reasons for regulating NBDTs as set out in this discussion paper? We would be interested in hearing your perspectives on this issue, including any alternative views you might have on the reasons for regulating NBDTs.

4. What are your views on the proposed objectives for the regulation and supervision of NBDTs?

5. Do you agree with the problems identified with the existing regulatory framework for NBDTs, as assessed in this discussion paper? If not, please provide your views on this issue.

6. Do you agree that the proposed creation of two tiers of NBDTs, with ADTs being restricted to lower-risk NBDTs, and other NBDTs being supervised under enhanced trust deed arrangements, is a more cost-effective means of meeting the proposed regulatory objectives that the alternative options? If not, please suggest the alternative options you would prefer and why.

7. Do you agree with the proposal that the ADT category be elective? Please give your reasons?

8. Do you agree that the Reserve Bank should have the power to require a deposit-taker to become an ADT where the size and nature of the deposit-taker's business is such that its failure could pose a risk to the soundness of the financial system?

9. Do you consider that some types of deposit-taking should require the NBDT providing those types of deposits to be in the ADT category? Please give your reasons.

10. What are your reactions to the proposed requirements for the ADT category and Tier 2 NBDT category? Do you think that they are appropriately calibrated for the proposed regulatory objectives and outcomes? If not, please suggest alternatives.

11. Do you agree that building societies and credit unions that cannot or do not seek to be ADTs should be supervised as a special category of NBDT, rather than being supervised as Tier 2 NBDTs? If not, please suggest your preferred approach and the reasons for it

Ministry of Economic Development

Manatū Ōhanga

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS:
SUPERVISION OF ISSUERS

Discussion Document

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Pages 3-70 contain information that is outside the scope of your request and so have been removed

287. Similarly, a debt investor has no ownership of the underlying business. However, a debt security is a promise by the issuer that it will repay that debt to the investor. For this reason, it may be that a debt investor should have some ability to have a say (for example, requesting an amendment to the trust deed) if it believes that the issuer will not meet that promise.

Questions for Submission

59. What should constitute a quorum at a meeting of debt security holders and what level of votes must be cast to pass a resolution at the meeting?

60. Is there any reason to distinguish between the thresholds required in respect of a debt security and an equity security?

61. Is there any reason to distinguish between the thresholds required in respect of a debt security and an equity security?

7.6 MATTERS TO BE ADDRESSED AND DISCLOSED IN TRUST DEEDS

288. We consider there are a number of matters that should be addressed and disclosed in every debt trust deed. We propose to prescribe high-level headings rather than specific provisions that prescribe how these matters must be addressed. This will provide assurance to the Government that minimum protections are being addressed and disclosed in trust deeds, whilst retaining flexibility for the trustee and issuer to determine how those minimum protections are met. It will also allow comparisons of protections across different trust deeds.

289. However, there are some matters that may need greater specification. These are identified below.

7.6.1 Corporate Governance

290. The trust deed should disclose the corporate form of the debt issuer so the investor knows what corporate governance requirements the debt issuer must comply with.

291. The trust deed should also disclose what additional corporate governance requirements apply to the debt issuer. For example, the entry criteria for registration as a debt issuer. All debt issuers will be required to satisfy negative assurance requirements. However, if the debt issuer is a Tier 2 NBDT it may be subject to qualitative entry requirements. For example, a Tier 2 NBDT that wants to issue debt securities may be required to have: sufficient experience and capital to run a financial institution; a minimum number of directors and independent directors on, and an independent chair of, the board; and possibly a credit rating. This proposal for Tier 2 NBDTs is discussed in detail in the discussion paper *Non-Bank Deposit-Taking Financial Institutions*.

292. If the debt issuer is listed, the trust deed should disclose that the debt issuer is also subject to the governance requirements set out in the applicable NZX Listing Rules.

7.6.1.1 Terms of the Securities

293. The trust deed should disclose what restrictions there are on the variation of securities after issue. For example, it is important for the investor to know whether the issuer is able to issue new securities, and if so, what impact the new securities will have on the investor's securities.

7.6.1.2 Financial Covenants

294. The trust deed should disclose what financial ratios are used and what financial covenant definitions are used.

295. It is proposed that trust deeds for Tier 2 NBDTs use a standardised capital adequacy measurement framework, most probably Basel II standardised, as the framework for measuring capital adequacy relative to on- and off-balance sheet exposures. It is also proposed that trust deeds for Tier 2 NBDTs specify a minimum tier 1 capital ratio, probably measured using the Basel II framework. An option is being raised regarding whether the minimum capital ratio should be left for the trustee to negotiate with the issuer, or whether a minimum capital ratio be prescribed for all Tier 2 NBDTs with the trustee still able to negotiate a capital ratio above the minimum. These proposals for Tier 2 NBDTs are discussed in detail in the discussion paper *Non-Bank Deposit-Taking Financial Institutions*.

7.6.1.3 Minimum Capital

296. The trust deed should disclose the minimum capital requirement that has been negotiated with the issuer.

297. It is proposed that Tier 2 NBDTs must have a minimum capital in the region of $500,000 to $2 million, with trustees able to negotiate a higher minimum capital requirement, where appropriate. The trust deed should clearly disclose the minimum capital and whether the minimum capital is over and above the regulatory minimum capital requirement.

7.6.1.4 Exposure

298. The trust deed should disclose what restrictions there are on any related party transactions. The trust deed should use the definitions of related parties and related party transactions as set out in NZIAS 24 *Related Party Disclosures*.

299. We seek feedback on whether trust deeds must specify a maximum limit for credit exposures to related parties.

300. The trust deed should also disclose, if applicable, whether there are any restrictions on concentration levels.

7.6.1.5 Reporting

301. The trust deed should disclose how the issuer will keep the trustee informed. As discussed above, we question whether trustees should have a power in law to require periodic reporting from the issuer. We consider that at the least, the trustee should consider what minimum reporting requirements are appropriate and to disclose the reporting obligations in the trust deed.

7.6.1.6 Trustee Duties and Powers

302. The trust deed should set out the duties and powers the trustee has, as set out in law or implied into the trust deed, and those negotiated under the trust deed.

7.6.1.7 Meetings

303. As discussed above, we are proposing that the process for meetings should be addressed at law. We consider that the process for meetings should also be explained in the trust deed, to give all parties sufficient certainty about how meetings can be initiated and conducted, and the rights of the parties during the meetings.

7.6.1.8 Appointment and Removal of Trustees

304. The trust deed should disclose the process for appointment and removal of trustees.

Questions for Submission

62. Do these headings cover all the key matters that should be addressed and disclosed in all debt trust deeds?

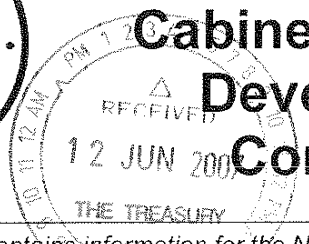
63. If no, what other key matters should be addressed and disclosed in all debt trust deeds?

64. Should the proposal that trust deeds for Tier 2 NBDTs use a standardised capital adequacy measurement framework, most probably Basel II standardised, as the framework for measuring capital adequacy relative to on- and off-balance sheet exposures be extended to all debt issuers? If no, why?

65. Should the proposal that trust deeds for Tier 2 NBDTs specify a minimum tier 1 capital ratio, probably measured using the Basel II framework, be extended to all debt issuers? If no, why? If yes, should the minimum capital ratio be left for the trustee to negotiate with the issuer, or prescribed (with the trustee still able to negotiate a capital ratio above the minimum)?

66. Should all debt trust deeds specify a maximum limit to related party exposures? If no, why?

67. Should trust deeds for Tier 2 NBDTs specify a maximum limit to related party exposures? If no, why?



Cabinet Economic Development Committee

EDC (07) 89

12 June 2007

Copy No: 37

Title

Review of Financial Products and Providers and Financial Intermediaries - Overview Paper

Purpose

This paper provides an overview of the findings of the reviews of Financial Products and Providers and Financial Intermediaries, and proposes a two step approach to introducing legislation to implement those findings.

This overview paper should be read in conjunction with a suite of six other papers covering the reviews of financial products, providers and financial intermediaries [EDC (07) 97, 99, 88, 98, 95 and 96].

Previous Consideration

In December 2005 the Cabinet Business Committee considered domestic institutional arrangements for financial sector regulation and regulation of financial intermediaries [CBC Min (05) 18/28].

In August 2006 the Cabinet Economic Development Committee (EDC) noted the intention of the Minister of Commerce to release a series of discussion documents as part of the review of Financial Products and Providers [EDC Min (06) 13/7].

Summary

The proposals in the suite of papers will result in the comprehensive modernisation of the regulatory frameworks that apply to all non-bank financial institutions, participants and products. The intention is to achieve an effective and consistent regulatory environment that better achieves government objectives, keeps any necessary compliance costs to a minimum and improves consumer confidence in the sector.

Non-bank financial products and providers include insurance, collective investment schemes, platforms and portfolio management services, non-bank deposit takers, securities offerings and issuers of equity and debt securities.

The key features of the proposals are to:

- register all financial service providers;
- strengthen the current model of trustee supervision that applies to debt issuers, non-bank deposit takers and collective investment schemes;
- strengthen trustee-based prudential regulation of non-bank deposit takers (Reserve Bank);
- provide for a more comprehensive regulatory oversight of financial intermediaries/advisors by a government regulator;
- provide for effective consumer dispute resolution and redress across all parts of the sector.

The proposals will help to ensure that New Zealand meets its international obligations, especially those arising from it membership of the Financial Action Task Force, which sets global standards for combating money laundering and terrorist financing.

Regulatory Impact Statements are attached to each of the other six papers in the suite of papers.

Baseline Implications

The proposals in the suite of papers will increase the roles and functions of the Ministry of Economic Development, the Securities Commission and the Reserve Bank. The indicative costs are $1.3 - $2.0 million in 2008/09 rising to $7.7 - $16.1 million in 2011/12. A further report in November 2007 will include detailed costings.

Legislative Implications

It is proposed that there be a two stage approach to legislation beginning with that urgently needed to implement decisions to achieve compliance with international obligations and to better protect consumers.

A Financial Products, Providers and Intermediaries Bill has a category 4 priority (to proceed to a select committee in 2007) on the 2007 Legislation Programme. It is proposed that this bill be replaced by a Financial Advisors Bill and a Financial Service Providers Registration and Dispute Resolution Bill, both holding category 4 priority, to enable work on the legislation to commence immediately (see EDC (07) 97 and 96 respectively).

A new Bill to amend the Reserve Bank of New Zealand Act 1989 is also proposed (see EDC (07) 88).

Timing Issues

It is planned that the legislation be passed in 2008.

Announcement	The Minister intends to announce any decisions arising out of the proposals in the suite of papers on 19 June 2007, including the details of the further work requested.
Consultation	The Minister indicates that the Minister of Finance has been consulted. The Minister indicates that consultation will be required with the government caucuses and with other parties represented in Parliament. Paper prepared by MED. DPMC, Treasury, Reserve Bank, Consumer Affairs, Justice, Securities Commission, IRD, Labour, DIA, SSC, Retirement Commission, MSD, MFAT, MfE, TPK, Customs, DBH and Office of the Privacy Commissioner were consulted.

The Minister of Commerce recommends that the Committee:

Background

1 note that in:

1.1 December 2005 Cabinet considered domestic institutional arrangements for financial sector regulation and regulation of financial intermediaries [CBC Min (05) 18/28];

1.2 August 2006 the Cabinet Economic Development Committee noted the intention of the Minister of Commerce to release a series of discussion documents as part of the review of Financial Products and Providers [EDC Min (06) 13/7];

2 note that a suite of seven papers has been prepared reporting on the outcomes of the review of Financial Products and Providers and Financial Intermediaries, following the consideration of submissions on the discussion documents referred to in paragraph 1;

Overview paper

3 agree, subject to the report in paragraph 8 on the detailed costings of the following proposals and the implications for Vote Commerce, to a two-stage approach to legislation beginning with the introduction of legislation most urgently needed to implement decisions necessary to achieve compliance with international obligations and to better protect consumers through:

3.1 registration of all financial service providers;

3.2 improved supervision of corporate trustees;

3.3 improved prudential supervision of non-bank deposit takers, to be overseen by a single prudential regulator that would also be responsible for the prudential regulation of insurers;

3.4 regulation of financial intermediaries;

3.5 providing for a comprehensive approach to consumer dispute resolution and redress;

4 note that policy recommendations necessary to draft legislation for the proposals in paragraph 3 are contained in the accompanying papers:

4.1 Registration of Financial Service Providers [EDC (07) 97];

4.2 Trustee Supervisory Model [EDC (07) 99];

4.3 Institutional Arrangements for Prudential Regulation [EDC (07) 88];

4.4 Regulation of Non-Bank Deposit Takers [EDC (07) 98];

4.5 Financial Advisers – A New Regulatory Framework [EDC (07) 95];

4.6 Consumer Dispute Resolution and Redress [EDC (07) 96];

Legislative implications

5 note that a Financial Products, Providers and Intermediaries Bill (the Bill) has a category 4 priority (to proceed to select committee in 2007) on the 2007 Legislation Programme;

6 agree to replace the Bill on the 2007 Legislation Programme with two Bills both holding a category 4 priority, the Financial Advisors Bill and the Financial Service Providers Registration and Dispute Resolution Bill, to give urgency to measures to achieve compliance with international obligations and to better protect consumers;

7 note that the paper under EDC (07) 88 separately seeks approval for a Reserve Bank of New Zealand Amendment Bill, with a category 4 priority, to give effect to proposals relating to the institutional arrangements for prudential regulation;

Next steps

8 direct officials from the Ministry of Economic Development, in consultation with the Securities Commission and Treasury, to report to EDC by 30 November 2007 on the detailed costings and funding options for Vote Commerce output expenses arising from the additional functions associated with:

8.1 the registration of all financial service providers;

8.2 the regulation of financial advisers;

8.3 the strengthened supervision of corporate trustees;

8.4 provision for industry provided dispute resolution schemes including options for industry or self funding;

9 direct officials from the Reserve Bank in consultation with the Treasury to report separately to EDC in July 2007 on details related to the regulation of non-bank deposit takers, including funding requirements;

10 direct officials from the Ministry of Economic Development (lead), the Treasury, the Reserve Bank of New Zealand and the Securities Commission to report to EDC by 30 November 2007 with proposals to provide for:

10.1 a single regulatory regime for collective investment schemes including the implications for all superannuation schemes of Ministerial decisions to separately progress regulation of KiwiSaver compliant schemes;

10.2 improved trustee supervision of debt issuers;

10.3 an improved approach to disclosure for securities offerings;

10.4 necessary amendments to the law relating to insurer contracts and disclosure;

10.5 a comprehensive and simplified approach to regulating mutuals' governance;

10.6 the regulation of platforms and portfolio management services that perform investment discretions on behalf of investors;

11 direct officials from the Reserve Bank of New Zealand (lead), the Treasury, the Ministry of Economic Development and the Securities Commission to report to EDC by 30 November 2007 with proposals to provide for a comprehensive prudential regulatory regime for insurers;

Publicity

12 note that the Minister of Commerce intends to announce the government's decisions on the reviews of Financial Products and Providers and Financial Intermediaries including details of:

12.1 the two step approach to legislation;

12.2 the specific policy decisions made on proposals in the accompanying papers under EDC (07) 88, 95, 96, 97, 98 and 99;

12.3 the further work directed of officials in paragraphs 8, 9, 10 and 11 above;

13 note that the Minister of Commerce intends, as part of the above announcement, to publicly release the paper under EDC (07) 89, and the related papers on:

13.1 Registration of Financial Service Providers [EDC (07) 97];

13.2 Trustee Supervisory Model [EDC (07) 99];

13.3 Institutional Arrangements for Prudential Regulation [EDC (07) 88];

13.4 Regulation of Non-Bank Deposit Takers [EDC (07) 98];

13.5 Financial Advisers – A New Regulatory Framework [EDC (07) 95];

13.6 Consumer Dispute Resolution and Redress [EDC (07) 96];

EDC (07) 89

Out of scope

Bob Macfarlane
for Secretary of the Cabinet

Copies to:
Cabinet Economic Development Committee
Chief Executive, DPMC
Paul Alexander, DPMC
PAG Subject Advisor, DPMC
Secretary to the Treasury
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Commissioner of Inland Revenue
Chief Parliamentary Counsel
Legislation Coordinator

OFFICE OF THE MINISTER OF COMMERCE

The Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

REVIEWS OF FINANCIAL PRODUCTS AND PROVIDERS AND FINANCIAL INTERMEDIARIES - OVERVIEW PAPER

PROPOSAL

1 This paper seeks the Committee's agreement to:

a A two step approach to introducing legislation to implement the findings of the reviews of Financial Products and Providers and Financial Intermediaries;

b The finalisation of funding implications prior to the introduction of legislation;

c Announcement of decisions; and

d Out of scope

EXECUTIVE SUMMARY

2 This is one of six papers that report on the outcomes of reviews of Financial Products and Providers and Financial Intermediaries.

3 It provides the Committee with an overview of the two reviews and seeks the Committee's agreement to:

a A two step approach to introducing legislation to implement the findings of the reviews of Financial Products and Providers and Financial Intermediaries:

i Beginning with legislation to implement decisions contained in the accompanying papers necessary to achieve compliance with international obligations and to better protect consumers through:

(a) Registration of all financial service providers;

(b) Improved supervision of corporate trustees;

(c) Improved trustee-based prudential supervision of non-bank deposit takers overseen by a single prudential regulator, being the Reserve Bank of New Zealand;

(d) Regulation of Financial Advisers; and

(e) Provision for a comprehensive approach to consumer dispute resolution and redress.

ii Followed by legislation to implement a second tranche of decisions to be taken by November 2007 on those parts of the review necessary to:

(a) Improve supervision by corporate trustees of collective investment schemes and debt issuers;

(b) Simplify and improve security offerings disclosure;

(c) Modernise insurer prudential and market conduct regulation;

(d) Consolidate regulation of mutuals' governance; and

(e) Regulate platforms and portfolio management services.

b Consider the funding implications for the Ministry of Economic Development, the Securities Commissions and the Reserve Bank of New Zealand prior to the introduction of legislation;

c Announcement of decisions; and

d Out of scope

4 This paper should be read in conjunction with the following papers:

a Registration of Financial Service Providers

b Trustee Supervisory Model

c Institutional Arrangements for Prudential Regulation

d Regulation of Non-Bank Deposit Takers

e Financial Advisers – A New regulatory Framework

f Consumer Dispute Resolution and Redress

BACKGROUND

5 Non-bank financial products and providers include insurance, collective investment schemes, platforms and portfolio management services, non-bank deposit takers, securities offerings and issuers of equity and debt securities.

6 These products and providers are currently regulated by a myriad of laws that have been developed in different decades and centuries, with confusing and conflicting objectives. This has led to gaps in coverage, inconsistencies in the regulatory treatment of similar products and unnecessary compliance costs. There are concerns about the adequacy of consumer protection in some areas and the overall effectiveness of regulation in achieving its objectives. In some areas New Zealand does not comply with current international principles and obligations including some of the recommendations of the Financial Action Task Force's 40 Recommendations on Money Laundering and its 9 Special Recommendations on Terrorist Financing.

7 To improve regulation of non-bank financial institutions, financial products and financial intermediaries, two separate but related reviews were commenced in 2004 and 2005, being:

a Review of Financial Intermediaries; and

b Review of Financial Products and Providers.

8 Both reviews share the objectives of:

a A sound and efficient financial system;

b Investment which encourages growth and innovation;

c An environment which facilitates wealth accumulation; and

d Confidence in the sector which encourages participation by consumers and market participants.

9 Both reviews were informed by expert advisory groups and taskforces made up of people from key industry organisations, industry participants, professional organisations and government bodies. Their input contributed to officials' identification of issues and development of proposals for consultation. Officials' proposals for consultation were noted by Cabinet prior to consultation in 2006. Over the three month period allowed for consultation, around 140 written submissions were received on each review. The implications of these submissions for the original proposals have been considered by officials and are reflected in the proposals to the Committee.

10 Officials have also given further consideration to institutional arrangements for prudential regulation of non-bank deposit takers and insurers, and the process for drafting and introducing the necessary legislation to implement the findings arising out of the reviews of Financial Intermediaries and Financial Products and Providers.

Previous Consideration

11 On 12 December 2005, Cabinet considered domestic institutional arrangements for financial sector regulation and regulation of financial intermediaries [Cab Min (05) 41/1 refers] and:

a Directed the interdepartmental working group (Chair, Treasury) to report to EDC on detailed institutional arrangements for the prudential regulator by 30 November 2006 [CBC Min (05) 18/28]; and

b Agreed in principle to a co-regulatory model for financial intermediaries and directed officials to carry out further detailed design work [CBC Min(05) 18/31 refers].

12 On 23 August 2006, EDC considered proposals to release a series of discussion documents as part of the review of Financial Products and Providers and [EDC Min (06) 13/7 refers]:

a Noted the intention of the Minister of Commerce to release the following discussion documents;

i Overview of the Review and Registration of Financial Institutions

ii Review of Securities Offerings

iii Supervision of Issuers

iv Collective Investment Schemes

v Non-Bank deposit Takers

vi Insurance

vii Mutuals' Governance

viii Consumer dispute resolution and redress

ix Platforms and Portfolio Management Services

b Invited the Minister of Commerce to submit a further paper to Cabinet by April 2007 seeking approval for policy decisions on the Review of Financial Products and Providers; and

c Agreed to defer the report to Cabinet on detailed institutional arrangements for the financial sector prudential regulator to April 2007.

13 On 2 April 2007, Cabinet agreed to defer the above report backs to 30 June 2007 [CAB Min (07) 11/4 and EDC Memo (07) 6/1 refer].

Overview of Proposals

14 If agreed to, the proposals arising from the reviews of Financial Intermediaries and Financial Products and Providers will result in a comprehensive

modernisation of the regulatory frameworks that apply to all non-bank financial institutions, participants and products. The intent is to achieve a more effective and consistent regulatory environment that better achieves government policy objectives, while keeping any necessary compliance costs to a minimum and improving consumer confidence in the sector.

15 The proposals will also help ensure that New Zealand meets its international obligations, especially those arising from its membership of the Financial Action Task Force which sets global standards for combating money laundering and terrorist financing.

16 For some sectors (such as non-bank deposit takers and financial advisers) this will mean an overall increase in the level of government regulation.

17 The main proposals arising from the reviews, so far, are contained in the accompanying papers and relate to the need to:

i Register all financial service providers which provide financial services in or from New Zealand. This is necessary to provide an initial means of identifying and monitoring financial service providers and is a critical first step in the implementation of other review proposals. It is also necessary to achieve compliance with international obligations;

ii Strengthen the current model of trustee supervision that applies to debt issuers, non-bank deposit takers, and collective investments schemes, by licensing trustees and providing for their supervision by the Securities Commission. This is necessary to promote consistency, provide assurance that trustees are competent and to achieve compliance with international obligations;

iii Strengthen trustee-based prudential regulation of non-bank deposit takers by, among other matters, requiring them to meet minimum prudential, governance and fit and proper requirements administered by a single prudential regulator that would also regulate insurers;

iv Provide for more comprehensive regulatory oversight of financial intermediaries by a government regulator (in conjunction with industry professional bodies). This is necessary to improve consumer confidence in the sector and to achieve compliance with International Organisation of Securities Commissions' objectives and principles of securities regulation; and

v Provide for effective consumer dispute resolution and redress across all parts of the sector. This is necessary to improve consumer confidence in the sector.

18 A further paper recommends that the Committee confirm Cabinet's earlier in principle decision that the Reserve Bank of New Zealand be the single prudential regulator (for banks, non-bank deposit takers and insurers).

19 Further policy work is necessary before decisions can be taken on the following additional proposals arising from the Review of Financial Products and Providers to:

i Enhance the trustee supervision model for collective investment schemes and debt issuers. The focus of this work is on improving the consistency of supervision by trustee's of collective investment schemes and debt issuers by setting in law minimum requirements for supervision and ensuring that trustee's have appropriate duties and powers to perform their roles;

ii Simplify and improve the relevancy of disclosure requirements for issuers of securities. The focus of this work is on clarifying the definition of public investors to which disclosure laws apply and simplifying the current two document disclosure regime to reduce compliance costs on issuers while ensuring that public investors are adequately informed in their investment decisions;

iii Modernise regulation of insurers in terms of both their prudential operation and their conduct. The focus of this work is on ensuring a consistent approach to the regulation of insurers through licensing and supervision by a single prudential regulator and improved market conduct and disclosure requirements;

iv Improve governance of entities utilising a mutual form. The focus of this work is on the development of base level corporate governance requirements for mutuals that would be set in a single statute; and

v Regulate platforms and portfolio management services. The focus of this work is on ensuring minimum protections for consumers of platform and portfolio management services that perform advisory and custodial roles.

20 Given the enhancements to KiwiSaver announced in Budget 2007, and Ministerial decisions to progress regulation of KiwiSaver compliant schemes separately, the proposed report back to Cabinet in November 2007 on collective investment schemes will include consideration of the implications for all superannuation schemes of the decision to progress regulation of KiwiSaver compliant schemes separately.

A Two Step Approach to Legislation and Decision Making

21 When taken together the above proposals will require a large legislative and operational effort to implement.

22 A *Financial Products, Providers and Intermediaries Bill* is currently included in the 2007 Legislation programme in Category 4 (to proceed to select committee in 2007).

23 I am advised by officials that the policy and drafting work necessary to complete this Bill for introduction would take up two years to complete. This would mean that legislation which is urgently required to implement the necessary proposals to improve New Zealand's compliance with the Financial Action Task Force Recommendations and to improve consumer confidence in the sector would not be passed in 2008.

24 To ensure that legislation necessary to implement the most urgent proposals is progressed quickly I propose a two-step approach to the drafting and introduction of legislation, beginning with that legislation necessary to implement decisions on the proposals contained in the accompanying papers. These are the highest priority proposals and are necessary to achieve compliance with international obligations and to better protect consumers through:

a Registration of all financial service providers;

b Improved supervision of corporate trustees;

c Improved prudential supervision of non-bank deposit takers;

d Regulation of Financial Advisers; and

e Providing for a comprehensive approach to consumer dispute resolution and redress.

25 Subject to the proposed report back to the Committee on the fiscal implications of these proposals (as discussed in paragraph 38), I intend seeking approval to introduce the following Bills, to be passed in 2008, to implement the above the provisions:

a Financial Advisers Bill; and

b Financial Service Providers Registration and Dispute Resolution Bill.

26 The Minister of Finance will separately report on legislation necessary to implement proposed changes to the governance and accountability arrangements necessary to make the Reserve Bank the single prudential regulator. This is likely to require a further Bill, also to be passed in 2008.

27 A second tranche of legislation would be developed with a longer timetable to provide for the implementation of less urgent initiatives necessary to:

a Improve supervision collective investment schemes and debt issuers by Corporate Trustees;

b Simplify and improve security offerings disclosure;

c Modernise insurer prudential and market conduct regulation;

d Consolidate regulation of mutuals' governance; and

e Regulate platforms and portfolio management services.

28 I propose reporting back to Cabinet with proposals necessary for the drafting of this second tranche of legislation on each of the above by November 2007.

Out of scope

CONSULTATION

34 The proposals in this paper have been developed in consultation with the Treasury, the Ministry of Justice, the Securities Commission and the Reserve Bank of New Zealand. The following departments have also been consulted on the proposals made in this paper and their views incorporated: the Ministry of Consumer Affairs, the Inland Revenue Department, Department of Labour, Department of Internal Affairs, State Services Commission, Retirement Commission, Ministry of Social Development, Ministry of Foreign Affairs and Trade, Ministry for the Environment, Te Puni Kokiri, Customs Department, Department of Building and Housing and the Office of the Privacy

Commission. The Department of the Prime Minister and Cabinet has been informed of the proposals.

FISCAL IMPLICATIONS

35 Implementation of the proposals in the accompanying papers will have implications for the roles and functions of the Ministry of Economic Development, the Securities Commission and the Reserve Bank of New Zealand (which in all cases will expand). Indicative estimates of the costs of these additional functions are summarised in the table below. Although the exact funding implications are still being worked through and may change as decisions are made, it is currently estimated that the proposals in the accompanying papers for registration of all financial institutions, consumer dispute resolution and redress, regulation of financial intermediaries, improved supervision of trustees and Reserve Bank prudential supervision of non-bank deposit takers and insurers will require additional operational funding in the order of:

a $1.3 – 2.0 million in 2008/09;

b $7.0 – 10.5 million in 2009/10;

c $7.4 – 14.2 million in 2010/11;

d $7.7 – 16.1 million in 2011/12; and

e $6.1 – 12.5 million per annum in outyears.

	08/09	09/10	10/11	11/12	Ongoing
Votes Commerce, and Economic, Industry and Regional Development	$M	$M	$M	$M	$M
Ministry of Economic Development – additional Companies Office functions and dispute resolution monitoring and advice (Vote Commerce)	0.4 – 0.6	1.2 – 1.5	0.9 – 1.6	0.9 – 1.6	0.9 – 1.6
Associated capital expenditure (Vote Economic, Industry and Regional Development)	0.4 – 1.0	0.7 – 2.0			
Securities Commission – additional regulation of financial Advisers and supervision trustee functions (Vote Commerce)	0.3	3.2 – 4.9	3.5 – 7.6	3.8 – 9.5	2.2 – 5.9
Associated capital expenditure (Vote Economic, Industry and Regional Development)		0.8 – 1.4			
Reserve Bank Funding Agreement					
Additional Reserve Bank functions to supervise the prudential regulation of Non-Bank Deposit Takers and Insurers	0.6 – 1.1	2.6 – 4.2	3.0 – 5.0	3.0 – 5.0	3.0 – 5.0
Associated capital expenditure	0.4	0.4	0.4	0.4	0.4
Total estimated operational expenditure	1.3 – 2.0	7.0 – 10.5	7.4 – 14.2	7.7 – 16.1	6.1 – 12.5
Total estimated capital expenditure	0.8 – 1.4	1.9 – 3.8	0.4	0.4	0.4

36 These estimates outlined above are indicative only. Additionally, they do not include the costs of additional functions associated with proposals still to be considered by November 2007 on insurer market conduct regulation; securities offering disclosure; supervision of debt issuers; regulation of collective investment schemes; mutuals' governance; regulation of platforms and portfolio management services; or any additional anti-money laundering supervision requirements to be proposed by the Ministry Justice later this year. Further consideration is also required of government support for the establishment of approved professional bodies for financial intermediaries and in the establishment of dispute resolution schemes. Depending on the timing of decisions and legislation, costs between years may also vary.

37 I propose to report back to Cabinet, prior to the introduction of the first tranche of legislation, with detailed costings of these proposals by 30 November 2007, rather than as part of Budget 2008, and seek any increases in baseline funding for Vote:Commerce at that stage. I also propose that officials consider options for industry or other self funding in that report back.

38 The Minister of Finance will separately report on the funding implications of additional functions for the Reserve Bank associated with its prudential supervision of non-bank deposit takers as part of the proposed July 2007 report back on non-bank deposit takers.

HUMAN RIGHTS

39 Overall the proposals in this and the accompanying papers do not appear to be inconsistent with the New Zealand Bill of Rights Act 1990, or the Human Rights Act 1993. However, if any issues do arise, officials from the Ministry of Economic Development and Ministry of Justice will work together to ensure that the legislation is consistent with the Bill of Rights Act. A final view as to whether the proposals will be consistent with the Bill of Rights Act will be possible once the legislation has been drafted.

PRIVACY IMPLICATIONS

40 Officials from the Ministry of Economic Development have received an initial assessment of the privacy implications of the proposals and will work with the Office of the Privacy Commissioner to ensure consistency of the legislation with the Privacy Act 1993 during the drafting process.

LEGISLATIVE IMPLICATIONS

41 A Financial Products, Providers and Intermediaries Bill is included in the 2007 Legislation programme in Category 4 (to proceed to select committee in 2007).

REGULATORY IMPACT ANALYSIS

42 Regulatory Impact Statements are attached to each of the accompanying papers.

PUBLICITY

43 There has been significant interest in the reviews of Financial Intermediaries and Financial Products and Providers, especially from market participants, some of whom have been involved as members of advisory groups and in making submissions to the reviews.

44 I propose announcing the decisions on this paper and each of the accompanying papers including the details of further work requested of officials and the specific policy decisions on 19 June 2007. This will provide feedback and some certainty to market participants, and allow a sufficient lead time for the sector to prepare for changes to regulatory frameworks,

RECOMMENDATIONS

45 It is recommended that the Committee:

1 **Note** that a Financial Products, Providers and Intermediaries Bill is included in the 2007 Legislation programme in Category 4 (to proceed to select committee in 2007);

2 **Note** that a period of up to two years would be required to complete the policy and drafting work necessary to introduce this bill for all of the proposals arising from the reviews of Financial Intermediaries, Financial Products and Providers and Domestic Institutional Arrangements;

3 **Agree**, subject to the report back in recommendation 5 below on the detailed costings of the following proposals and the implications for Vote:Commerce, to a two-stage approach to legislation beginning with the introduction of legislation most urgently needed to implement decisions necessary to achieve compliance with international obligations and to better protect consumers through:

3.1 Registration of all financial service providers;

3.2 Improved supervision of corporate trustees;

3.3 Improved prudential supervision of non-bank deposit takers, to be overseen by a single prudential regulator that would also be responsible for the prudential regulation of insurers;

3.4 Regulation of financial intermediaries;

3.5 Providing for a comprehensive approach to consumer dispute resolution and redress;

4 **Note** that policy recommendations necessary to draft legislation in respect of the proposals in 3.1, 3.2, 3.3, 3.4 and 3.5 are contained in the accompanying papers entitled:

4.1 Registration of Financial Service Providers;

4.2 Trustee Supervisory Model;

4.3 Institutional Arrangements for Prudential Regulation;

4.4 Regulation of Non-Bank Deposit Takers;

4.5 Financial Advisers – A New regulatory Framework;

4.6 Consumer Dispute Resolution and Redress;

5 **Direct** officials from the Ministry of Economic Development, in consultation with the Securities Commission and Treasury, to report back to Cabinet by 30 November 2007 on the detailed costings and funding

options for Vote:Commerce output expenses arising from the additional functions associated with the registration of all financial service providers; the regulation of financial advisers; the strengthened supervision of corporate trustees; and provision for industry provided dispute resolution schemes including options for industry or self funding;

6 **Note** that officials from the Reserve Bank in consultation with the Treasury will report separately to Cabinet in July 2007 on details related to the regulation of non-bank deposit takers, including funding requirements;

7 **Direct** officials from the Ministry of Economic Development (lead), the Treasury, the Reserve Bank of New Zealand and the Securities Commission to report back to EDC by 30 November 2007 with proposals to provide for:

7.1 A single regulatory regime for collective investment schemes including the implications for all superannuation schemes of Ministerial decisions to separately progress regulation of KiwiSaver compliant schemes;

7.2 Improved trustee supervision of debt issuers;

7.3 An improved approach to disclosure for securities offerings;

7.4 Necessary amendments to the law relating to insurer contracts and disclosure;

7.5 A comprehensive and simplified approach to regulating Mutuals' governance;

7.6 The regulation of platforms and portfolio management services that perform investment discretions on behalf of investors;

8 **Direct** officials from the Reserve Bank of New Zealand (lead), the Treasury, the Ministry of Economic Development and the Securities Commission to report back to Cabinet by 30 November 2007 with proposals to provide for a comprehensive prudential regulatory regime for insurers;

9 **Invite** the Minister of Commerce to announce the government's decisions on the reviews of Financial Intermediaries and Financial Products and Providers including details of:

9.1 The two step approach to legislation;

9.2 The specific policy decisions made on proposals in the accompanying papers;

9.3 The further work directed of officials in Recommendations 7 & 8 above;

10 **Agree**, as part of the above announcement, to publicly release this paper and the related papers on:

10.1 Registration of Financial Service Providers;

10.2 Trustee Supervisory Model;

10.3 Institutional Arrangements for Prudential Regulation;

10.4 Regulation of Non-Bank Deposit Takers;

10.5 Financial Advisers – A New regulatory Framework;

10.6 Consumer Dispute Resolution and Redress;

11 Out of scope

12

s9(2)(k)

Hon Lianne Dalziel
Minister of Commerce

CAB 100/2006/1

Consultation on Cabinet and Cabinet Committee Submissions

Certification by Department

Guidance on the consultation requirements for Cabinet and Cabinet committee papers is provided in chapter 11 of the Step by Step Guide: Cabinet and Cabinet Committee Processes, available at http://www.dpmc.govt.nz/cabinet/guide/11.html.

Departments/agencies consulted: The attached submission has implications for the following departments/agencies whose views have been sought and are accurately reflected in the submission:

The Department of the Prime Minister and Cabinet, the Treasury, the Reserve Bank, the Ministry of Consumer Affairs, the Ministry of Justice, the Securities Commission, the Inland Revenue Department, Department of Labour, Internal Affairs, State Services Commission, Retirement Commission, Ministry of Social Development, Ministry of Foreign Affairs and Trade, Ministry for the Environment, Te Puni Kokiri, Customs Department, Department of Building and Housing and the Office of the Privacy Commissioner.

Departments/agencies informed: In addition, the following departments/agencies have an interest in the submission and have been informed:

Others consulted: Other interested groups have been consulted as follows:

Signature	Name, Title, Department	Date
s9(2)(k)	Justine Gilliland, Manager, Ministry of Economic Development	24 5 07

Certification by Minister

Ministers should be prepared to update and amplify the advice below when the submission is discussed at Cabinet/Cabinet committee. The attached submission/proposal:

Consultation at Ministerial level	☐ did not need consultation with other Ministers ☑ has been consulted with the Minister of Finance *[required for all submissions seeking new funding]* ☐ has been consulted with the following Minister(s) .....
Consultation with Labour/ Progressive caucuses	☐ does not need consultation with the government caucuses ☐ **has been** or ☑ **will be** consulted with the government caucuses
Consultation with other parties	☐ does not need consultation at parliamentary level ☐ **has been** consulted with the following other parties represented in Parliament: ☐ New Zealand First ☐ United Future ☐ Green Party ☐ Other [specify] ☑ **will be** consulted with the following other parties represented in Parliament: ☑ New Zealand First ☑ United Future ☑ Green Party ☐ Other [specify]

Signature	Portfolio	Date
s9(2)(k)	Commerce	29 5 07

Cabinet Economic Development Committee

EDC Min (07) 11/11

Minute of Decision

Copy Number: 21

Review of Financial Products and Providers and Financial Intermediaries - Overview Paper

On 13 June 2007, the Cabinet Economic Development Committee (EDC):

Background

1 **noted** that in:

1.1 December 2005 Cabinet considered domestic institutional arrangements for financial sector regulation and regulation of financial intermediaries [CBC Min (05) 18/28];

1.2 August 2006 the Cabinet Economic Development Committee noted the intention of the Minister of Commerce to release a series of discussion documents as part of the review of Financial Products and Providers [EDC Min (06) 13/7];

2 **noted** that a suite of seven papers has been prepared reporting on the outcomes of the review of Financial Products and Providers and Financial Intermediaries, following the consideration of submissions on the discussion documents referred to in paragraph 1 [EDC Min (07) 11/11-11/17];

Overview paper

3 **agreed**, subject to the report in paragraph 8 on the detailed costings of the following proposals and the implications for Vote Commerce, to a two-stage approach to legislation beginning with the introduction of legislation most urgently needed to implement decisions necessary to achieve compliance with international obligations and to better protect consumers through:

3.1 registration of all financial service providers;

3.2 improved supervision of corporate trustees;

3.3 improved prudential supervision of non-bank deposit takers, to be overseen by a single prudential regulator that would also be responsible for the prudential regulation of insurers;

3.4 regulation of financial intermediaries;

3.5 providing for a comprehensive approach to consumer dispute resolution and redress;

4 **noted** that the decisions on the policy proposals necessary to draft legislation for the proposals in paragraph 3 are contained in the following minutes:

4.1 Registration of Financial Service Providers [EDC Min (07) 11/12];

4.2 Trustee Supervisory Model [EDC Min (07) 11/13];

4.3 Institutional Arrangements for Prudential Regulation [EDC Min (07) 11/14];

4.4 Regulation of Non-Bank Deposit Takers (referred to Cabinet for further consideration);

4.5 Financial Advisers – A New Regulatory Framework [EDC Min (07) 11/16];

4.6 Consumer Dispute Resolution and Redress [EDC Min (07) 11/17];

Legislative implications

5 **noted** that a Financial Products, Providers and Intermediaries Bill (the Bill) has a category 4 priority (to proceed to select committee in 2007) on the 2007 Legislation Programme;

6 **agreed** to replace the Bill on the 2007 Legislation Programme with two Bills both holding a category 4 priority, the Financial Advisors Bill and the Financial Service Providers Registration and Dispute Resolution Bill, to give urgency to measures to achieve compliance with international obligations and to better protect consumers;

7 **noted** that it has also agreed to the inclusion of a Reserve Bank of New Zealand Amendment Bill on the Legislation Programme, with a category 4 priority, to give effect to proposals relating to the institutional arrangements for prudential regulation [EDC Min (07) 11/14];

Next steps

8 **directed** officials from the Ministry of Economic Development, in consultation with the Securities Commission and Treasury, to report to EDC by 30 November 2007 on the detailed costings and funding options for Vote Commerce output expenses arising from the additional functions associated with:

8.1 the registration of all financial service providers;

8.2 the regulation of financial advisers;

8.3 the strengthened supervision of corporate trustees;

8.4 provision for industry provided dispute resolution schemes including options for industry or self funding;

9 **directed** officials from the Reserve Bank in consultation with the Treasury to report separately to EDC in July 2007 on details related to the regulation of non-bank deposit takers, including funding requirements;

10 **directed** officials from the Ministry of Economic Development (lead), the Treasury, the Reserve Bank of New Zealand and the Securities Commission to report to EDC by 30 November 2007 with proposals to provide for:

10.1 a single regulatory regime for collective investment schemes including the implications for all superannuation schemes of Ministerial decisions to separately progress regulation of KiwiSaver compliant schemes;

10.2 improved trustee supervision of debt issuers;

10.3 an improved approach to disclosure for securities offerings;

10.4 necessary amendments to the law relating to insurer contracts and disclosure;

10.5 a comprehensive and simplified approach to regulating mutuals' governance;

10.6 the regulation of platforms and portfolio management services that perform investment discretions on behalf of investors;

11 **directed** officials from the Reserve Bank of New Zealand (lead), the Treasury, the Ministry of Economic Development and the Securities Commission to report to EDC by 30 November 2007 with proposals to provide for a comprehensive prudential regulatory regime for insurers;

Publicity

12 **noted** that the Minister of Commerce intends to announce the government's decisions on the reviews of Financial Products and Providers and Financial Intermediaries including details of:

12.1 the two step approach to legislation;

12.2 the specific policy decisions made on proposals in the accompanying papers under EDC (07) 88, 95, 96, 97, 98 and 99;

12.3 the further work directed of officials in paragraphs 8, 9, 10 and 11 above;

13 **noted** that the Minister of Commerce intends, as part of the above announcement, to publicly release the paper under EDC (07) 89, and the related papers on:

13.1 Registration of Financial Service Providers [EDC (07) 97];

13.2 Trustee Supervisory Model [EDC (07) 99];

13.3 Institutional Arrangements for Prudential Regulation [EDC (07) 88];

13.4 Regulation of Non-Bank Deposit Takers [EDC (07) 98];

13.5 Financial Advisers – A New Regulatory Framework [EDC (07) 95];

13.6 Consumer Dispute Resolution and Redress [EDC (07) 96];

Out of scope

[redacted]

s9(2)(k)

[redacted]

Kate Mallalieu
Secretary

Reference: EDC (07) 89

Present:
Hon Dr Michael Cullen (Chair)
Hon Jim Anderton
Hon Parekura Horomia
Hon Lianne Dalziel
Hon David Cunliffe
Hon Clayton Cosgrove

Officials present from:
Department of the Prime Minister and Cabinet
Treasury
Ministry of Economic Development

Copies to: (see over)

Copies to:
Cabinet Economic Development Committee
Chief Executive, DPMC
Paul Alexander, DPMC
PAG Subject Advisor, DPMC
Secretary to the Treasury
Secretary of Foreign Affairs and Trade
State Services Commissioner
Chief Executive, Ministry of Economic Development
Chief Executive, Te Puni Kokiri
Minister of Justice
Secretary for Justice
Secretary of Labour
Chief Executive, Ministry of Social Development (Senior Citizens)
Minister of Internal Affairs
Secretary for Internal Affairs
Chief Executive, Ministry of Social Development
Secretary for the Environment
Chief Executive, Ministry of Economic Development (Commerce)
Comptroller of Customs
Chief Executive, Department of Building and Housing
Head, Ministry of Consumer Affairs
Minister of Revenue
Commissioner of Inland Revenue
Chief Parliamentary Counsel
Legislation Coordinator

Cabinet Economic Development Committee

EDC Min (07) 11/15

Minute of Decision

Copy Number: 21

Review of Financial Products and Providers and Financial Intermediaries: Regulation of Non-Bank Deposit Takers

On 13 June 2007, the Cabinet Economic Development Committee:

1 **referred** the paper under EDC (07) 98 to Cabinet for consideration at its meeting on 18 June 2007;

2 **invited** the Minister of Commerce to provide further information for Cabinet on 18 June 2007 on;

2.1 whether there is evidence to justify treating credit unions differently to other non-bank deposit takers;

2.2 the status of other work underway relating to credit unions, particularly the government's review of the credit union provisions in the Friendly Societies and Credit Unions Act 1982;

2.3 Out of scope

s9(2)(k)

Kate Mallalieu
Secretary

Reference: EDC (07) 98

Present:
Hon Dr Michael Cullen (Chair)
Hon Jim Anderton
Hon Phil Goff
Hon Parekura Horomia
Hon Lianne Dalziel
Hon David Cunliffe
Hon Clayton Cosgrove

Officials present from:
Department of the Prime Minister and Cabinet
Treasury
Ministry of Economic Development

Copies to: (see over)

Copies to:
Cabinet Economic Development Committee
Chief Executive, DPMC
Paul Alexander, DPMC
PAG Subject Advisor, DPMC
Secretary to the Treasury
Chief Executive, Ministry of Economic Development
Minister of Justice
Secretary for Justice
Chief Executive, Ministry of Economic Development (Commerce)
Head, Ministry of Consumer Affairs
Chief Parliamentary Counsel
Legislation Coordinator

10

11711

Cabinet

CAB (07) 249

15 June 2007

Copy No: 24

Review of Financial Products and Providers and Financial Intermediaries: Regulation of Non-Bank Deposit-Takers

Portfolio: **Commerce**

On 13 June 2007 the Cabinet Economic Development Committee (EDC) considered the attached paper [EDC (07) 98] and referred it to Cabinet for consideration on 18 June 2007.

EDC invited the Minister of Commerce to provide further information to Cabinet on:

- the treatment of credit unions compared with other non-bank deposit-takers;
- the status of other work relating to credit unions that is currently underway.

A supplementary paper providing this information is attached directly below this coversheet as Annex 1.

Out of scope

The original paper submitted to EDC is attached below the second coloured divider as Annex 3.

The Minister of Commerce recommends that Cabinet:

Recommendations from supplementary information

1 note that on 13 June 2007 the Cabinet Economic Development Committee (EDC):

1.1 referred the paper under EDC (07) 98 to Cabinet for consideration at its meeting on 18 June 2007;

1.2 invited the Minister of Commerce to provide further information for Cabinet on 18 June 2007 on:

1.2.1 whether there is evidence to justify treating credit unions differently to other non-bank deposit takers;

1.2.2 the status of other work underway relating to credit unions, particularly the government's review of the credit union provisions in the Friendly Societies and Credit Unions Act 1982;

1.2.3 Out of scope

[EDC Min (07) 11/15]

Credit unions (Annex 1, pages 1-5)

2 note the contents of the supplementary information on the impact of the proposed non-bank deposit-taker regulation on credit unions, and the status of other work related to credit unions that is underway, as discussed in the paper attached as Annex 1 under CAB (07) 249;

3 note that credit unions perform very similar functions to those of other non-bank deposit-takers (NBDTs);

4 note that credit unions' business entails risks of a similar nature to those of other NBDTs and that they should be subject to appropriate prudential regulation similar to that of other NBDTs;

5 note that the proposed reduction in operational constraints on NBDTs will expose credit unions to somewhat greater financial risks and hence there will be a greater need for credit unions to be regulated on much the same basis as for other NBDTs;

6 agree that the supervisory framework structures outlined in the paper on the regulation of NBDTs (attached as Annex 3 under CAB (07) 249) be applied in full to credit unions, subject to advice being submitted to Cabinet by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers;

7 confirm, subject to the supervisory framework for the regulation of NBDTs being applied to credit unions, that the changes agreed to in principle by Cabinet in April 2006 [EDC Min (05) 9/7] in respect of credit unions be adopted, namely:

7.1 allow credit unions to:

7.1.1 have the equivalent flexibility to borrow and invest surplus funds and to hold land as any other NBDT, if credit union rules allow and if trust deeds are amended accordingly;

7.1.2 raise capital by issuing securities to their members, if their rules and trust deeds allow it;

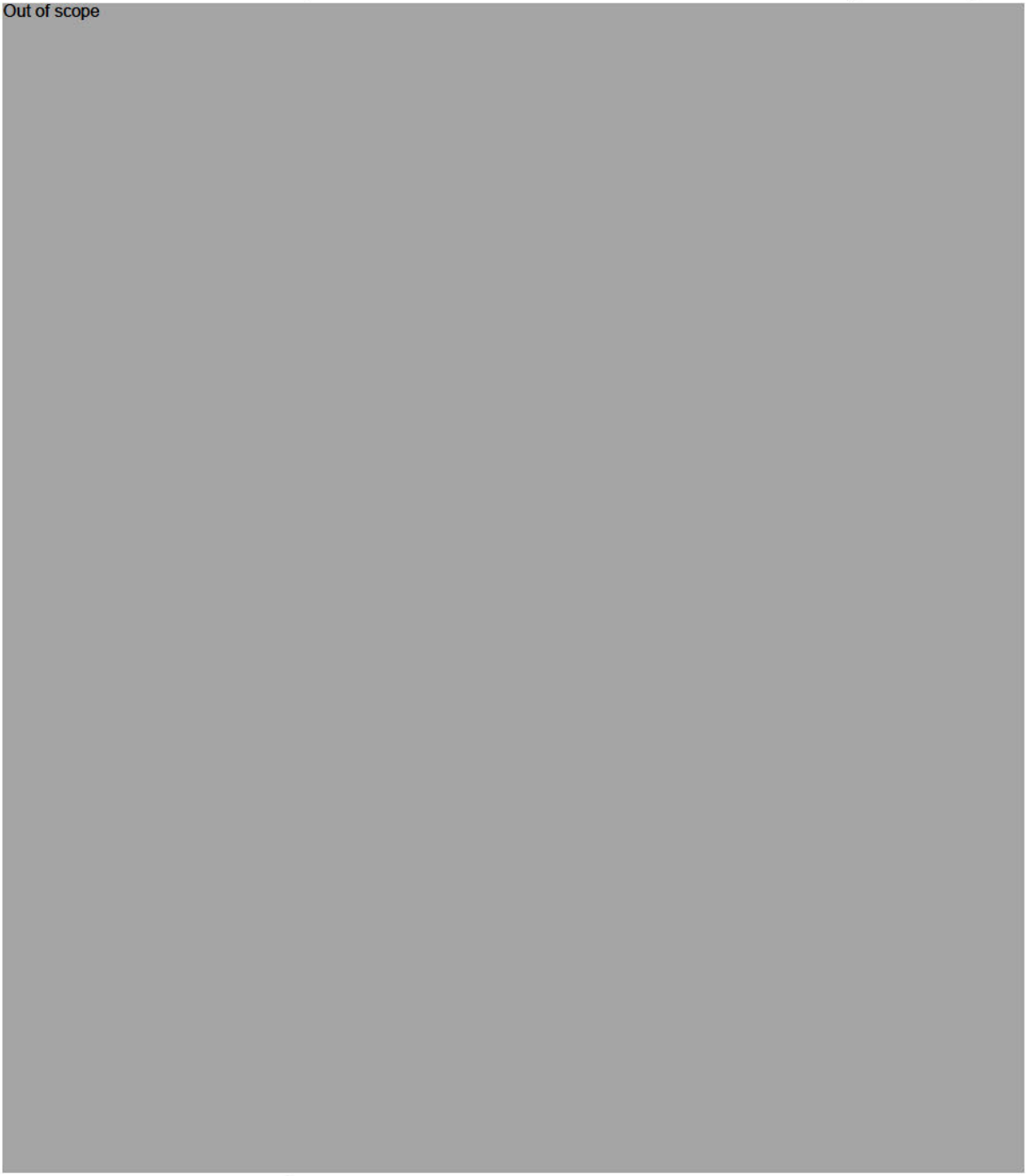
7.1.3 have legal status so that they can have limited liability, own property, have perpetual succession, sue and be sued;

7.1.4 utilise a conversion mechanism that would allow them to convert to a limited liability company provided credit union reserves are locked up for a minimum of five years or applied for charitable purposes (subject to some restrictions on the use of the moniker "credit union");

7.1.5 make it explicit that members of the committee of management owe directors' duties;

7.2 agree to the Minister of Commerce and the Minister of Finance announcing these decisions as part of the announcement of decisions on non-bank deposit-takers;

Out of scope



15 Out of scope

Recommendations from original EDC paper (Annex 3, pages 20-54)

Background

16 note that a suite of seven papers has been prepared reporting on the outcomes of the review of Financial Products and Providers and Financial Intermediaries, following the consideration of submissions on a series of discussion documents;

17 note that the submission under EDC (07) 98 covers the prudential regulation of non-bank deposit takers, such as finance companies, building societies and credit unions;

18 note that non-bank deposit-takers (NBDTs) are different in some key respects from other debt issuers and that additional regulatory requirements are necessary to promote a sound and efficient financial system and assist depositors to better protect their interests in investing in the NBDT sector;

Proposals in discussion document

19 note that the NBDT discussion document issued in August 2006 identified a range of deficiencies in the current regulation of NBDTs, including:

19.1 the absence of a licensing requirement and minimum prudential and governance standards;

19.2 inconsistency in supervisory requirements across the sector;

19.3 inadequate means of assisting depositors to identify and compare the risks of different NBDTs;

20 note that the NBDT discussion document proposed a two-tier regulatory framework for NBDTs, with:

20.1 the first tier being supervised by the Reserve Bank and regulated to a uniformly applied minimum level, and would include building societies and credit unions;

20.2 the second tier supervised by trustee corporations where the level of supervisory requirements would vary, subject to some base level requirements;

21 note that submissions on the NBDT discussion document generally supported the need for a strengthening of NBDT regulation, including licensing and some minimum regulatory requirements, but expressed a desire to retain trustee-based supervision for all NBDTs in a single tier, and that there was little support for the proposed multi-tier structure;

Proposed single tier supervisory framework

22 note that, in light of submissions and further analysis, the retention of a single tiered, trustee-based supervisory framework, bolstered by licensing and minimum regulatory requirements specified by a government regulatory authority, would be a more cost-effective and less distortionary means of achieving the desired regulatory objectives;

23 agree that the objectives of prudential regulation of NBDTs should be to promote a sound and efficient financial system by:

23.1 ensuring that NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence;

23.2 providing depositors with a clearer basis for distinguishing between lower-risk and high-risk NBDTs;

resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.

24 agree to the following proposals:

24.1 legislation will be required to define both a "deposit" (distinguishing this from other debt securities) and an NBDT, with provision, where appropriate, for a regulatory agency – either the Securities Commission or Reserve Bank – to declare certain securities or classes of securities to be deposits where they should be treated as such in terms of the policy of the law;

24.2 any entity, other than a registered bank, that meets the definition of an NBDT be required to be licensed by the prudential regulator for NBDTs, and supervised in accordance with the requirements for NBDTs, unless exempted from those requirements;

24.3 a regulatory agency – either the Securities Commission or Reserve Bank - will need to have the ability to exempt entities from being NBDTs in some situations, such as where deposit-taking by a particular entity is ancillary to its business and is immaterial in nature;

24.4 all NBDTs to be supervised by trustee corporations under the enhanced trustee model applying to debt issuers and with additional requirements for NBDTs (EDC (07) 99);

24.5 fit and proper requirements be applied to NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT;

24.6 NBDTs be required to satisfy their trustee supervisors, at the time of licensing and on an ongoing basis, that they have the capacity to carry on their business in a prudent manner;

24.7 NBDTs be required to have and maintain a minimum amount of capital, as set out in regulation;

24.8 NBDTs be required to include in their trust deeds a minimum capital ratio, determined by the trustee, and that the capital ratio be measured on the basis set out in regulation;

24.9 NBDTs be required by regulation to disclose, or to be subject to a limit on, credit exposures to parties related to an NBDT, such as shareholders with control or significant influence, and directors;

24.10 NBDTs be subject to prescribed minimum governance standards, set out in regulation;

24.11 NBDTs be required to obtain and disclose a credit rating from a rating agency approved by the prudential regulator of NBDTs, subject to advice being submitted to the Cabinet Economic Development Committee (EDC) by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers;

24.12 NBDTs be subject to enhanced public disclosure arrangements pursuant to the Securities Act 1978, in the context of reforms to public offer document requirements in that Act;

Reserve Bank role

25 agree that as the prudential regulator of NBDTs, the Reserve Bank will be the agency that:

25.1 licenses and de-licenses NBDTs, in consultation with the Securities Commission;

25.2 is responsible for setting by regulation and enforcing compliance with minimum prudential and governance regulatory requirements for NBDTs, in consultation with the Securities Commission;

25.3 administers fit and proper requirements for NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT;

25.4 administers the credit rating requirements;

25.5 provides advice and recommendations to the Securities Commission on the performance by trustee corporations of their responsibilities for supervising NBDTs;

25.6 has powers to intervene to assume control of the process for managing acute distress or failure of an NBDT in situations where the Reserve Bank is satisfied that this is necessary to avoid significant damage to the financial system;

Securities Commission role

26 agree that the Securities Commission will have responsibility for:

26.1 authorising and supervising trustee corporations in respect of NBDTs;

26.2 setting and enforcing NBDT disclosure and advertising requirements under the Securities Act 1978, in consultation with the Reserve Bank;

Further Report

27 invite the Minister of Commerce to report to EDC by 31 July 2007 with detailed proposals relating to the above proposals and on other matters that require approval, including:

27.1 the proposed definition of a NBDT and whether the Securities Commission or Reserve Bank should administer this definition;

27.2 the power to exempt an entity from being classified as a NBDT and whether the Securities Commission or Reserve Bank should have that power;

27.3 the requirement for minimum capital;

27.4 the requirements for related party exposures;

27.5 credit ratings requirements;

27.6 powers to deal with NBDT distress and failure;

27.7 the appropriate legislative vehicle.

Kate Mallalieu
for Secretary of the Cabinet

Reference: EDC (07) 98; EDC Min (07) 11/15

Annex 1

OFFICE OF THE MINISTER OF COMMERCE

The Chair
CABINET

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS: REGULATION OF NON-BANK DEPOSIT-TAKERS – ADDENDUM PAPER

PROPOSAL

1. This paper responds to questions raised during the EDC consideration of the proposed Non-Bank Deposit-Taker (NBDT) regulation in relation to the impact on credit unions. It notes that credit unions perform very similar functions to other NBDTs, have a similar risk profile and should be regulated in a like manner as other NBDTs. It proposes that the proposed NBDT regulatory arrangements can be applied in ways that enable credit unions to retain their character while liberalising certain current credit union operational restrictions, and providing depositors with an appropriate level of protection.

ANALYSIS

2 Proposals relating to the Review of Financial Products and Providers: Regulation of Non Bank Deposit Takers were considered at the EDC meeting on 13 June 2007.

3 EDC (EDC Min (07) 11/15 refers) invited me to provide further information to Cabinet on 18 June 2007 on:

- whether there is evidence to justify treating credit unions differently to other non-bank deposit takers; and
- the status of other work underway relating to credit unions, particularly the government's review of the credit union provisions in the Friendly Societies and Credit Unions Act 1982.

Is there evidence to justify treating credit unions differently from other non-bank deposit takers?

4 A credit union, established under the Friendly Societies and Credit Unions (FSCU) Act 1982, is an unincorporated co-operative financial organisation set up to provide savings and loan facilities to its members who have a "common bond" permitted by the FSCU Act.

5 Unlike companies, mutual financial institutions are generally owned by their customers, and their management is made up of members. It can be argued that as a consequence the members take a close interest in the affairs of the mutual association, and management has a strong incentive to act in the interests of members, and that this justifies a lower level of supervision than for other non-bank deposit takers.

6 While these arguments provide some basis for treating credit unions differently from other non-bank deposit takers, I consider that these arguments are outweighed by the size of the industry and the need to ensure all investors, whether members of credit unions or other investors in non-bank deposit takers, are afforded similar levels of protection.

- Significant financial assets are invested in credit unions. There are 52 credit unions registered under the Friendly Societies and Credit Unions Act. Total assets of the sector amount to at least $737 million (as at 31 December 2006), with membership in excess of 204,000.

- 38 of the unions are members of the NZ Association of Credit Unions (NZACU). These unions, including the Association have assets in excess of $600 million, and membership exceeding 160,000.

- Six are members of the Manchester Unity Association of Credit Unions with total assets of $74 million, and a membership in excess of 17,000.

- There are seven independent unions, the largest two having assets of $56 million and $19 million respectively. Membership of these unions amounts to in excess of 27,000.

- Credit unions are very similar to other NBDTs in terms of the functions they provide including lending, deposit-taking and the provision of other financial services. The two associations provide operating services for systems and internet banking for their member unions, while the NZACU and the two largest independent unions have an arrangement to access EFTPOS and ATMs. NZACU members are also offered credit card facilities and foreign exchange facilities.

- The most recent statistical data provided to the Reserve Bank indicates that 45% of credit union assets comprise unsecured consumer lending, including hire purchase credit. Less than 29% of assets relate to housing loans.

- They carry similar risks to many other NBDTs, including the risk that their members – depositors – could lose money in the event that a credit union fails. The ratio of capital to total assets ranges from 5% to 18%.

- There have been at least five failures or remedial restructurings of credit unions over the past ten years as a result of credit union distress.

- Credit unions are participating fully in the financial system, offering their members a product range that is similar in many respects to that offered by finance companies, building societies and banks. The need for adequate capital and other prudential requirements is just as great for credit unions as for other NBDTs, particularly given their relatively low level of risk diversification.

- The need for appropriate prudential regulation will be greater if the operational constraints on credit unions are reduced as part of the credit union reforms.

The status of other work underway relating to credit unions, particularly the government's review of the credit union provisions in the Friendly Societies and Credit Unions Act 1982 in the light of the non-bank deposit proposals

7 A one-tier regulatory framework has been proposed, where all NBDTs (including credit unions) continue to be supervised by trustee corporations under enhanced trust deed arrangements for debt issuers, and are subject to some additional minimum requirements. It is intended that these requirements be the same for all entities, including credit unions.

8 In respect of credit unions, prior to the review of financial products and providers, Cabinet agreed to (CAB Min (05) 14/4 refers):

- allow credit unions to determine their own common bond provided it is an objectively verifiable characteristic;
- allow charities and incorporated societies affiliated with the common bond to become Credit Union members;
- allow credit unions to determine their own minimum deposit amount;
- remove the requirement to specify service charges in credit union rules provided mechanism for levying the charges is specified in the rules; and
- allow credit union associations to extend new services to members without Ministerial approval.

These amendments were included in the Business Law Reform Bill, passed last year

9 Cabinet also previously agreed in April 2006 (CAB Min (05) 14/4 refers), in principle, subject to the review of financial products and providers, to allow credit unions to:

- have the equivalent flexibility to borrow and invest surplus funds and to hold land as any other NBDT, if credit union rules allow and if trust deeds are amended accordingly;
- raise capital by issuing securities to their members, if their rules and trust deeds allow it;
- have legal status so that they can have limited liability, own property, have perpetual succession, sue and be sued;
- utilise a conversion mechanism that would allow them to convert to a limited liability company provided credit union reserves are locked up for minimum of 5 years or applied for charitable purposes (subject to some restrictions on the use of the moniker "credit union"); and
- make it explicit that members of the committee of management owe directors' duties.

10 These changes did not proceed into legislation at the time because of the possibility that these decisions might need further consideration as a result of Review of Financial Products and Providers. The relevant area of the Review

is now complete (the non-bank deposit taker workstream) and no issues were raised that I consider as impacting on or requiring further consideration of the in principle decisions. I recommend Cabinet now confirm their in principle agreement, in light of the proposal that credit unions will now be subject to the NBDT regime.

11 Consultation feedback suggests that NZACU members, at least, will welcome the overall package, most particularly the removal of these limitations. I, as well as officials, have discussed the proposals for non-bank deposit takers with the NZACU and no major concerns were raised.

Credit ratings

12 One of the regulatory requirements proposed for non-bank deposit takers is that they would be required to obtain and disclose a credit rating. I recognise that some credit unions may find it difficult to meet the requirement for an ongoing credit rating, due to their small size and mutual nature. Similarly, the costs of obtaining a rating may also be significant for other small NBDTs.

13 Consequently, in the paper "Regulation of Non-Bank Deposit Takers", I have sought agreement for NBDTs to be required to obtain and disclose a credit rating, subject to advice being submitted to Cabinet by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers.

14 These options include (either individually or in combination) exemptions or qualified exemptions (for example restrictions on business) for small NBDTs; the application of ratings to a group of entities (such as affiliated credit unions); the possibility of negotiating reduced fees on a collective basis with the rating agencies.

15 For example, NBDTs with a balance sheet below a defined level, such as $50 million of total assets, could be exempted from a rating requirement, but required to disclose the absence of a rating from an approved agency and restricted in the nature of alternative ratings they disclose. An exemption set at $50m would have the effect of excluding all Manchester Unity credit unions and the independent credit unions.

5

RECOMMENDATIONS

I recommend that Cabinet:

a. **note** that credit unions perform very similar functions to those of other non-bank deposit-takers (NBDTs);

b. **note** that credit unions' business entails risks of a similar nature to those of other NBDTs and that they should be subject to appropriate prudential regulation similar to that of other NBDTs;

c. **note** that the proposed reduction in operational constraints on NBDTs will expose credit unions to somewhat greater financial risks and hence there will be a greater need for credit unions to be regulated on much the same basis as for other NBDTs;

d. **agree** that the supervisory framework structures outlined in the Cabinet paper on the regulation of NBDTs be applied in full to credit unions, subject to advice being submitted to Cabinet by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers;

e. **confirm**, subject to the supervisory framework for the regulation of NBDTs being applied to credit unions, that the changes agreed to in principle by Cabinet in April 2006 (CAB Min (05) 14/4 refers) in respect of credit unions be adopted, namely:
   - allow credit unions to:
     - have the equivalent flexibility to borrow and invest surplus funds and to hold land as any other NBDT, if credit union rules allow and if trust deeds are amended accordingly;
     - raise capital by issuing securities to their members, if their rules and trust deeds allow it;
     - have legal status so that they can have limited liability, own property, have perpetual succession, sue and be sued;
     - utilise a conversion mechanism that would allow them to convert to a limited liability company provided credit union reserves are locked up for minimum of 5 years or applied for charitable purposes (subject to some restrictions on the use of the moniker "credit union"); and
     - make it explicit that members of the committee of management owe directors' duties; and

f. **Agree** to the Minister of Commerce and the Minister of Finance announcing these decisions as part of the announcement of decisions on non-bank deposit takers.

s9(2)(k) [redacted]

Hon Lianne Dalziel
Minister of Commerce

Date 15.6.07

Annex 2 contains information that is outside the scope of your request and so has been removed

Annex 3

Cabinet Economic Development Committee

EDC (07) 98

12 June 2007

Copy No:

Title

Review of Financial Products and Providers and Financial Intermediaries: Regulation of Non-Bank Deposit Takers

Purpose

This paper seeks approval to the prudential regulatory arrangements for non-bank deposit takers, such as finance companies, building societies and credit unions.

This paper should be read in conjunction with a suite of six other papers covering the reviews of financial products, providers and financial intermediaries [EDC (07) 89, 97, 99, 88, 95 and 96]

Previous Consideration

In: December 2005 Cabinet Business Committee considered domestic institutional arrangements for financial sector regulation and regulation of financial intermediaries [CBC Min (05) 18/28].

In August 2006 the Cabinet Economic Development Committee (EDC) noted the intention of the Minister of Commerce to release a series of discussion documents as part of the review of Financial Products and Providers [EDC Min (06) 13/7].

Summary

Non-bank deposit takers (NBDTs) are entities whose core business involves offering deposits or deposit-like securities to the public and the provision of financial services. The NBDT sector comprises a wide range of financial institutions, including finance companies, building societies and credit unions.

The current regulatory arrangements for NBDTs are inadequate in several respects: inconsistency in regulatory requirements and supervision across different NBDTs; absence of minimum entry requirements for NBDTs; and insufficient information to enable depositers to assess and compare the risks of depositing with NBDTs.

The proposals provide for:

- a one-tier regulatory framework, where all NBDTs are supervised by trustee corporations;

20

- all NBDTS to be required to be licensed by a prudential regulator and subject to minimum requirements;
- NBDTs to be subject to enhanced public disclosure requirements under the Securities Act 1978;
- NBDTs to be required to obtain and disclose a credit rating from an approved rating agency;
- the Reserve Bank to the prudential regulator for NBDTs;
- the Securities Commission to authorise and supervise trustee corporations and set and enforce public disclosure requirements.

See EDC (07) 88 for more information on the detail of the role of the Reserve Bank, and EDC (07) 99 on the new regime for supervision of corporate trustees, including the role of the Securities Commission.

A Regulatory Impact Statement is attached at **page 19**.

Baseline Implications

The proposals in the suite of papers will increase the roles and functions of the Ministry of Economic Development, the Securities Commission and the Reserve Bank. The indicative costs are $1.3 - $2.0 million in 2008/09 rising to $7.7 - $16.1 million in 2011/12. A further report in November 2007 will include detailed costings.

Legislative Implications

Legislation will be required to implement the proposed prudential requirements for NBDTs. The legislation is likely to take the form of a new Act, focused on prudential and associated regulation of NBDTs. (See also Overview Paper EDC (07) 89 and Institutional Arrangements Paper EDC (07) 88).

Timing Issues

None indicated.

Announcement

The Minister intends to announce any decisions arising out of the proposals in the suite of papers on 19 June 2007, including the details of the further work requested.

Consultation

The Minister indicates that the Minister of Finance has been consulted. The Minister indicates that consultation will be required with the government caucuses and with other parties represented in Parliament.

Paper prepared by Reserve Bank. MED, Securities Commission, Treasury, Justice and Consumer Affairs have been consulted. DPMC has been informed.

The Minister of Commerce recommends that the Committee:

Background

1 note that a suite of seven papers has been prepared reporting on the outcomes of the review of Financial Products and Providers and Financial Intermediaries, following the consideration of submissions on a series of discussion documents;

2 note that the submission under EDC (07) 98 covers the prudential regulation of non-bank deposit takers, such as finance companies, building societies and credit unions;

3 note that non-bank deposit-takers (NBDTs) are different in some key respects from other debt issuers and that additional regulatory requirements are necessary to promote a sound and efficient financial system and assist depositors to better protect their interests in investing in the NBDT sector;

Proposals in discussion document

4 note that the NBDT discussion document issued in August 2006 identified a range of deficiencies in the current regulation of NBDTs, including:

4.1 the absence of a licensing requirement and minimum prudential and governance standards;

4.2 inconsistency in supervisory requirements across the sector;

4.3 inadequate means of assisting depositors to identify and compare the risks of different NBDTs;

5 note that the NBDT discussion document proposed a two-tier regulatory framework for NBDTs, with:

5.1 the first tier being supervised by the Reserve Bank and regulated to a uniformly applied minimum level, and would include building societies and credit unions;

5.2 the second tier supervised by trustee corporations where the level of supervisory requirements would vary, subject to some base level requirements;

6 note that submissions on the NBDT discussion document generally supported the need for a strengthening of NBDT regulation, including licensing and some minimum regulatory requirements, but expressed a desire to retain trustee-based supervision for all NBDTs in a single tier, and that there was little support for the proposed multi-tier structure;

Proposed single tier supervisory framework

7 note that, in light of submissions and further analysis, the retention of a single tiered, trustee-based supervisory framework, bolstered by licensing and minimum regulatory requirements specified by a government regulatory authority, would be a more cost-effective and less distortionary means of achieving the desired regulatory objectives;

8 agree that the objectives of prudential regulation of NBDTs should be to promote a sound and efficient financial system by:

8.1 ensuring that NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence;

8.2 providing depositors with a clearer basis for distinguishing between lower-risk and high-risk NBDTs;

8.3 resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.

9 agree to the following proposals:

9.1 legislation will be required to define both a "deposit" (distinguishing this from other debt securities) and an NBDT, with provision, where appropriate, for a regulatory agency – either the Securities Commission or Reserve Bank – to declare certain securities or classes of securities to be deposits where they should be treated as such in terms of the policy of the law;

9.2 any entity, other than a registered bank, that meets the definition of an NBDT be required to be licensed by the prudential regulator for NBDTs, and supervised in accordance with the requirements for NBDTs, unless exempted from those requirements;

9.3 a regulatory agency – either the Securities Commission or Reserve Bank - will need to have the ability to exempt entities from being NBDTs in some situations, such as where deposit-taking by a particular entity is ancillary to its business and is immaterial in nature;

9.4 all NBDTs to be supervised by trustee corporations under the enhanced trustee model applying to debt issuers and with additional requirements for NBDTs (EDC (07) 99);

9.5 fit and proper requirements be applied to NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT;

9.6 NBDTs be required to satisfy their trustee supervisors, at the time of licensing and on an ongoing basis, that they have the capacity to carry on their business in a prudent manner;

9.7 NBDTs be required to have and maintain a minimum amount of capital, as set out in regulation;

9.8 NBDTs be required to include in their trust deeds a minimum capital ratio, determined by the trustee, and that the capital ratio be measured on the basis set out in regulation;

9.9 NBDTs be required by regulation to disclose, or to be subject to a limit on, credit exposures to parties related to an NBDT, such as shareholders with control or significant influence, and directors;

9.10 NBDTs be subject to prescribed minimum governance standards, set out in regulation;

9.11 NBDTs be required to obtain and disclose a credit rating from a rating agency approved by the prudential regulator of NBDTs, subject to advice being submitted to the Cabinet Economic Development Committee (EDC) by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers;

9.12 NBDTs be subject to enhanced public disclosure arrangements pursuant to the Securities Act 1978, in the context of reforms to public offer document requirements in that Act;

Reserve Bank role

10 agree that as the prudential regulator of NBDTs, the Reserve Bank will be the agency that:

10.1 licenses and de-licenses NBDTs, in consultation with the Securities Commission;

10.2 is responsible for setting by regulation and enforcing compliance with minimum prudential and governance regulatory requirements for NBDTs, in consultation with the Securities Commission;

10.3 administers fit and proper requirements for NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT;

10.4 administers the credit rating requirements;

10.5 provides advice and recommendations to the Securities Commission on the performance by trustee corporations of their responsibilities for supervising NBDTs;

10.6 has powers to intervene to assume control of the process for managing acute distress or failure of an NBDT in situations where the Reserve Bank is satisfied that this is necessary to avoid significant damage to the financial system;

Securities Commission role

11 agree that the Securities Commission will have responsibility for:

11.1 authorising and supervising trustee corporations in respect of NBDTs;

11.2 setting and enforcing NBDT disclosure and advertising requirements under the Securities Act 1978, in consultation with the Reserve Bank;

Further Report

12 invite the Minister of Commerce to report to EDC by 31 July 2007 with detailed proposals relating to the above proposals and on other matters that require approval, including:

12.1 the proposed definition of a NBDT and whether the Securities Commission or Reserve Bank should administer this definition;

12.2 the power to exempt an entity from being classified as a NBDT and whether the Securities Commission or Reserve Bank should have that power;

12.3 the requirement for minimum capital;

12.4 the requirements for related party exposures;

12.5 credit ratings requirements;

12.6 powers to deal with NBDT distress and failure;

12.7 the appropriate legislative vehicle.

Bob Macfarlane
for Secretary of the Cabinet

Copies to:
Cabinet Economic Development Committee
Chief Executive, DPMC
Paul Alexander, DPMC
PAG Subject Advisor, DPMC
Secretary to the Treasury
Chief Executive, Ministry of Economic Development
Minister of Justice
Secretary for Justice
Chief Executive, Ministry of Economic Development (Commerce)
Head, Ministry of Consumer Affairs
Chief Parliamentary Counsel
Legislation Coordinator

OFFICE OF THE MINISTER OF COMMERCE

The Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS: REGULATION OF NON-BANK DEPOSIT-TAKERS

PROPOSAL

1. This paper seeks the agreement of the Committee to proposals for changes to the prudential regulation of non-bank deposit-takers (NBDTs), such as finance companies, building societies and credit unions. A subsequent paper on remaining details of the proposals will be brought to Cabinet in July.

2. The proposals in this paper include:

   - All NBDTs to be required to be licensed by a prudential regulator and to comply with minimum prudential, governance and fit and proper requirements at licensing and on an ongoing basis.

   - NBDTs to continue to be supervised by trustee corporations under the proposed enhancements to trustee-based supervision for debt issuers.

   - NBDTs to be required to obtain and publicly disclose a credit rating, subject to Cabinet report back by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers.

   - NBDTs to be subject to enhanced public disclosure requirements.

   - The Reserve Bank to be the prudential regulator of NBDTs, with the Securities Commission continuing to have responsibility for market conduct regulation and authorisation and supervision of trustee corporations.

EXECUTIVE SUMMARY

3. Non-bank deposit-takers (NBDTs) are entities whose core business involves offering deposits or deposit-like securities to the public and the provision of financial services. The NBDT sector comprises a wide range of financial institutions, including finance companies, building societies and credit unions.

4. The discussion document on NBDTs, issued in August 2006, noted that the current regulatory arrangements for NBDTs, while not fundamentally flawed, are inadequate in several respects. The deficiencies highlighted included inconsistency in regulatory requirements and supervision across different NBDTs, the absence of minimum entry requirements for NBDTs, and

insufficient information to enable depositors to assess and compare the risks of depositing with NBDTs.

5. The discussion document proposed some substantive changes to the regulation of NBDTs to address these problems, while still seeking to keep regulatory costs low and preserving diversity and flexibility in the NBDT sector. The proposals included a requirement for all NBDTs to be licensed and to meet minimum prudential, governance and fit and proper requirements, both at licensing and on an ongoing basis. It proposed a new (elective) category of NBDT, supervised directly by the Reserve Bank and required to meet a higher level of prudential standards, with other NBDTs continuing to be supervised by trustee corporations, but under enhancements to their trust deed requirements.

6. These proposals were aimed at promoting a sound and efficient financial system, by ensuring all NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence, providing depositors with a clearer basis for distinguishing between lower-risk and higher-risk NBDTs, and resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to depositors and the financial system.

7. Submissions on the proposals expressed mixed views. There was widespread agreement on the identified deficiencies with existing arrangements and support for the proposed objectives for reforms. However, most submitters preferred to retain the existing trustee-based supervision arrangements, supplemented with some uniform minimum requirements, and were not supportive of a two-tiered structure.

8. Officials have assessed submissions received on the proposals and undertaken further analysis. As a result of this analysis, I am recommending that the Committee agree to revised proposals for the regulation of NBDTs, including:

- A one-tier regulatory framework, where all NBDTs are supervised by trustee corporations, under the enhanced trust deed requirements for debt issuers. The enhanced trustee deed requirements will be implemented in the second tranche of RFPP arrangements later this year;

- All NBDTs to be required to be licensed by a prudential regulator and subject to minimum prudential, governance and fit and proper requirements set and enforced by that regulator;

- NBDTs to be subject to enhanced public disclosure requirements under the Securities Act 1978;

- NBDTs to be required to obtain and disclose a credit rating from an approved rating agency, subject to a Cabinet report back by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers;

- The Reserve Bank to be the prudential regulator for NBDTs, with responsibility for licensing and de-licensing NBDTs in consultation with the Securities Commission, setting and enforcing minimum prudential and governance requirements in consultation with the Securities Commission, administering the fit and proper requirements, administering the ratings regime, and having the capacity to intervene in situations of serious NBDT distress or failure where the soundness of the financial system is at risk; and

- The Securities Commission to authorise and supervise trustee corporations, and to set and enforce public disclosure requirements for NBDTs, in consultation with the Reserve Bank.

BACKGROUND

Proposals released last year

9. One of the nine RFPP discussion documents released in August 2006 related to non-bank deposit-takers (NBDTs). These were defined as entities whose core business involves offering deposits or deposit-like securities to the public and the provision of financial services. The NBDT sector comprises a wide range of financial institutions, including finance companies, building societies and credit unions. They are currently regulated as debt issuers under the Securities Act 1978 in much the same way as other debt issuers. As such, they are required to be supervised by trustee corporations and issue prospectuses and investment statements. In addition, some NBDTs, such as credit unions, are regulated under specific legislation.

10. The discussion document on NBDTs highlighted a number of deficiencies in the existing regulation of NBDTs, including: the absence of minimum entry requirements for NBDTs, inconsistency in governance and prudential requirements across NBDTs, inadequate official oversight of trustee corporation supervision, inadequacies in public disclosures, and insufficient means for investors to assess and compare NBDT risk profiles.

11. The discussion document noted that NBDTs have special features that warrant a form of regulation that goes beyond that required for other debt issuers. These features include the following:

    - Many NBDTs perform bank-like functions, including providing on-call or short-term deposit facilities that are relied on for transaction purposes, the provision of payments facilities and the provision of foreign exchange services. These functions suggest that NBDTs should be regulated in some respects in a manner similar to that applicable to banks, while still facilitating continued diversity, flexibility and competitiveness in the NBDT sector;

- Unlike corporate bond and other debt issues, in which the funds are used to finance an issuer's own business, NBDTs, like banks, lend to many clients. This makes it particularly difficult for depositors to ascertain the true risk of an NBDT and provides a justification for additional prudential and disclosure-based regulation;

- NBDTs are potentially vulnerable to contagion risk, whereby the distress or failure of some NBDTs could trigger acute distress or failure in others. This suggests the need for enhancements to the standard regulation of debt issuers, such as in respect of public disclosure requirements, ratings and distress management arrangements;

12. Reflecting these considerations, the discussion document proposed that all NBDTs would have to be licensed and subject to enhanced prudential, governance and fit and proper requirements. It proposed the creation of two tiers of NBDTs:

- The first tier – Authorised Deposit Takers - would be licensed and supervised by the Reserve Bank in a manner similar to that for registered banks, as a category of lower-risk deposit-takers. Any NBDT would be able to become an Authorised Deposit Taker, provided that it could meet the prescribed requirements; and

- The second tier of NBDTs – comprising all NBDTs other than those that became Authorised Deposit Takers - would continue to be supervised by trustee corporations, overseen by the Securities Commission, but would be licensed as a deposit-taker by the Commission on the recommendation of the relevant trustee and subject to enhanced requirements, including minimum prudential, governance and disclosure requirements.

13. The discussion document suggested that building societies and credit unions be treated as distinct categories of NBDT and supervised directly by the Reserve Bank.

14. The proposals included a requirement that Authorised Deposit Takers obtain a minimum credit rating from a rating agency approved by the Reserve Bank. For second tier NBDTs, an option was proposed that they be required to obtain and disclose a credit rating from a rating agency approved by the Securities Commission.

Reactions from submitters

15. Submitters generally supported the proposed outcomes and objectives of NBDT regulation. Although submissions agreed that there were deficiencies in the existing regulatory requirements, most argued that the trustee-based framework generally works well and did not support fundamental change to regulatory arrangements. A strong preference was expressed by most submitters for retention of the trustee-based framework.

16. There was support for enhancements to the trustee-based framework, including the need for a standardised licensing framework for NBDTs, so that all NBDTs meet minimum requirements; a common measurement framework for assessing NBDTs' capital adequacy; minimum supervisory requirements for all NBDTs; improved oversight of trustee corporations; and more user-friendly and timely disclosures by NBDTs.

17. There were mixed, but generally negative, reactions to the proposal for a two-tier model. The main concerns were that a two-tier model could distort market pricing of NBDT products by providing an artificial wedge between the two tiers, and that the proposed Authorised Deposit Taker category would lose the benefits of trustee-based supervision and impose transitional costs on NBDTs. There were also concerns about the moral hazard risks associated with direct Reserve Bank supervision and the complications associated with a two-tier approach to regulating the NBDT sector.

18. There was some support for all NBDTs being required to obtain and disclose credit ratings, with some submitters arguing that ratings would be the best means of informing depositors on risk, and for strengthening market disciplines. However, most submitters opposed mandatory ratings on the grounds of cost and a concern that small NBDTs could be unfairly disadvantaged by the rating process.

19. Very few submitters supported the proposal that building societies and credit unions be supervised as a special NBDT category by the Reserve Bank. It was seen as unnecessary, with trustees being capable of supervising them effectively. Many submitters also argued that supervision by the Reserve Bank would confer a competitive advantage on building societies and credit unions and create a moral hazard risk.

COMMENT

PROPOSED CHANGES TO NBDT REGULATION

20. In light of the submissions and further consideration by officials, I am proposing a regulatory framework that retains the trustee-based framework for all NBDTs and avoids the creation of a multi-tiered structure, but which contains enhancements that go beyond those proposed for ordinary debt issuers, in line with the proposals for second tier NBDTs set out in the discussion document. I believe the revised proposals are justified, having regard to a number of considerations including the following:

    a) A two-tier structure, as set out in the discussion document, while having merit in a number of respects, could create a risk of distorting market perceptions of the risk profile of NBDTs. In particular, it risks portraying Authorised Deposit Takers as being government-approved and second tier NBDTs as being of higher risk than may necessarily be the case. A two-tier structure therefore potentially weakens the efficiency of the NBDT sector and could impede the sound allocation and management of risks.

b) The proposals in the discussion document would complicate the regulatory arrangements for the NBDT sector to a greater degree than is required to meet the proposed objectives. I am satisfied that a single tier model, where all NBDTs are subject to a uniform set of minimum requirements, and where all are supervised by trustees, would be a more cost-effective and less complex means of meeting the desired objectives.

c) The proposal to require building societies and credit unions to be supervised by the Reserve Bank would further complicate the regulatory arrangements and create an artificial distinction between categories of financial institution on the basis of organisational form, notwithstanding their similarity of function with other NBDTs.

21. The revised proposals are set out below. In some areas, more detailed proposals will be brought to Cabinet in July for approval.

Regulatory objectives

22. As set out in the NBDT discussion document, the proposed objectives for prudential regulation of the NBDT sector are to promote a sound and efficient financial system by:

- Ensuring that NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence;
- Providing depositors with a clearer basis for distinguishing between lower-risk and high-risk NBDTs; and
- Resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.

Requirement to be licensed

23. Any entity, other than a registered bank, wishing to be a retail deposit-taker and provider of financial services would be required to be licensed as an NBDT. Licensing would be performed by the prudential regulator of NBDTs, which I am proposing will be the Reserve Bank.

24. Legislation will be required to define both a "deposit" (distinguishing this from other debt securities) and an NBDT, with provision for a regulatory agency – either the Securities Commission or Reserve Bank – to declare certain securities or classes of securities to be deposits where they should be treated as such in terms of the policy of the law. This is consistent with powers currently in the Securities Act 1978 and Securities Markets Act 1988, and provides an ability to ensure that like instruments receive like regulatory treatment. A regulatory agency – either the Securities Commission or Reserve Bank - would also need to have the ability to exempt entities from being NBDTs in some situations, such as where deposit-taking by a particular

entity is ancillary to its business and is immaterial in nature. Detailed proposals on this will be brought to Cabinet in July.

One-tier of NBDTs

25. All NBDTs would be supervised in a one-tier arrangement, where trustee corporations continue to be the supervisors. The standard enhancements for trustee-based supervision applicable to debt issuers would also apply in respect of NBDTs, subject to some additional requirements as set out below.

Role of trustees

26. Trustees would continue to have responsibility for setting appropriate financial and other covenants in the trust deeds, in negotiation with each NBDT, and for monitoring and enforcing compliance with these covenants. It is proposed that trustees will have enhanced powers to supervise NBDTs on the same basis as for other debt issuers. Proposals for these enhanced trustee powers will be set out in the second tranche of RFPP reforms later this year.

Minimum prudential, governance and fit and proper requirements

27. Minimum requirements would apply to all NBDTs at the time of licensing and on an ongoing basis. The requirements would be designed to promote greater consistency in supervision, and sound governance and risk management in the NBDT sector. The requirements would not be designed to prevent NBDT failures or to achieve a uniform level of risk across the NBDT sector. To do so would impose substantial compliance costs on the sector and reduce the scope for NBDTs to meet the needs of investors and borrowers.

28. The requirements would be prescribed in regulation and would be very similar to those proposed in the discussion document for second tier NBDTs. I am proposing that the requirements would comprise:

    i Fit and proper requirements for NBDT shareholders with control or significant influence, directors and senior management. These would be designed to ensure that NBDTs are controlled and managed by persons with appropriate capability and experience and do not have serious criminal records. I am proposing that the prudential regulator of NBDTs would apply the fit and proper assessments, both at the time of licensing and on an ongoing basis, as they relate to capability and experience. The fit and proper assessments for criminal records would be conducted by the Registrar of Financial Service Providers, under the new proposed financial service provider registration framework.

    This differs from the fit and proper proposals in the NBDT discussion document, which proposed that the fit and proper requirements be administered by the trustees (in liaison with the Securities Commission). The revised proposal – for the regulator to apply the fit

and proper assessments – reflects a number of considerations, including:

- The view that government agencies have now reached that it would be more efficient for the regulator to apply the fit and proper tests and that this would lead to greater consistency across NBDTs;

- A recognition that fit and proper tests involve an exercise of regulatory or quasi-judicial authority, with the authority derived directly from statute, and that this is better exercised by a government agency than by a trustee; and

- The views expressed by trustees that they do not think it appropriate that they administer fit and proper requirements.

ii A requirement that an NBDT must demonstrate the capacity to manage its affairs prudently, in line with the nature of business it proposes to undertake. This would be determined by the trustee supervising the NBDT, both at the time of licensing and on a regular basis thereafter.

iii A minimum dollar level of capital to demonstrate shareholder commitment and to ensure that the entity has sufficient capital to enable it to perform its intended functions prudently. The minimum requirement would be prescribed in regulation by the prudential regulator. I will report to Cabinet in July with the details of the proposed minimum capital requirement.

iv A requirement that every NBDT must include in its trust deed(s) a minimum capital ratio, determined by the trustee, and that the ratio must be measured on the basis set out in regulation by the prudential regulator. This is intended to ensure that there is a consistent approach to the recognition and measurement of capital adequacy across all NBDTs. However, the trustee would continue to have responsibility to specify the level of the capital ratio for the NBDT it supervises, in negotiation with that NBDT.

v Either disclosure of, or a limit on, credit exposures to parties related to an NBDT, such as shareholders with control or significant influence, and directors. Details on this proposal will be brought to Cabinet in July.

vi Minimum governance requirements, including relating to a minimum board size and composition, and probably including a minimum number of independent directors and a non-executive or independent chairman. These proposed requirements would be designed to strengthen the governance arrangements in NBDTs, reduce the risk of corporate abuse by related parties and provide a stronger foundation for risk management within NBDTs. In addition, NBDTs that take the

form of mutual organisations (such as building societies and credit unions) will be subject to the mutuals governance enhancements scheduled for implementation in the second tranche of RFPP reforms later this year. Details on governance requirements for NBDTs will be brought to Cabinet in July.

Credit ratings

29. I am proposing that all NBDTs would be required to obtain and disclose a credit rating, subject to advice being submitted to Cabinet by 31 July 2007 year on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers. I believe that requiring NBDTs to obtain and disclose a credit rating from a rating agency approved by the prudential regulator of NBDTs would bring a number of important benefits, both to depositors and to the financial system as a whole:

- Ratings provide a relatively simple metric summarising, in one measure, the risk of an NBDT defaulting on its financial obligations. A rating therefore reduces the need for investors to try to understand more complex and voluminous financial information on NBDTs. Ratings would provide the most cost-effective means of enabling depositors to distinguish between higher and lower risk NBDTs and thereby make better-informed investment decisions. This is particularly so if ratings are disclosed prominently in public offer documents and advertisements in ways that can be readily understood by non-expert investors, backed by greater initiatives to promote financial literacy among investors.

- Ratings would result in a better matching of risk and return, reducing the distortions that currently apply in the NBDT sector. This would facilitate more efficient, and potentially more productive, resource allocation in the financial sector and help to promote financial system soundness. At present, the absence of ratings in the NBDT sector hinders the ability of investors to make well-informed risk/return decisions.

- Ratings would also strengthen market disciplines on NBDTs and reduce the need for a more intrusive form of regulation and supervision, both in terms of a reduced need for prudential restrictions on NBDTs and less detailed financial public disclosure requirements. In turn, this would reduce the regulatory costs for the NBDT sector relative to the situation where there are no required ratings.

30. I note that mandatory ratings are increasingly being used in many countries as an element in the regulation of financial institutions – mainly to enhance market disciplines, promote sound risk management and facilitate informed investor decision-making. The proposal to require NBDTs to be rated is therefore consistent with the approach being taken in a number of countries.

31. It is also consistent with the current requirements for registered banks in New Zealand, where all banks are required to maintain and disclose a rating from an approved rating agency. I also note that property and disaster insurers in New Zealand have for many years been required to obtain and publicly disclose a financial strength rating.

32. For a ratings requirement to be effective, it will need to be accompanied by a requirement for NBDTs to make clear, prominent and user-friendly public disclosure of their ratings. There will also need to be disclosure of comparisons between the rating scales of different rating agencies. I have asked officials to report back on how this kind of disclosure can most effectively be achieved.

33. Another essential element in making ratings an effective tool is the promotion of public understanding of what a rating is and how to use it. I believe there are various means by which public understanding of ratings can be enhanced, including through financial literacy initiatives (jointly between government and the private sector) and by encouraging the financial news media and other bodies to regularly highlight the importance of ratings and provide information on the ratings of NBDTs. Again, I intend to report back in July on the specific nature of initiatives that could be taken in these areas.

34. Requiring NBDTs to obtain and disclose a rating will involve costs for NBDTs – both in terms of the direct cost of the rating and the indirect cost of management time, systems and controls. I am advised that the costs of mandatory ratings are expected to be modest for most NBDTs, relative to their revenue, assets and liabilities. However, the costs could be more significant for very small NBDTs. Moreover, in the case of NBDTs that can only achieve a low rating, a ratings requirement could increase their funding costs and in some cases may place them under greater commercial pressure than is currently the case. This could lead to consolidation or rationalisation in the NBDT sector, depending on market reaction to ratings. However, this need not be a negative development; it may be a desirable outcome of better informed investor decision-making and efficient markets.

35. There are various options available to reduce the costs of ratings for NBDTs, including the possibility of exemptions for small NBDTs, the application of ratings to groups of entities (for example, groups of affiliated credit unions) rather than necessarily requiring ratings to be applied to all individual entities, and the possibility of reduced fees negotiated on a collective basis with the rating agencies. I have asked officials to explore these options and report back to Cabinet in July.

36. Overall, I believe the costs and risks of mandatory ratings are outweighed by the benefits and I therefore consider that a persuasive case exists for Cabinet to agree to the ratings proposal, subject to Cabinet making a final decision on this in July on the basis of more information on the means by which costs can be minimised.

Public disclosure requirements

37. As noted in the discussion document, it is proposed that NBDTs will be subject to enhanced public disclosure requirements administered by the Securities Commission. This could involve the adoption of more regular disclosure (possibly six-monthly), with more user-friendly formats and risk-focused disclosures. I have asked officials to report back to Cabinet in July with more details on the nature of the proposed disclosure arrangements for NBDTs.

Responding to NBDT distress and failure

38. Trustees will continue to have the primary role in responding to breaches of trust deeds and in taking action where an NBDT's solvency may be under threat. The Companies Office would also continue to have the capacity to conduct investigations under the Corporations (Investigation and Management) Act 1989. However, under the new arrangements, it is proposed that the NBDT prudential regulator be empowered to intervene in situations where the distress or failure of an NBDT could pose a threat to the soundness of the financial system. The details of this proposal will be brought to Cabinet in July.

PROPOSAL FOR RESERVE BANK TO BE PRUDENTIAL REGULATOR OF NBDTS

39. As set out in the accompanying paper "Institutional Arrangements for Prudential Regulation", it is proposed that the Reserve Bank would become the prudential regulator of NBDTs.

40. There are synergies and efficiencies in having one regulator with prudential regulatory responsibility for banks, insurers and NBDTs. There is also a need for a degree of consistency in prudential regulation across some of these categories of financial institution, including in respect of capital adequacy measurement, fit and proper requirements, ratings and corporate governance.

41. Allocating prudential regulation of NBDTs to the Reserve Bank also recognises that there are similarities in the way that banks and NBDTs operate and in the nature of their functions. The Reserve Bank is best placed to ensure consistency of regulation where appropriate and to deal with NBDT distress in ways that minimise disruption to the financial system. It is likely that, over time, NBDTs are likely to become more bank-like in their functions, and hence there is value in having one authority to oversee the sector.

42. As the prudential regulator of NBDTs, the Reserve Bank will be the authority that:

    a) Licenses and (subject to appropriate checks and balances) de-licenses NBDTs, in consultation with the Securities Commission;

b) Prescribes and enforces compliance with the minimum regulatory prudential and governance regulatory requirements for NBDTs, in consultation with the Securities Commission;

c) Applies the fit and proper requirements to NBDTs' owners (with control or significant influence), directors and senior managers;

d) Prescribes the credit rating requirements;

e) Provides advice and recommendations to the Securities Commission on the performance of trustee corporations in the discharge of their NBDT supervisory functions; and

f) Can intervene to manage the resolution of NBDT distress or failure in situations where the NBDT's situation may pose a threat to the soundness of the financial system.

ROLE OF TRUSTEES

43. The trustees will continue to be the front-line supervisors for NBDTs. Their functions will include:

a) Establishing a trust deed for particular offers of securities, in agreement with the NBDT;

b) Prescribing the financial, reporting and other covenants in the trust deed;

c) Enforcing trust deed covenants and supervising and monitoring NBDTs; and

d) Taking remedial actions to respond to breaches of trust deed requirements or financial distress in a NBDT, including advising the Registrar of Companies of any material breaches of trust deed covenants or emerging financial difficulties.

ROLE OF THE SECURITIES COMMISSION

44. As in the case of other aspects of trustee-based supervision (for example, debt issuers), it is proposed that the Securities Commission would retain responsibility for authorising and supervising trustee corporations. The Commission would also have responsibility for enforcing NBDT disclosure and advertising requirements under the Securities Act 1978, in consultation with the Reserve Bank. The obligation to consult the Bank before taking actions to enforce disclosure and advertising requirements would be designed not to constrain the Commission from properly performing its functions, including the ability to act promptly and unilaterally to suspend security offers.

Out of scope

45. Out of scope

REVIEW OF CREDIT UNION LAW

46. The NBDT discussion document noted that the government's review of the credit union provisions of the Friendly Societies and Credit Unions Act 1982 (FSCU Act) would be put on hold until the conclusion of the Review of Financial Products and Providers. Once Cabinet decisions on the NBDT proposals have been made, these decisions will be factored into the FSCU Act review, with a view to ensuring a sensible coordination of legislative reforms for the credit union sector. Proposals will be brought back to Cabinet in due course.

LEGISLATIVE IMPLICATIONS

47. Legislation will be required to implement the proposed prudential requirements for NBDTs. The legislation is likely to take the form of a new Act, focused on prudential and associated regulation of NBDTs. It would set out, among other matters:

- The definition of a NBDT and scope for exemptions;
- The requirement for an entity to be licensed as an NBDT in order to offer deposits to the public;
- The powers of the prudential regulator of NBDTs and the purposes for which those powers may be exercised;
- The minimum requirements for NBDTs, with scope for more specific matters to be determined either by regulation or set administratively by the prudential regulator.

48. It is proposed that legislation to give effect to the NBDT regulatory framework will be introduced later this year, subject to obtaining final Cabinet agreement to the detailed proposals in late July.

REGULATORY IMPACT STATEMENT

49. The Ministry of Economic Development confirms that the Code of Good Regulatory Practice and the regulatory impact analysis requirements, including the consultation RIA requirements, have been complied with. A RIS was prepared and MED considers the RIS and the RIA analysis undertaken to be adequate. A draft RIS was circulated with the Cabinet paper for departmental consultation purposes.

IMPLICATIONS FOR THE TREATY OF WAITANGI

50. There are no implications for the Treaty of Waitangi.

HUMAN RIGHTS

51. There are no implications in relation to the Human Rights Act.

FISCAL IMPLICATIONS

52. The fiscal implications of the proposals are discussed in the accompanying paper "Reviews of Financial Products and Providers and Financial Intermediaries – Overview Paper".

PUBLICITY

53. It is proposed that Cabinet's decisions in relation to NBDTs will be announced as part of the overall package of RFPP decisions, as proposed in the "Overview" Paper.

CONSULTATION

54. The proposals in this paper closely reflect the proposals set out in the NBDT discussion document released in August 2006, in respect of the "Tier 2 NBDTs" – those NBDTs that continue to be supervised by trustee corporations. The only significant differences relate to:

- The proposal that all NBDTs be required to obtain and disclose a credit rating from an approved rating agency. This was identified as an option, but was not a firm proposal, in the discussion document.

- The proposal that the Reserve Bank be the prudential regulator of NBDTs, including the proposed role in licensing NBDTs, setting and enforcing minimum requirements for NBDTs and advising the Securities Commission on the supervisory performance of trustee corporations.

- The proposal that fit and proper requirements be administered by the Reserve Bank, as prudential regulator of NBDTs, rather than by trustees.

55. Although the revised proposals are very similar to those in the discussion document, some stakeholders may view the proposal for the Reserve Bank to be the regulator, and its role in applying the fit and proper tests, as a

significant change in the nature of the regulatory arrangements for NBDTs. As such, there may be expectations that a second round of consultation should occur.

56. Given that the revised proposals as set out in this paper are very close to those in the discussion document, I do not think it necessary for a second consultation paper to be issued. The proposal that the Reserve Bank be the regulator of NBDTs does not substantively change the nature of the regulatory arrangements from those set out for second tier 2 NBDTs in the discussion document, even though some may perceive otherwise.

57. However, as noted above, there are a number of details still to be developed in respect of requirements relating to: administering the definition of NBDT and determining exemptions from the NBDT category: the minimum dollar level of capital: credit exposures to related parties: minimum governance requirements: credit rating requirements; and responding to NBDT distress and failure. I have asked officials to consult with trustees and some other stakeholders on these and the other matters covered in this paper and the result of these consultations will be included in the report back to Cabinet in July.

RECOMMENDATIONS

It is recommended that the Committee:

1 **Note** that non-bank deposit-takers (NBDTs) are different in some key respects from other debt issuers and that additional regulatory requirements are necessary in order to promote a sound and efficient financial system and assist depositors to better protect their interests in investing in the NBDT sector;

2 **Note** that the NBDT discussion document issued in August 2006 identified a range of deficiencies in the current regulation of NBDTs, including the absence of a licensing requirement and minimum prudential and governance standards, inconsistency in supervisory requirements across the sector, and an inadequate means of assisting depositors to identify and compare the risks of different NBDTs;

3 **Note** that the NBDT discussion document proposed a two-tier regulatory framework for NBDTs, with the first tier being supervised by the Reserve Bank and regulated to a uniformly applied minimum level, and a second tier supervised by trustee corporations where the level of supervisory requirements would vary, subject to some base level requirements, and that building societies and credit unions would be supervised by the Reserve Bank;

4 **Note** that submissions on the NBDT discussion document generally supported the need for a strengthening of NBDT regulation, including licensing and some minimum regulatory requirements, but expressed a desire to retain trustee-based supervision for all NBDTs in a single tier, and that there was little support for the proposed multi-tier structure;

5 **Note** that, in light of submissions and further analysis, the retention of a single tiered, trustee-based supervisory framework, bolstered by licensing and minimum regulatory requirements specified by a government regulatory authority, would be a more cost-effective and less distortionary means of achieving the desired regulatory objectives;

6 **Agree** that the objectives of prudential regulation of NBDTs should be to promote a sound and efficient financial system by:

6.1 Ensuring that NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence;

6.2 Providing depositors with a clearer basis for distinguishing between lower-risk and high-risk NBDTs; and

6.3 Resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.

7 **Agree** to the following proposals:

7.1 Legislation will be required to define both a "deposit" (distinguishing this from other debt securities) and an NBDT, with provision, where appropriate, for a regulatory agency – either the Securities Commission or Reserve bank – to declare certain securities or classes of securities to be deposits where they should be treated as such in terms of the policy of the law.

7.2 Any entity, other than a registered bank, that meets the definition of an NBDT be required to be licensed by the prudential regulator for NBDTs, and supervised in accordance with the requirements for NBDTs, unless exempted from those requirements.

7.3 A regulatory agency – either the Securities Commission or Reserve Bank - will need to have the ability to exempt entities from being NBDTs in some situations, such as where deposit-taking by a particular entity is ancillary to its business and is immaterial in nature.

7.4 All NBDTs be supervised by trustee corporations under the enhanced trustee model applying to debt issuers and with additional requirements for NBDTs.

7.5 Fit and proper requirements be applied to NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT.

7.6 NBDTs be required to satisfy their trustee supervisors, at the time of licensing and on an ongoing basis, that they have the capacity to carry on their business in a prudent manner.

7.7 NBDTs be required to have and maintain a minimum amount of capital, as set out in regulation.

7.8 NBDTs be required to include in their trust deeds a minimum capital ratio, determined by the trustee, and that the capital ratio be measured on the basis set out in regulation.

7.9 NBDTs be required by regulation to disclose, or to be subject to a limit on, credit exposures to parties related to an NBDT, such as shareholders with control or significant influence, and directors.

7.10 NBDTs be subject to prescribed minimum governance standards, set out in regulation.

7.11 NBDTs be required to obtain and disclose a credit rating from a rating agency approved by the prudential regulator of NBDTs, subject to advice being submitted to Cabinet by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers.

7.12 NBDTs be subject to enhanced public disclosure arrangements pursuant to the Securities Act 1978, in the context of reforms to public offer document requirements in that Act.

8 **Agree** that as the prudential regulator of NBDTs, the Reserve Bank will be the agency that:

8.1 Licenses and de-licenses NBDTs, in consultation with the Securities Commission;

8.2 Is responsible for setting by regulation and enforcing compliance with minimum prudential and governance regulatory requirements for NBDTs, in consultation with the Securities Commission;

8.3 Administers fit and proper requirements for NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT;

8.4 Administers the credit rating requirements;

8.5 Provides advice and recommendations to the Securities Commission in respect of the performance by trustee corporations of their responsibilities for supervising NBDTs; and

8.6 Has powers to intervene to assume control of the process for managing acute distress or failure of an NBDT in situations where the Reserve Bank is satisfied that this is necessary to avoid significant damage to the financial system.

9 **Agree** that the Securities Commission will have responsibility for:

9.1 Authorising and supervising trustee corporations in respect of NBDTs; and

9.2 Setting and enforcing NBDT disclosure and advertising requirements under the Securities Act 1978, in consultation with the Reserve Bank.

10 **Invite** the Minister of Commerce to report back to Cabinet by 31 July 2007 with detailed proposals relating to the above recommendations and on other matters that require approval:

10.1 The proposed definition of a NBDT and whether the Securities Commission or Reserve Bank should administer this definition;

10.2 The power to exempt an entity from being classified as a NBDT and whether the Securities Commission or Reserve Bank should have that power;

10.3 The requirement for minimum capital;

10.4 The requirements for related party exposures;

10.5 Credit ratings requirements; and

10.6 Powers to deal with NBDT distress and failure.

s9(2)(k) [redacted]

Hon Lianne Dalziel
Minister of Commerce

Regulatory Impact Statement - Proposal for Prudential Regulation of Non-Bank Deposit-Takers

This paper sets out the Regulatory Impact Statement for the proposed regulation of Non-Bank Deposit-Takers. It should be read in conjunction with the associated paper to Cabinet Economic Development Committee.

EXECUTIVE SUMMARY

The Discussion Document on Non-Bank Deposit-Takers (NBDTs) issued last year noted that there are deficiencies in the current regulation of NBDTs, particularly a lack of consistent minimum prudential and other regulatory requirements, the absence of fit and proper tests for senior NBDT office holders, and inadequate disclosure to enable depositors to identify and compare the risks of NBDTs. To address these problems, it is proposed that all NBDTs will be subject to a licensing requirement and be required to meet minimum regulatory requirements at licensing and on an ongoing basis, set and enforced by the Reserve Bank in consultation with the Securities Commission. It is also proposed that trustee-based supervision will be retained, but where trustees are subject to greater supervision by the Securities Commission. Disclosure requirements under the Securities Act will be strengthened and NBDTs will be required to obtain and disclose a credit rating from an approved rating agency, subject to satisfactory arrangements being in place to minimise the cost of ratings.

ADEQUACY STATEMENT

The Regulatory Impact Analysis Unit has reviewed the RIS and considers the RIS is adequate according to the adequacy criteria.

STATUS QUO AND PROBLEM

There are around 130 NBDTs currently operating in New Zealand – mainly finance companies, building societies and credit unions. They represent around 10% of total deposits and lending, and are growing in market share relative to banks.

NBDTs are currently regulated as debt issuers under the Securities Act in much the same way as other debt issuers. As such, they are required to be supervised by trustees and issue prospectuses and investment statements. Under those arrangements, trustees set the prudential, reporting and other requirements for each NBDT and have the power to enforce compliance and take remedial action where necessary. In addition, credit unions are regulated under specific legislation.

The Discussion Document noted that NBDTs have special features that warrant a form of regulation that goes beyond that required for other debt issuers, including:

- Many NBDTs perform bank-like functions, including providing on-call or short-term deposit facilities that are relied on for transaction purposes. This suggests that NBDTs should be regulated in some respects in a manner similar to that

applicable to banks, while still facilitating continued diversity, flexibility and competitiveness in the NBDT sector.

- Unlike corporate bond and other debt issues, in which the funds are used to finance the issuer's own business, NBDTs, like banks, lend to many clients. This makes it difficult for depositors to ascertain the true risk of an NBDT and provides a justification for additional prudential and disclosure-based regulation.

- NBDTs are potentially vulnerable to contagion risk, whereby the distress or failure of some NBDTs could trigger acute distress or failure in others. This suggests the need for enhancements to the standard regulation of debt issuers, such as in respect of public disclosure requirements, ratings and distress management arrangements.

The Discussion Document highlighted a number of deficiencies in the existing regulation of NBDTs, including: the absence of minimum entry requirements for NBDTs, inconsistency in governance and prudential requirements across NBDTs, inadequate official oversight of trustee supervision, inadequacies in public disclosures, and insufficient means for investors to assess and compare NBDT risk profiles. These deficiencies impede the ability to maintain a sound and efficient financial system, undermine competitive neutrality in the sector and have the potential to lead to a misallocation of resources and potential instability in the sector.

The NBDT sector has experienced some difficulties in recent times, with three finance companies having failed in 2006. Parts of the NBDT sector could be vulnerable to any significant weakening in the economy in the next year or two, potentially giving rise to more NBDT failures. Although it is unlikely that these would pose problems for the soundness of the financial system, they could lead to an erosion in confidence in the NBDT sector, with the potential for some NBDT failures causing instability for others. Significant turbulence in the NBDT sector could also lead to depositors migrating to banks, thereby reducing the overall competitiveness of the deposit-taking sector. The proposed reforms to NBDT regulation will not provide any quick solutions to this situation, but should help to foster the longer term soundness and resilience of the NBDT sector.

The retention of the status quo is not desirable for a number of reasons, including the following:

- The existing arrangements do not adequately meet the policy objectives. They fail to adequately promote sound governance and risk management practices within NBDTs or to provide depositors with a reliable and accessible means of assessing and comparing risks across the NBDT sector.

- The existing arrangements are not competitively neutral within the NBDT sector – there are inconsistencies in regulation of like-entities.

- The existing arrangements are not conducive to achieving market disciplines in the NBDT sector, mainly due to lack of user-friendly, timely and complete financial disclosures and lack of information that clearly identifies the riskiness of an NBDT.

- The absence of a licensing requirement creates a risk that an NBDT may be controlled or managed by persons with insufficient capacity to manage the NBDT in a sound manner, or by persons with significant conflicts of interest. This creates a risk of an NBDT being imprudently managed or used for purposes that benefit related parties at the expense of depositors.

- There are no minimum requirements for ongoing supervision, including prudential requirements relating to capital, constraints on lending to related parties, limits on exposure concentration or standardised triggers for prompt corrective action. The absence of these requirements reduces the capacity to promote a minimum level of prudential soundness in the NBDT sector and creates a risk of excessive or non-commercial lending to related parties

OBJECTIVES

The proposals seek to promote a sound and efficient financial system by:

- ensuring all NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence;

- providing depositors with a clearer basis for distinguishing between lower-risk and higher-risk NBDTs; and

- resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to depositors and the financial system.

ALTERNATIVE OPTIONS

A number of options have been considered in assessing how the regulation of NBDTs could be improved to meet the proposed regulatory objectives. These are summarised below.

The criteria against which options to meet the objectives have been assessed are:

- which arrangements would best address the objectives;

- which arrangements would have least adverse impact on compliance costs for NBDTs and regulatory administration costs for government;

- impact on dynamic efficiency in the financial sector;

- implications for moral hazard risks;

- competitive neutrality;

- maintaining or enhancing market disciplines on NBDTs; and

- relevant international principles and best practice.

Option 1 – Uniform licensing and supervision for all NBDTs

Another option considered for the regulation of NBDTs is to require all NBDTs to be licensed and supervised in a uniform manner by a government agency. This would be similar to the type of arrangement that applies to deposit-takers in many countries.

Under this arrangement, any entity wishing to offer deposits or deposit-like securities to the public would be required to meet fit and proper and minimum regulatory requirements at licensing and on an ongoing basis. These would be set and enforced by a government regulator, which would monitor and supervise the NBDTs and respond to distress or failure situations. There would be no trustee requirements for NBDTs – a government agency would be the sole supervisor of NBDTs.

This option has benefits and costs:

- It would promote consistency in regulatory requirements across the NBDT sector and meet the principle of competitive neutrality and ensure that all NBDTs meet some minimum prudential, governance and fit and proper requirements, applied uniformly across the sector. This option would also facilitate some regulatory administrative efficiencies and synergies, given that one agency would regulate all NBDTs, rather than this being spread across a number of different trustee corporations.

- This option would also have a number of costs and risks. In particular, the application of uniform requirements across a diverse range of generally small and relatively riskier NBDTs could impose efficiency costs on the sector, potentially forcing some NBDTs out of business. It would not facilitate the diversity of NBDTs that currently exist under a trustee-based framework. Trustees can tailor supervisory requirements to meet the particular nature and circumstances of an individual NBDT, thereby facilitating a more flexible approach to the regulation of NBDTs.

- Another risk associated with this option is the moral hazard risk it could induce – ie NBDTs may have incentives to take higher risks if they or their depositors believe that government regulation and supervision implies a form of implicit guarantee.

For these reasons, this option is not considered to be cost-effective.

Option 2 – A two-tiered approach – as proposed in the Discussion Document

Under this option, all NBDTs would have to be licensed and subject to enhanced prudential, governance and fit and proper requirements, but regulated in two tiers:

- The first tier – Authorised Deposit Takers - would be licensed and supervised by the Reserve Bank in a manner similar to that for registered banks, as a category of lower-risk deposit-takers. Any NBDT would be able to become an Authorised Deposit Taker, provided that it could meet the prescribed requirements. They would be monitored by the Reserve Bank and the Bank would have powers to enforce compliance and intervene in situations of acute distress or insolvency.

- The second tier of NBDTs – comprising all NBDTs other than those that became Authorised Deposit Takers - would continue to be supervised by trustees, overseen by the Securities Commission, but with enhanced requirements, including minimum prudential, governance and disclosure requirements. Trustees would monitor NBDTs and have the powers to enforce compliance and intervene in distress situations. The Securities Commission would oversee trustees in the performance of their duties.

This option would enable NBDTs that meet a higher level of standards to be distinguished from other NBDTs. This could help depositors to distinguish between higher and lower risk NBDTs and potentially help to lift governance and risk management standards across the sector. It would avoid imposing uniform arrangements across all NBDTs and facilitate the continuation of trustee-based arrangements for those NBDTs that elect to remain in the second tier.

Notwithstanding these benefits, a two-tier structure could create a risk of distorting market perceptions of the risk profile of NBDTs. In particular, it risks portraying Authorised Deposit Takers as being government-approved and Tier 2 NBDTs as being of higher risk than may necessarily be the case. A two-tier structure therefore potentially weakens the efficiency of the NBDT sector and could impede the sound allocation and management of risks. This option would also complicate the regulatory arrangements for the NBDT sector to a greater degree than is required to meet the proposed objectives.

PREFERRED OPTION

The preferred option is to retain the benefits of a trustee-based supervisory framework, but with enhancements, with the following features:

- Any entity, other than a registered bank, wishing to be a retail deposit-taker and provider of financial services would be required to be licensed as an NBDT. Licensing would be performed by the prudential regulator of NBDTs, proposed to be the Reserve Bank. There will be scope to exempt entities from being regulated as NBDTs (but still being regulated as debt issuers) where, for example, their deposit-taking activities is immaterial in amount and is ancillary to their core business.

- All NBDTs would be supervised in a one-tier arrangement, where trustee corporations continue to be the supervisors.

- Minimum requirements would apply to all NBDTs at the time of licensing and on an ongoing basis, including fit and proper requirements, a minimum level of capital, a requirement that trust deeds contain capital ratios measured in accordance with a prescribed framework, and minimum governance requirements. Consideration is being given to either imposing a standardised maximum limit on credit exposures to NBDT related parties or introducing a standardised form of disclosure of related party exposures. The requirements would be designed to promote greater consistency in supervision, and sound governance and risk management, in the NBDT sector.

- All NBDTs would be required to obtain and disclose a credit rating (subject to the possibility of exemptions for small NBDTs). It is proposed that the Reserve Bank will be empowered by statute to prescribe credit rating requirements for NBDTs, including the nature of the rating that must be obtained and how it must be disclosed. The proposal for NBDTs to obtain a rating is subject to report back to Cabinet by end July on further details, including on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers

- NBDTs would be subject to enhanced public disclosure arrangements, potentially including six monthly disclosures, more user-friendly formats, and more risk-focused disclosure.

- The proposed arrangements would involve three coordinated elements of NBDT regulation:

    - Trustees would continue to be the supervisors of NBDTs, setting and enforcing financial and reporting requirements for NBDTs, and being responsible for taking remedial action in situations of NBDT distress or failure.

    - The Reserve Bank would be the prudential regulator of NBDTs, with responsibility for licensing NBDTs, prescribing and enforcing minimum prudential and governance regulatory requirements, in consultation with the Securities Commission, and administering the proposed credit rating arrangements and fit and proper requirements. It would also have the power to intervene in NBDT distress situations where the soundness of the financial system is at risk.

    - The Securities Commission would have responsibility for authorising and supervising trustee corporations and, in consultation with the Reserve Bank, for setting and enforcing NBDT disclosure and advertising requirements under the Securities Act.

In order to implement the preferred option, legislation will be required to empower the Reserve Bank to license NBDTs and recommend regulations specifying minimum prudential and other requirements for NBDTs, and to require NBDTs to obtain and disclose a credit rating. Legislation will also be required to amend some existing legislation governing some categories of NBDTs – specifically credit unions and building societies. Among other matters, this legislation will repeal those provisions in existing legislation that specify prudential requirements for these categories of NBDTs.

Further details on the NBDT proposals will be reported back to Cabinet by end July, including in respect of:

- the proposed definition of a NBDT and whether the Securities Commission or Reserve Bank should administer this definition;
- the power to exempt an entity from being classified as a NBDT and whether the Securities Commission or Reserve Bank should have that power;
- the requirement for minimum capital;

- the requirements for related party exposures;
- credit ratings requirements; and
- powers to deal with NBDT distress and failure.

Benefits of preferred option

The preferred option is expected to be the most cost-effective means of achieving the proposed objectives. Its benefits (relative to the status quo) are likely to comprise:

- Greater consistency in supervisory requirements across the NBDT sector and minimum requirements that will assist in promoting sound governance and risk management.

- Preserving the flexibility of trustee-based supervision and allowing financial and other requirements to be tailored to the nature and circumstances of individual NBDTs.

- Facilitating efficiency and synergy in regulatory oversight through the Reserve Bank.

- Providing depositors with much improved capacity to identify and compare risks in the NBDT sector, via ratings.

- Ratings are expected to strengthen market disciplines on the NBDT sector, assisting in promoting sound governance and risk management.

Costs and risks of preferred option

The costs and risks are expected to comprise:

- Minimum prudential, governance and fit and proper requirements will impose some compliance costs and operational constraints on NBDTs, but the proposed requirements have been kept to a minimal level and are not expected to impose significant costs.

- Trustees may increase their fees to NBDTs, given the enhanced role they will have under the proposed arrangements. However, trustee fees are a relatively modest proportion of total expenses for NBDTs and any increase is unlikely to be particularly significant relative to NBDTs' total assets, deposits or revenue.

- The Reserve Bank will not be charging fees for its regulatory functions, other than possibly charging a cost-recovery fee for licensing NBDTs. If a licensing fee is charged, it is likely to be relatively minor and is not likely to represent an impediment to entry into the NBDT sector. Any proposal for a licensing fee, including the level of any fee, will be brought to Cabinet for decision by end July.

- Credit ratings will impose additional costs on NBDTs. These are expected to be relatively modest in relation to NBDTs' revenue, assets and deposits. For an NBDT at the median of the range of NBDTs, the annual ratings fee is estimated at between $25,000 to $35,000, which would represent only around 0.02% of NBDT

total assets. In addition, there would be indirect costs associated with ratings, such as management time and provision of information to NBDTs. However, there are options available to minimise compliance costs for small NBDTs, including exempting NBDTs below a defined level (eg those with total assets below $50 million) from a rating, applying ratings to groups of NBDTs where they are cross-guaranteed and exploring the possibility of lower fees for industry rating arrangements. The proposal for NBDTs to obtain a rating is subject to report back to Cabinet by end July on further details, including on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers.

- Ratings could result in some (higher risk) NBDTs having higher funding costs as a result of investors having a clearer understanding of the risks involved in placing funds with those NBDTs. This could place commercial pressure on some NBDTs and potentially lead to consolidation in parts of the NBDT sector, including the possibility of some NBDTs merging with others or leaving the sector. This is not a negative outcome for the NBDT sector or for investors to the extent that it merely reflects more efficient awareness and pricing of risks by investors. Rather, it would reflect the consequence of better-informed risk/return decisions by investors.

- There will be transition costs for NBDTs to come into compliance with the proposed requirements. In most cases, trust deeds will need to be amended to come into compliance with some elements of the proposed requirements, such as the minimum prudential standards. Some NBDTs are unlikely to initially meet proposed governance requirements. A transition period will be allowed to enable NBDTs to meet the requirements and to enable trust deeds to be amended.

- In the absence of effective coordination across the three agencies (trustees, Securities Commission and Reserve Bank) there would be a risk of duplication or uncoordinated regulatory action, which could add to the compliance burdens for the NBDT sector and compromise regulatory outcomes. In order to avoid these risks, there will be clear delineation between the functions of the trustees, the Reserve Bank and the Securities Commission, together with robust information-sharing and coordination arrangements. The Privacy Commissioner will be consulted and their approval sought for any proposed information-sharing powers.

- The fiscal costs for the Reserve Bank associated with the NBDT proposals are estimated to be in the range of $1 million to 1.5 million per annum on an ongoing basis (once the NBDT arrangements have been fully implemented).

It is considered that the benefits of the proposals outweigh these costs.

MPLEMENTATION AND REVIEW

Legislation will be required to implement the proposed option. The legislation is likely to take the form of a new Act, focused on prudential and associated regulation of NBDTs.

It is expected that the legislation will be ready for introduction into Parliament by late 2007 or early 2008, with the aim of having the legislation enacted by September 2008. Commencement of the new arrangements is scheduled for 2010 and will be coordinated with other relevant elements in the RFPP arrangements.

Regulatory proposals as set out in the Preferred Option will be developed in consultation with stakeholders, including NBDTs and trustees. It is expected that much of this consultation will occur prior to the report back to Cabinet by end July.

Implementation of the arrangements will include the development of appropriate and transparent coordination arrangements between the Reserve Bank, Securities Commission and trustees.

The Reserve Bank's costs in performing its NBDT functions will be funded through its Funding Agreement, under the Reserve Bank of New Zealand Act.

CONSULTATION

Stakeholder Consultation

The review of NBDT regulation has been subject to extensive consultation with stakeholders, including many NBDTs, industry associations, trustees and consumer bodies.

Submitters on the Discussion Document generally supported the proposed outcomes and objectives of NBDT regulation. Although submissions agreed that there were deficiencies in the existing regulatory requirements, most argued that the trustee-based framework generally works well and did not support fundamental change to regulatory arrangements. A strong preference was expressed by most submitters for retention of the trustee-based framework, with the proposed enhancements.

There were mixed, but generally negative, reactions to the proposal for a two-tier model. The main concerns were that a two-tier model could distort market pricing of NBDT products by providing an artificial wedge between the two tiers, and that the proposed Authorised Deposit Taker category would lose the benefits of trustee-based supervision and impose transitional costs on NBDTs.

There was some support for all NBDTs being required to obtain and disclose credit ratings, with some submitters arguing that ratings would be the best means of informing depositors on risk, and for strengthening market disciplines. However, most submitters opposed mandatory ratings on the grounds of cost and a concern that small NBDTs could be unfairly disadvantaged by the rating process.

Although the revised proposals are very similar to those in the Discussion Document, some stakeholders may view the proposal for the Reserve Bank to be the regulator, and its role in applying the fit and proper tests, as a significant change in the nature of the regulatory arrangements for NBDTs. The proposal that the Reserve Bank be the prudential regulator of NBDTs does not substantively change the nature of the regulatory arrangements from those set out for Tier 2 NBDTs in the Discussion Document, even though some may perceive otherwise. Therefore a second full round of consultation is not required, but officials will consult some stakeholders –

particularly trustees and industry associations - in preparing the details of the proposals.

The proposal to implement a one-tier arrangement and to retain trustees as the supervisors is expected to substantially address most of the concerns raised by submitters. Concerns over the cost of mandatory ratings will be addressed through consideration of a possible exemption from mandatory ratings for small NBDTs and assessment of the feasibility of reduced industry-based rating fees.

Government Departments/Agencies Consultation

The following government agencies have been consulted on the proposals in this paper: Reserve Bank, Treasury, Ministry of Justice, Securities Commission, and the Ministry of Consumer Affairs. All these government agencies support the preferred option.

CAB 100/2006/1

Consultation on Cabinet and Cabinet Committee Submissions

Certification by Department

Guidance on the consultation requirements for Cabinet and Cabinet committee papers is provided in chapter 11 of the Step by Step Guide: Cabinet and Cabinet Committee Processes, available at http://www.dpmc.govt.nz/cabinet/guide/11.html.

Departments/agencies consulted: The attached submission has implications for the following departments/agencies whose views have been sought and are accurately reflected in the submission:

Reserve Bank, Ministry of Economic Development, Securities Commission, Treasury, Ministry of Justice and Ministry of Consumer Affairs

.....

.....

Departments/agencies informed: In addition, the following departments/agencies have an interest in the submission and have been informed: Department of Prime Minister and Cabinet

.....

Others consulted: Other interested groups have been consulted as follows:

Non-Bank Deposit-Takers, financial sector industry associations, trustee corporations, Trustee Corporations Association,, and other stakeholders

.....

s9(2)(k)	Geof Mortlock, Manager, Special Issues, Financial Stability Department, Reserve Bank	**Date** 24 / 5 / 2007

Certification by Minister

Ministers should be prepared to update and amplify the advice below when the submission is discussed at Cabinet/Cabinet committee. The attached submission/proposal:

Consultation at Ministerial level	☐ did not need consultation with other Ministers ☑ has been consulted with the Minister of Finance *[required for all submissions seeking new funding]* ☐ has been consulted with the following Minister(s) ....
Consultation with Labour/ Progressive caucuses	☐ does not need consultation with the government caucuses ☑ **has been** or ☑ **will be** consulted with the government caucuses
Consultation with other parties	☐ does not need consultation at parliamentary level ☐ **has been** consulted with the following other parties represented in Parliament: ☐ New Zealand First ☐ United Future ☐ Green Party ☐ Other [specify]..... ☑ **will be** consulted with the following other parties represented in Parliament: ☑ New Zealand First ☑ United Future ☑ Green Party ☐ Other [specify].....

Sig s9(2)(k)	**Portfolio** Commerce	**Date** 29/5/07

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Cabinet

CAB Min (07) 21/10

Minute of Decision

Minister of Finance
Minister of Commerce

Copies to:
Prime Minister
Deputy Prime Minister
Hon Jim Anderton
Minister of Pacific Island Affairs
Minister for Economic Development
Minister of Justice
Minister for Social Development and Employment (MSD)
Minister of Consumer Affairs
Associate Minister of Pacific Island Affairs
Chief Parliamentary Counsel
Legislation Coordinator
Secretary, EDC

Review of Financial Products and Providers and Financial Intermediaries: Regulation of Non-Bank Deposit-Takers

On 18 June 2007, following reference from the Cabinet Economic Development Committee (EDC), Cabinet:

Background

1 **noted** that EDC considered a suite of seven papers reporting on the outcomes of the review of Financial Products and Providers and Financial Intermediaries, following the consideration of submissions on a series of discussion documents [EDC (07) M 11/11 – 11/17];

2 **noted** that the submission under EDC (07) 98 (Annex 3 of the submission attached to CAB (07) 249) covers the prudential regulation of non-bank deposit takers, such as finance companies, building societies and credit unions;

3 **noted** that non-bank deposit-takers (NBDTs) are different in some key respects from other debt issuers and that additional regulatory requirements are necessary to promote a sound and efficient financial system and assist depositors to better protect their interests in investing in the NBDT sector;

4 **noted** that on 13 June 2007 EDC:

4.1 referred the paper under EDC (07) 98 to Cabinet for consideration at its meeting on 18 June 2007;

4.2 invited the Minister of Commerce to provide further information for Cabinet on 18 June 2007 on:

4.2.1 whether there is evidence to justify treating credit unions differently to other non-bank deposit takers;

4.2.2 the status of other work underway relating to credit unions, particularly the government's review of the credit union provisions in the Friendly Societies and Credit Unions Act 1982;

4.2.3 Out of scope

[EDC Min (07) 11/15]

Credit unions

5 **noted** the contents of the supplementary information on the impact of the proposed non-bank deposit-taker regulation on credit unions, and the status of other work related to credit unions that is underway, as discussed in the paper attached as Annex 1 under CAB (07) 249;

6 **noted** that credit unions perform very similar functions to those of other NBDTs;

7 **noted** that credit unions' business entails risks of a similar nature to those of other NBDTs and that they should be subject to appropriate prudential regulation similar to that of other NBDTs;

8 **noted** that the proposed reduction in operational constraints on NBDTs will expose credit unions to somewhat greater financial risks and hence there will be a greater need for credit unions to be regulated on much the same basis as for other NBDTs;

9 **agreed** that the supervisory framework structures agreed to below be applied in full to credit unions, subject to advice being submitted by the Minister of Finance to Cabinet by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers [see also paragraphs 25.11 and 28];

10 **confirmed**, subject to the supervisory framework for the regulation of NBDTs being applied to credit unions, that the changes agreed to in principle by Cabinet in April 2006 [EDC Min (05) 9/7] in respect of credit unions be adopted, namely to allow credit unions to:

10.1 have the equivalent flexibility to borrow and invest surplus funds and to hold land as any other NBDT, if credit union rules allow and if trust deeds are amended accordingly;

10.2 raise capital by issuing securities to their members, if their rules and trust deeds allow it;

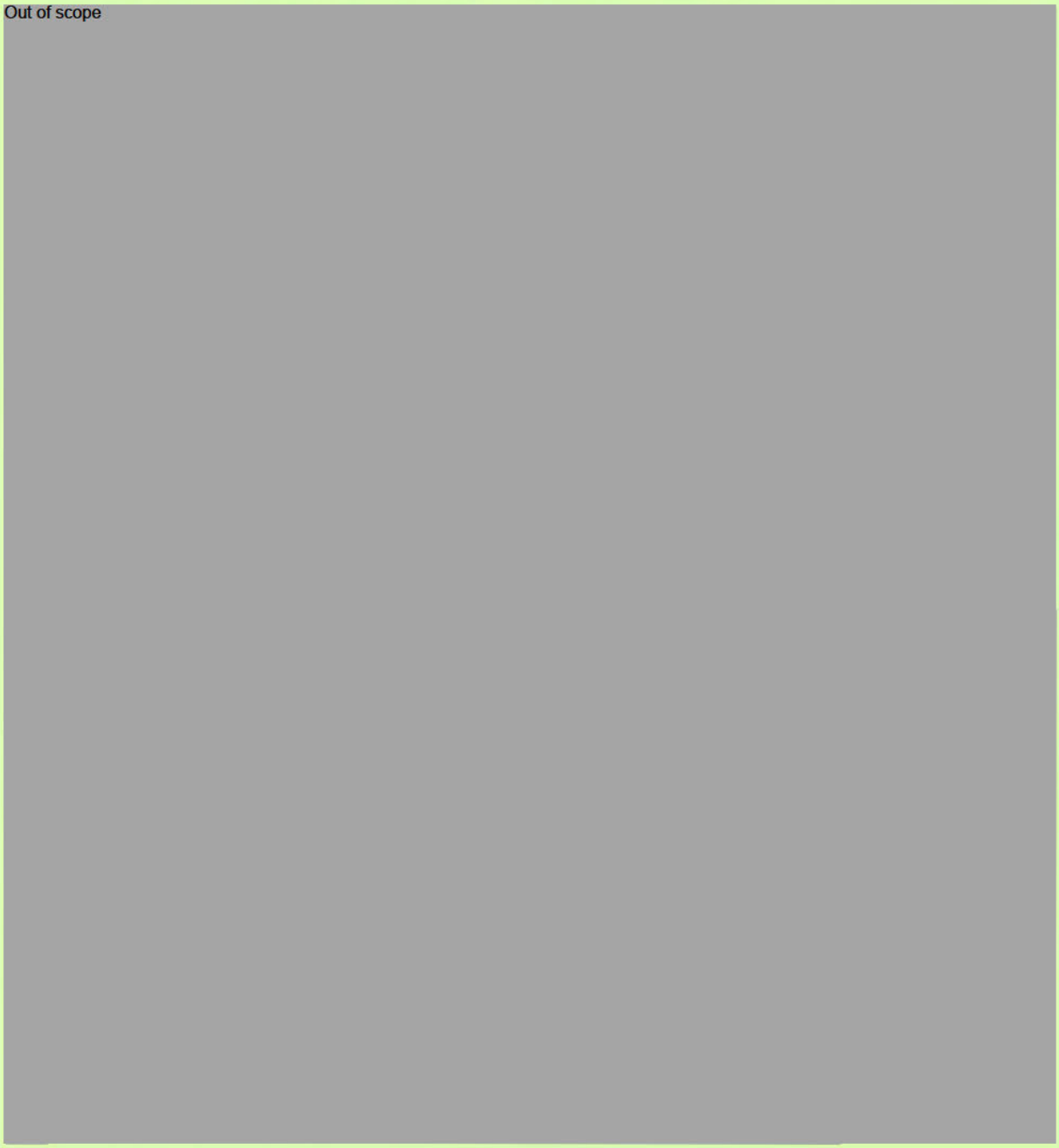
10.3 have legal status so that they can have limited liability, own property, have perpetual succession, sue and be sued;

10.4 utilise a conversion mechanism that would allow them to convert to a limited liability company provided credit union reserves are locked up for a minimum of five years or applied for charitable purposes (subject to some restrictions on the use of the moniker "credit union");

10.5 make it explicit that members of the committee of management owe directors' duties;

11 **noted** that the Minister of Commerce and the Minister of Finance would announce these decisions as part of the announcement of decisions on NBDTs;

Out of scope



19 Out of scope

Proposals in NBDT discussion document

20 **noted** that the NBDT discussion document issued in August 2006 identified a range of deficiencies in the current regulation of NBDTs, including:

20.1 the absence of a licensing requirement and minimum prudential and governance standards;

20.2 inconsistency in supervisory requirements across the sector;

20.3 inadequate means of assisting depositors to identify and compare the risks of different NBDTs;

21 **noted** that the NBDT discussion document proposed a two-tier regulatory framework for NBDTs, with:

21.1 the first tier being supervised by the Reserve Bank and regulated to a uniformly applied minimum level, and would include building societies and credit unions;

21.2 the second tier supervised by trustee corporations where the level of supervisory requirements would vary, subject to some base level requirements;

22 **noted** that submissions on the NBDT discussion document generally supported the need for a strengthening of NBDT regulation, including licensing and some minimum regulatory requirements, but expressed a desire to retain trustee-based supervision for all NBDTs in a single tier, and that there was little support for the proposed multi-tier structure;

Proposed single tier supervisory framework

23 **noted** that, in light of submissions and further analysis, the retention of a single tiered, trustee-based supervisory framework, bolstered by licensing and minimum regulatory requirements specified by a government regulatory authority, would be a more cost-effective and less distortionary means of achieving the desired regulatory objectives;

24 **agreed** that the objectives of prudential regulation of NBDTs should be to promote a sound and efficient financial system by:

24.1 ensuring that NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence;

24.2 providing depositors with a clearer basis for distinguishing between lower-risk and high-risk NBDTs;

24.3 resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.

25 **agreed** to the following proposals:

25.1 legislation will be required to define both a "deposit" (distinguishing this from other debt securities) and an NBDT, with provision, where appropriate, for a regulatory agency – either the Securities Commission or Reserve Bank – to declare certain securities or classes of securities to be deposits where they should be treated as such in terms of the policy of the law;

25.2 any entity, other than a registered bank, that meets the definition of an NBDT be required to be licensed by the prudential regulator for NBDTs, and supervised in accordance with the requirements for NBDTs, unless exempted from those requirements;

25.3 a regulatory agency – either the Securities Commission or Reserve Bank - will need to have the ability to exempt entities from being NBDTs in some situations, such as where deposit-taking by a particular entity is ancillary to its business and is immaterial in nature;

25.4 all NBDTs to be supervised by trustee corporations under the enhanced trustee model applying to debt issuers and with additional requirements for NBDTs [EDC Min (07) 11/13];

25.5 fit and proper requirements be applied to NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT;

25.6 NBDTs be required to satisfy their trustee supervisors, at the time of licensing and on an ongoing basis, that they have the capacity to carry on their business in a prudent manner;

25.7 NBDTs be required to have and maintain a minimum amount of capital, as set out in regulation;

25.8 NBDTs be required to include in their trust deeds a minimum capital ratio, determined by the trustee, and that the capital ratio be measured on the basis set out in regulation;

25.9 NBDTs be required by regulation to disclose, or to be subject to a limit on, credit exposures to parties related to an NBDT, such as shareholders with control or significant influence, and directors;

25.10 NBDTs be subject to prescribed minimum governance standards, set out in regulation;

25.11 NBDTs be required to obtain and disclose a credit rating from a rating agency approved by the prudential regulator of NBDTs, subject to advice being submitted to EDC by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers [see also paragraphs 9 and 28];

25.12 NBDTs be subject to enhanced public disclosure arrangements pursuant to the Securities Act 1978, in the context of reforms to public offer document requirements in that Act;

Reserve Bank role

26 **agreed** that as the prudential regulator of NBDTs, the Reserve Bank will be the agency that:

26.1 licenses and de-licenses NBDTs, in consultation with the Securities Commission;

26.2 is responsible for setting by regulation and enforcing compliance with minimum prudential and governance regulatory requirements for NBDTs, in consultation with the Securities Commission;

26.3 administers fit and proper requirements for NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT;

26.4 administers the credit rating requirements;

26.5 provides advice and recommendations to the Securities Commission on the performance by trustee corporations of their responsibilities for supervising NBDTs;

26.6 has powers to intervene to assume control of the process for managing acute distress or failure of an NBDT in situations where the Reserve Bank is satisfied that this is necessary to avoid significant damage to the financial system;

Securities Commission role

27 **agreed** that the Securities Commission will have responsibility for:

27.1 authorising and supervising trustee corporations in respect of NBDTs;

27.2 setting and enforcing NBDT disclosure and advertising requirements under the Securities Act 1978, in consultation with the Reserve Bank;

Further Report

28 **invited** the Minister of Finance to report to EDC by 31 July 2007 with detailed proposals relating to the above proposals and on other matters that require approval, including:

28.1 the proposed definition of a NBDT and whether the Securities Commission or Reserve Bank should administer this definition;

28.2 the power to exempt an entity from being classified as a NBDT and whether the Securities Commission or Reserve Bank should have that power;

28.3 the requirement for minimum capital;

28.4 the requirements for related party exposures;

28.5 credit ratings requirements;

28.6 powers to deal with NBDT distress and failure;

28.7 the appropriate legislative vehicle.

s9(2)(k)

Secretary of the Cabinet

Reference: CAB (07) 249; EDC Min (07)11/15

In Confidence

Cabinet Economic Development Committee

EDC (07) 160

4 September 2007

Copy No: 3/

This document contains information for the New Zealand Cabinet. It must be treated in confidence and handled in accordance with any security classification, or other endorsement. The information can only be released, including under the Official Information Act 1982, by persons with the appropriate authority.

Title

Review of Financial Products and Providers: Regulation of Non-Bank Deposit-Takers - Further Details

Purpose

This paper seeks agreement to further details for the non-bank deposit-takers regulatory framework.

Previous Consideration

In June 2007 the Cabinet Economic Development Committee agreed to proposals for governance and accountability arrangements for prudential regulation for the financial sector [EDC Min (07) 11/14].

In June 2007 Cabinet agreed to proposals for changes to the regulation of Non-Bank Deposit-Takers, and invited the Minister of Finance to report to the Cabinet Economic Development Committee with further detail on the proposals and with any outstanding matters [CAB Min (07) 21/10].

Summary

The paper sets out further details relating to the regulation of non-bank deposit-takers, referred to as registered deposit-takers (RDTs), with the following main features:

- deposit-takers would be defined in accordance with the principle that they are entities that offer debt securities to the public and are in the business of lending money or providing financial services (**page 5**);
- entities could be designated by regulation as deposit-takers, and the Reserve Bank could exempt entities from RDT requirements in certain situations (**pages 5-6**);
- it would be unlawful to be a deposit-taker without being licensed (**pages 6-7**);
- RDTs must comply with prudential requirements including minimum capital, capital adequacy, credit exposure to related parties, liquidity and credit rating, prescribed by RDT legislation and regulation (**pages 8-13**)
- RDTs would continue to be subject to Securities Act requirements, with additional requirements for trust deeds and disclosure imposed by this reform (**page 15**);

- RDTs would be required to maintain policies and procedures to ensure that they check the suitability and integrity of prospective directors and senior managers (**page 14**);
- Enforcement of the RDT framework would be the responsibility of the trustees and the Reserve Bank (**pages 17-18**)
- trustees would continue to have primary responsibility for dealing with RDT financial distress and failure, but in certain circumstances the Reserve Bank would be able to take crisis response action with the agreement of the Minister Finance (**page 16**);
- Credit Unions would be brought into the RDT framework on the same basis as other RDTs (including an exemption for those with assets less than $10 million), and existing prudential constraints in the Friendly Societies and Credit Unions Act 1982 would be removed (**pages 16-17**);
- some offences for non-compliance and indicative penalties are set out on **pages 19-20**;
- no minimum corporate governance requirements will be specified in the RDT framework (**page 13**).

A Regulatory Impact Statement is attached on **page 29**.

Baseline Implications

None indicated.

Legislative Implications

The Minister proposes that the regulatory framework for RDTs be contained in two separate bills, both of which will amend the Reserve Bank of New Zealand Act 1989. This is because of the inability to advance some of the proposals ahead of other financial sector reforms relating to financial service provider registration.

The first Bill, a Reserve Bank of New Zealand Amendment Bill, would implement the credit rating and prudential requirements (as well as the transparency and accountability amendments to the Reserve Bank of New Zealand Act already agreed to by Cabinet). This bill holds a category 4 priority (to be referred to a select committee in 2007) on the 2007 Legislation Programme.

The second Bill, a Registered Deposit Takers Bill, would contain the proposals relating to the licensing of RDTs. These proposals are linked to the registration process to be implemented by the Financial Service Providers (Registration and Dispute Resolution) Bill, which holds a category 4 priority (to be referred to a select committee in 2007) on the 2007 legislation programme, and cannot proceed ahead of that bill. The Minister intends to seek a category 5 priority (instructions to the Parliamentary Counsel Office to be provided in 2007) on the 2007

Legislation Programme for a Registered Deposit Takers Bill.

Timing Issues It is envisaged that the Reserve Bank of New Zealand Amendment Bill would be introduced before Christmas 2007, and that a Registered Deposit Takers Bill would be introduced in March/April 2008.

Announcement The Minister intends to publicly release the paper.

Consultation Paper prepared by the Reserve Bank. DPMC, Treasury, MED, Securities Commission, Justice, and PCO were consulted.

The Minister of Finance indicates that the Minister of Commerce has been consulted, and that there will be discussion with the government caucuses and the other parties represented in Parliament.

The Minister of Finance recommends that the Committee:

Background

1 note that in June 2007 the Cabinet Economic Development Committee agreed to proposals for governance and accountability arrangements for prudential regulation for the financial sector [EDC Min (07) 11/14];

2 note that in June 2007 Cabinet agreed to proposals for the regulation of Non-Bank Deposit-Takers, which are referred to in this paper as Registered Deposit Takers (RDTs), and invited the Minister of Finance to report to the Cabinet Economic Development Committee with further detail on the proposals and with any outstanding matters [CAB Min (07) 21/10];

Summary of main features

3 note that the paper under EDC (07) 160 sets out the details of the proposed regulation of RDTs, which includes the following main features:

3.1 RDTs will continue to be subject to regulation under the Securities Act 1978 in their capacity as issuers of securities to the public, and will therefore continue to be required to have offer documents and trust deeds;

3.1.1 trustees will continue to have responsibility for agreeing the terms and conditions of trust deeds with RDTs, and for monitoring and enforcing trust deed requirements;

3.2 RDTs will be subject to the enhanced trustee arrangements previously agreed in CAB Min (07) 21/10, whereby trustees are subject to authorisation and supervision by the Securities Commission;

3.3 all RDTs will be required to be licensed by the Reserve Bank and to comply with minimum prudential and other requirements prescribed in regulation;

3.3.1 some of these requirements will be required to be incorporated into RDT trust deeds and enforced by trustees, and others will be enforced directly by the Reserve Bank;

3.4 RDTs will be subject to enhanced public disclosure requirements in their offer documents, including in respect of their credit rating, capital position, lending to related parties and key risk information;

3.4.1 these requirements will be enforced by the Securities Commission;

3.4.2 the disclosure proposals set out below may only be a subset of the disclosure requirements to be prescribed for RDTs;

3.5 trustees will have the principal responsibility for responding to RDT financial distress, however, it is proposed that the Reserve Bank will have powers of intervention, with the agreement of the Minister of Finance, in situations where an RDT poses a threat to the soundness or efficiency of the financial system;

4 note that in June 2007 Cabinet invited the Minister of Finance to report on details of the proposed RDT regulatory arrangements, including in respect of:

4.1 the definition of RDTs;

4.2 ratings requirements for RDTs (and the means of avoiding excessive compliance costs for smaller RDTs);

4.3 prudential requirements;

4.4 the legislative vehicle for the proposed arrangements;

[CAB Min (07) 21/10]

5 note that in June 2007 Cabinet agreed that the supervisory framework for the regulation of RDTs should be applied in full to credit unions, subject to satisfactory options for minimising the compliance costs for ratings for credit unions [CAB Min (07) 21/10];

Legislative structure

6 note that the Minister of Finance would like to introduce into the House in 2007 as much as possible of the legislation required to implement decisions on RDTs in order to facilitate enactment in 2008;

7 note that in order to introduce as much as possible of the legislation it will be necessary to implement the proposals in two phases, in separate bills, given the inability to advance some of the RDT proposals ahead of other financial sector reforms (such as those relating to financial service provider registration);

8 agree that the decisions below be enacted in two separate bills, each amending the Reserve Bank of New Zealand Act 1989, as follows:

8.1 the first bill – Reserve Bank of New Zealand Amendment Bill – will contain required definitions and the provisions permitting regulations to be promulgated to prescribe requirements for credit ratings, minimum capital, capital adequacy,

limits on exposures to related parties, board composition and size, liquidity, and associated offences, penalties and enforcement powers, as specified in paragraph 12 below;

8.2 the second bill – a Registered Deposit Takers Bill – will contain all remaining amendments to the Reserve Bank of New Zealand Act required to implement the RDT regime, including licensing and fit and proper requirements.;

9 note that the Reserve Bank of New Zealand Amendment Bill will also include the transparency and accountability amendments to the Reserve Bank of New Zealand Act, as agreed in CAB Min (07) 21/10, and that this Bill holds a category 4 priority on the 2007 Legislation Programme (to be referred to a select committee in 2007);

10 agree that a Registered Deposit Takers Bill be added to the 2007 Legislation Programme with a category 5 priority (instructions to Parliamentary Counsel to be provided in 2007);

11 note that that the Minister of Finance intends to introduce the Registered Deposit Takers Bill by March/April 2008,;

Reserve Bank of New Zealand Amendment Bill

12 agree that the following decisions be included in the Reserve Bank of New Zealand Amendment Bill ;

Definition of deposit-taker

12.1 "deposit-takers" be defined as entities, other than registered banks and other specified categories, that offer debt securities to the public and that are in the business of lending money or providing other financial services, and include building societies and credit unions;

Power to designate entities as deposit-takers

12.2 legislation empower the designation of an entity as a deposit-taker by regulation and set out broad criteria for the making of this regulation;

Power to exempt entities from the RDT regime

12.3 the Reserve Bank be empowered to exempt deposit-takers from the requirements applicable to RDTs, with conditions, and to amend or revoke an exemption, where the legislation sets out the broad matters to which conditions may be applied;

Purposes for which powers may be exercised

12.4 the purposes for which powers may be exercised under the legislation governing RDTs be:

12.4.1 to promote the maintenance of a sound and efficient financial system;

12.4.2 to avoid significant damage to the financial system resulting from the failure of an RDT;

Prudential requirements for RDTs

12.5 the legislation empower the making of regulations by the Governor General, in accordance with advice from the Minister of Finance on the recommendation of the Reserve Bank, prescribing requirements for all RDTs or classes of RDT, in respect of an RDT and/or its borrowing group, in relation to:

12.5.1 minimum amount and form of capital, to be included in trust deeds;

12.5.2 level and form of capital in relation to the size and nature of business of an RDT and its borrowing group, to be included in trust deeds;

12.5.3 liquidity requirements, to be included in trust deeds;

12.5.4 restrictions on exposures to parties related to an RDT and its borrowing group, to be included in trust deeds;

12.5.5 credit ratings and the matters applying to RDTs exempted from a credit rating (including a requirement to disclose that the RDT is unrated, prohibitions or restrictions on the disclosure by an RDT of ratings from non-approved agencies, and minimum prudential requirements);

12.5.6 the size and composition of an RDT's board of directors (or its equivalent governing body), and the constitution of the RDT;

12.5.7 the systems for identifying and managing interest rate risk, exchange rate risk and other market price risks;

12.6 the legislation provide that the regulations may specify a minimum capital ratio and a maximum limit of exposures to related parties for RDTs or classes of RDT;

12.7 the legislation require the Reserve Bank to consult interested parties, including the Securities Commission and trustees, before making recommendations to the Minister of Finance for the promulgation of regulations;

Power to exempt RDTs from regulatory requirements

12.8 the Reserve Bank be empowered to exempt, by notice, an individual RDT, a class of RDT or all RDTs from any or all RDT requirements, to issue exemption notices subject to conditions, and to amend or revoke exemption notices, based on the equivalent power of the Securities Commission provided in section 5(5) of the Securities Act 1978;

Obligations to amend RDT trust deed to incorporate regulatory requirements

12.9 RDTs and trustees be required to amend trust deeds to incorporate matters required by regulations;

Minimum amount and form of capital

12.10 RDTs be required to include in their trust deed a minimum level of capital, of an amount and in a form prescribed by regulation, with the minimum level of capital being initially set at $2 million in regulation;

Capital adequacy requirements

12.11 RDTs be required to have a trust deed that specifies a minimum ratio of capital relative to the size and nature of an RDT and its borrowing group, in accordance with a capital adequacy framework prescribed by regulation;

Restrictions on credit exposures to related parties

12.12 RDTs be required to have a trust deed that specifies a limit on exposures of the RDT and its borrowing group to related parties, in accordance with a framework prescribed by regulation, and on the basis of a definition of related party set in legislation, where the definition may be varied by regulation;

Liquidity requirements

12.13 RDTs be required to have a trust deed that specifies minimum liquidity requirements, in accordance with a framework prescribed in regulation;

Credit rating requirement

12.14 RDTs be required to have and to disclose a credit rating in accordance with requirements prescribed by regulation, but that RDTs with total assets of less than $10 million be exempted from the rating requirement;

12.15 RDTs exempted from a credit rating requirement be subject to conditions imposed by the Reserve Bank including disclosure requirements and additional prudential requirements relating to minimum capital, capital ratio, liquidity requirements and related party exposures;

12.16 the Reserve Bank be empowered to approve rating agencies for the purpose of the RDT rating requirement, and be empowered to revoke an approval or issue an approval with conditions;

Obligations on trustees of RDTs

12.17 the legislation place an obligation on trustees:

12.17.1 to ensure that trust deeds of RDTs comply with the requirements set in regulation under the RDT legislation;

12.17.2 to provide to the Reserve Bank information in relation to RDT compliance with requirements and financial condition as requested by the Bank;

12.17.3 to disclose as soon as practicable to the Reserve Bank any failure or expected failure by an RDT to comply with requirements imposed under the legislation, any other significant breach of a trust deed and where it has cause to believe that a RDT is insolvent or about to become insolvent;

12.17.4 to make attestations to the Reserve Bank in relation to RDT compliance and financial condition as requested by the Bank from time to time;

Powers of trustees

12.18 trustees be given powers to take actions to ensure RDT compliance with requirements prescribed under the legislation, including the powers to:

12.18.1 obtain information from RDTs as necessary for the trustee to perform its functions under the regulations and the trust deed;

12.18.2 require amendments to the trust deed to enable trust deeds to comply with regulatory requirements;

12.18.3 require the RDT to come into compliance with trust deed requirements.

Powers of Reserve Bank

12.19 the legislation empower the Reserve Bank to:

12.19.1 obtain information from an RDT and its trustee to ascertain whether the RDT is in compliance with regulatory requirements;

12.19.2 appoint a third party (such as an audit firm) to investigate an RDT to ascertain whether it is in compliance with regulatory requirements, and oblige the RDT to provide access to relevant records;

12.19.3 issue a notice to the RDT advising of non-compliance with RDT regulatory requirements and requiring the RDT to explain how and when it plans to come into compliance;

Information-sharing powers

12.20 the legislation to contain information-sharing powers between the Reserve Bank, Securities Commission, trustees and the Companies Office to enable information gathered by any of these parties to be shared with each other for the purposes of exercising their regulatory responsibilities, subject to maintaining confidentiality of the information;

Reserve Bank statement of principles

12.21 the legislation to require the Reserve Bank to publish a Statement of Principles and guidelines setting out the framework for regulating RDTs and explaining the requirements applicable to RDTs and trustees under this framework;

Commencement date for legislation

12.22 the legislation commences at a date or dates set by Order in Council providing sufficient time for RDTs to come into compliance with the credit rating and other requirements of this legislation and for the Reserve Bank to prepare regulations that are required;

Registered Deposit-Takers Bill

13 agree that the following decisions be included in the Registered Deposit Takers Bill ;

Purposes for which powers may be exercised

13.1 the purposes for which powers may be exercised under the legislation governing RDTs be:

13.1.1 to promote the maintenance of a sound and efficient financial system;

13.1.2 to avoid significant damage to the financial system resulting from the failure of an RDT;

Definition of registered deposit-taker

13.2 "Registered Deposit Taker" be defined as a deposit-taker licensed by the Reserve Bank;

Prohibition on deposit-taking and other restrictions on entities that are not RDTs

13.3 it be unlawful for a person to conduct the business of a deposit-taker unless it has been licensed as an RDT, or is a registered bank or has been exempted from the RDT requirements;

13.4 it be unlawful for an entity to hold itself out as an RDT unless it has been licensed as an RDT by the Reserve Bank;

Licensing of RDTs

13.5 the Reserve Bank be empowered by legislation to license entities as RDTs where:

13.5.1 the applicant is able to comply with the requirements applied to RDTs, including the prudential and other requirements prescribed in regulations under the legislation;

13.5.2 the applicant has a trust deed registered or eligible to be registered by the Companies Office that complies with regulatory requirements for RDTs;

13.5.3 the applicant has a prospectus and investment statement registered or eligible to be registered by the Companies Office that comply with the requirements of the Securities Regulations as they relate to RDTs;

13.5.4 the applicant has either been registered or is eligible for registration by the Registrar of Financial Service Providers under the proposed Financial Services Providers (Registration and Dispute Resolution) Bill as a financial service provider;

13.5.5 the applicant's directors and senior management meet suitability and integrity criteria prescribed under the legislation or in regulation;

13.5.6 the trustee of the applicant has attested to the Reserve Bank that the applicant has sufficient capital relative to the size and nature of its business, governance, and risk management systems and controls to manage its proposed business, consistent with the level of risk represented to depositors in the prospectus and investment statement;

13.5.7 unless exempted, the applicant has a credit rating from a rating agency approved by the Reserve Bank that meets the requirements prescribed in regulations;

Transition period for existing RDTs

13.6 the legislation provide a transition period, of a length specified by Order in Council, during which deposit-takers, other than those exempted by the Reserve Bank, must apply to be licensed as RDTs and to enable RDTs to come into compliance with RDT requirements;

De-licensing of RDTs

13.7 the Reserve Bank be empowered, after consultation with the Securities Commission and trustee, to de-license an RDT, on the request of the RDT, where the legislation sets out the matters on which the Bank must be satisfied before agreeing to the de-licensing;

13.8 the Reserve Bank be empowered, after consultation with the Securities Commission and trustee, and, upon the request of an RDT, to prohibit the RDT from taking new deposits, but to enable the RDT to continue to service existing deposits;

13.9 the Reserve Bank be empowered, after consultation with the Securities Commission, Companies Office and trustee, to de-license or suspend the license of an RDT on grounds set out in the RDT legislation, including:

13.9.1 serious or persistent failure to comply with the licensing requirements and obligations of an RDT;

13.9.2 where an RDT is about to become or is insolvent, or has been placed into receivership, liquidation, voluntary administration or statutory management;

Fit and proper requirements

13.10 RDTs be required to have trust deeds that include provisions requiring RDTs to establish and maintain policies and procedures relating to fit and proper assessments of directors and senior managers, in accordance with standards prescribed in legislation or regulations;

13.11 the Reserve Bank be empowered to disallow the appointment of a director or senior manager of an RDT, or to require the removal of such a person, where the Bank is satisfied that the person does not meet fit and proper requirements prescribed by legislation or regulation, subject to appropriate natural justice requirements;

RDT distress and failure

13.12 the Reserve Bank may recommend to the Minister of Finance that an RDT (including its subsidiaries or associated persons) be given directions (with the consent of the Minister of Finance), under section 113 of the Reserve Bank of New Zealand Act, or to recommend to the Minister of Finance that the RDT be placed into statutory management, under section 117 of that Act, where an RDT:

13.12.1 is insolvent or about to become insolvent; or

13.12.2 has failed to comply with RDT regulatory requirements; and

13.12.3 the failure of the RDT could impede the maintenance of a sound and efficient financial system or cause significant damage to the financial system;

13.13 the Reserve Bank be required to consult the Securities Commission, Companies Office and trustee before exercising the powers in paragraph 13.12 above;

13.14 the Reserve Bank be empowered to suspend all or some of the powers of a trustee in situations where an RDT has been brought under the Reserve Bank of New Zealand Act;

13.15 the legislation make provision for trustees to be relieved of liability resulting from the suspension of their powers or from any actions taken by the Reserve Bank in a situation where an RDT has been given directions or placed into statutory management under the Reserve Bank of New Zealand Act;

Treatment of credit unions

14 agree that credit unions be subject to the legislation applying to RDTs on the basis that:

14.1 the Friendly Societies and Credit Unions Act 1982 will be amended to remove existing prudential and operational constraints on credit unions as previously agreed;

14.2 credit unions with total assets of less than $10 million be exempted from the need for a credit rating (where the $10 million asset threshold be prescribed in regulation), subject to requirements being prescribed by regulation or as a condition to the exemption, including a requirement for:

14.2.1 the credit union to disclose prominently that it is not rated by an approved rating agency;

14.2.2 the credit union to be prohibited or restricted from disclosing ratings or rankings from agencies not approved by the Reserve Bank

14.2.3 the credit union to comply with minimum prudential requirements;

14.3 credit unions be exempted from the need for a minimum amount of capital of $2 million on the basis that they comply with a minimum capital ratio prescribed in regulation;

14.4 credit unions be exempted by the Reserve Bank from other elements of the RDT requirements where this is required by their mutual form;

14.5 the general power to provide exemptions from requirements under the RDT legislation provides adequate flexibility to deal with the special characteristics of credit unions;

Offences

15 agree that both the Reserve Bank of New Zealand Amendment Bill and the Registered Deposit Takers Bill set out offences that may be committed by either RDTs or trustees for failure to comply with regulatory requirements to be imposed under the particular Bill, including:

15.1 failure by RDTs to comply with the obligations imposed upon RDTs by regulation, such as to have a credit rating and failure to incorporate minimum regulatory requirements into trust deeds;

15.2 failure to comply with fit and proper requirements, such as employing a senior manager who has been disallowed by the Reserve Bank.;

15.3 failure by trustees to meet statutory obligations to the Reserve Bank, such as failure to provide information requested by the Bank;

Penalties

16 agree that both the Reserve Bank of New Zealand Amendment Bill and the Registered Deposit Takers Bill prescribe penalties for offences, on the basis that:

16.1 fines on deposit-takers and RDTs be prescribed in a range of $500,000 to $2 million, depending on the severity of the offence;

16.2 fines for directors and the chief executive officer of RDTs, and trustees, be prescribed in the range of $50,000 to $200,000, depending on the severity of the offence;

16.3 imprisonment terms for directors and senior managers be prescribed in the range of 3 to 18 months, depending on the severity of the offence;

16.4 fines in the range of $10,000 to $50,000 for lower level offences such as failure to provide information requested by the Reserve Bank within required timeframes;

Disclosure and director/CEO attestation requirements

17 agree that, at the time that new disclosure requirements are introduced for debt issuers under the Securities Act, specific requirements be applied to RDTs by regulation made under that Act, including (but not limited to) the following matters:

17.1 disclosure at six monthly intervals of a brief key information summary, either as part of or as a supplement to, an RDT's offer document, containing information on an RDT's credit rating, capital ratio and exposures to related parties;

17.2 a requirement that the directors and chief executive officer of an RDT sign attestations in offer documents in relation to whether:

17.2.1 the RDT and its borrowing group are complying with its trust deed and all RDT requirements;

17.2.2 the RDT and its borrowing group have sufficient capital, and adequate governance, risk management systems and internal controls for the nature of the RDT's business;

17.2.3 exposures to, and dealings with, related parties have been entered into, and conducted on, commercial terms and are not contrary to the interests of the RDT's depositors;

17.3 disclosure of a summary of the RDT's trust deed terms and conditions;

17.4 RDTs exempted from a credit rating requirement to disclose prominently that they do not have a rating from an approved rating agency, and prohibitions or restrictions on the disclosure of ratings or rankings from agencies not approved by the Reserve Bank;

Next steps

18 note that the Minister of Finance intends to release the paper attached to EDC (07) 160;

19 invite the Minister of Finance to issue drafting instructions to the Parliamentary Counsel Office to give effect to the decisions above.

Kate Mallalieu
for Secretary of the Cabinet

Copies to:
Cabinet Economic Development Committee
Chief Executive, DPMC
Paul Alexander, DPMC
PAG Subject Advisor, DPMC
Secretary to the Treasury
Chief Executive, Ministry of Economic Development
Minister of Justice
Secretary for Justice
Chief Executive, Ministry of Economic Development (Commerce)
Chief Executive, Ministry of Economic Development (RIAU)
Chief Parliamentary Counsel
Legislation Coordinator

OFFICE OF THE MINISTER OF FINANCE

CABINET ECONOMIC DEVELOPMENT COMMITTEE

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS: REGULATION OF NON-BANK DEPOSIT-TAKERS

PROPOSAL

1. In June this year, the Committee agreed to proposals for changes to the regulation of Non-Bank Deposit-Takers, such as finance companies, building societies and credit unions. Cabinet confirmed this decision on 18 June (CAB Min (07) 21/10). I was asked to report back to Cabinet on remaining details for the regulation of Non-Bank Deposit-Takers. This paper sets out proposals for final decisions on these matters and seeks approval for the submission of drafting instructions to Parliamentary Counsel Office.

EXECUTIVE SUMMARY

2. In June this year, the Committee agreed to a new framework for the regulation of Non-Bank Deposit-Takers (referred to in this paper as Registered Deposit Takers – RDTs). The main elements of the framework are summarised later in this paper.

3. The Committee's agreement to the RDT proposals was on the basis that I would report back to the Committee with further details on the proposed regulation of RDTs, including in respect of:

   a. the proposed definition of deposit-taker;

   b. the requirements for minimum capital, capital adequacy and restrictions on lending to an RDT's related parties;

   c. the credit rating requirements, including options for minimising compliance costs, especially for small RDTs; and

   d. the powers required to enable the Reserve Bank to respond to RDT financial distress where the soundness of the financial system is affected.

4. I am now recommending that the Committee agree to the details of the RDT regulatory framework, as set out in the recommendations section of this paper, with the following main features:

   a. Deposit-takers would be defined in accordance with the principle that they are entities that offer debt securities to the public and are directly or indirectly in the business of lending money or providing other financial services. Some fine-tuning of this definition will be required in the legislative drafting process.

   b. The legislation would empower the designation of entities as deposit-takers by regulation to cover situations where some entities which are deposit-takers in substance are technically not caught by the definition.

   c. The legislation would empower the Reserve Bank to exempt entities or classes of entity from the RDT requirements in situations where it makes no sense to capture them in the RDT regime.

d. The legislation will make it unlawful to be a deposit-taker without being licensed by the Reserve Bank as a Registered Deposit Taker (RDT).

e. RDTs will continue to be subject to Securities Act requirements, as enhanced by the RFPP reforms, including the need to have a trust deed and a prospectus and investment statement.

f. Trustees will continue to be the supervisors of RDTs, and will have responsibility for enforcing most of the requirements imposed on RDTs by the RDT framework.

g. Unless exempted, all RDTs must comply with requirements prescribed by regulation under the RDT legislation, including minimum capital of $2 million, a capital ratio set by trustees measured by a standardised capital adequacy framework, a limit on exposures to parties related to RDTs, possibly liquidity requirements, and a credit rating. I am proposing that RDTs with total assets of under $10 million will be exempted from the rating requirement.

h. RDTs will be required to maintain policies and procedures to ensure that they check the suitability and integrity of prospective directors and senior managers. The Reserve Bank will have the power to dis-approve proposed appointees as directors or senior managers, and to remove them from office if already appointed, where the Bank is satisfied that they do not meet the suitability and integrity criteria. Legislation will set out suitability and integrity criteria, with scope for this to be amended or added to by regulation.

i. Trustees will continue to have primary responsibility for dealing with RDT financial distress and failure. However, in circumstances where an RDT's distress poses a threat to the soundness of the financial system, I am recommending that the legislation empower the Reserve Bank to be able to take crisis response actions, with the agreement of the Minister of Finance.

j. In accordance with Cabinet decisions in June, I am proposing that credit unions should be brought into the RDT framework on much the same basis as other RDTs, and that existing prudential constraints in the Friendly Societies and Credit Unions Act (FSCU Act) be removed. It is proposed that credit unions will be exempted from some RDT requirements – particularly in the case of small credit unions – on the basis that they will be subject to some additional prudential restrictions.

5. The proposed regulatory framework for RDTs will require legislation. I wish to have as much of this legislation as possible introduced into Parliament this year, with a view to enactment in 2008. However, given the linkages between the licensing requirements for RDTs and some other aspects of the non-bank financial sector reforms within the Review of Financial Products and Providers, the legislation will need to be progressed in two stages, with one bill being introduced before Christmas and a second bill being introduced by March/April 2008. In both cases, the bills are likely to take the form of amendments to the Reserve Bank of New Zealand Act.

6. I am proposing that the first bill will implement the credit rating and prudential requirements, including those relating to minimum capital, capital adequacy, related party lending and liquidity, and associated offences, penalties and enforcement powers for the Reserve Bank. Once enacted, that legislation would facilitate the promulgation of regulations in these areas, and for these to become binding on RDTs after a transition period. The second bill will implement remaining elements in the RDT framework, including the requirement for RDTs to be licensed by the Reserve Bank and the associated suitability and integrity requirements for directors and senior managers of RDTs.

BACKGROUND AND OVERVIEW

7. In June this year, the Committee agreed to a number of proposed reforms to financial sector regulation as part of the Review of Financial Products and Providers (RFPP). These reforms included a new framework requiring all providers of financial services to be registered with the Companies Office, a strengthening of Securities Act requirements for disclosure by issuers, a new

requirement for all trustee corporations to be authorised and supervised by the Securities Commission, and enhancements to the trustee-based supervision arrangements for issuers, including deposit-takers.

8. One of the RFPP proposals related to the regulation of deposit-takers – referred to in this paper as Registered Deposit Takers (RDTs). The Committee agreed to a new regulatory framework for RDTs.

9. The main features of the proposed regulatory framework are summarised below.

a. ***Regulatory objectives.*** The objectives for the regulation of RDTs are to promote a sound and efficient financial system by:

- encouraging sound governance and risk management in RDTs and promoting depositor confidence;
- providing depositors with a clearer basis for distinguishing between lower-risk and high-risk RDTs; and
- resolving RDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.

However, for the purposes of the proposed RDT legislation dealt with in this paper (relating to the licensing of RDTs and minimum prudential and other requirements for RDTs), it is proposed that a subset of the above objectives will be incorporated into legislation – only those that are relevant to the matters dealt with in the legislation. On that basis, it is proposed that the purposes for which powers may be exercised under the RDT legislation will be to:

- promote the maintenance of a sound and efficient financial system; and
- avoid significant damage to the financial system resulting from the failure of an RDT.

These purposes encapsulate the concept of promoting depositor confidence. The other objectives, such as providing depositors with a clearer basis for distinguishing between lower-risk and higher-risk RDTs, and the minimising of disruption to depositors, can be appropriately incorporated into legislation dealing with the enhanced trustee and offer document disclosure requirements, being implemented in other parts of the RFPP process.

b. ***Securities Act regulation.*** RDTs will continue to be subject to Securities Act regulation as issuers of securities to the public. As such, they will continue to be required to have a trust deed with an independent trustee and an offer document.

c. ***Trust deeds.*** The trust deed will continue to set out the financial and reporting obligations of RDTs. Most of the content of the trust deed will be determined between by the trustee and the RDT and will continue to vary across the RDT sector. However, all trust deeds will have to comply with new minimum standards applicable to RDTs, as set out in the RDT legislation and in regulation made under that legislation.

d. ***Licensing by Reserve Bank.*** All RDTs will be required to be licensed by the Reserve Bank, in its capacity as the prudential regulator of RDTs. At the time of licensing and thereafter, RDTs will be required to meet prudential requirements set in regulation. It is proposed that these requirements will include:

- A minimum amount of capital (ie owners' equity).
- A minimum capital ratio, agreed between the RDT and its trustee, measured in accordance with a capital adequacy framework specified in regulation.
- Restrictions on lending to parties closely related to an RDT.

- An RDT's directors and senior management meeting suitability and integrity criteria set out in the RDT legislation.

- A requirement to obtain and disclose a credit rating from an approved rating agency – subject to Cabinet being satisfied on measures to avoid excessive compliance costs for small RDTs.

e. ***Role of trustees.*** Trustees will be responsible for ensuring that RDT trust deeds comply with the minimum standards set out in regulation, evaluating their financial condition, enforcing compliance with trust deeds and taking remedial action in situations of non-compliance or distress.

f. ***Responding to RDT distress.*** In most cases, trustees will have responsibility for responding to an RDT's distress, including by appointing a receiver. Some strengthening of the powers to deal with RDT distress and failure may be necessary; these will be incorporated, as appropriate, into the enhancements to the trustee regime. These are being advanced in a separate work stream in the RFPP process. The Companies Office will also continue to have the capacity to intervene in distress or fraud situations under the Corporations (Investigation and Management) Act. In situations where an RDT poses a risk to the soundness of the financial system, I am proposing that the Reserve Bank will be empowered to give directions (with the consent of the Minister of Finance) to an RDT or to recommend to the Minister of Finance that the RDT be placed into statutory management under the Reserve Bank of New Zealand Act.

10. As the minister now responsible for RDT regulation, I was invited by the Committee to report back with detailed proposals, including:

a. the proposed definition of deposit-taker and whether the Securities Commission or the Reserve Bank should administer this definition;

b. the power to exempt an entity from being brought into the RDT regime and whether the Securities Commission or the Reserve Bank should have that power;

c. the requirement for minimum capital;

d. the requirements in respect of related party exposures;

e. credit rating requirements – including the options for minimising the compliance costs of a rating regime, particularly for small RDTs;

f. powers to deal with RDT distress and failure; and

g. the appropriate legislative vehicle for the proposed arrangements.

11. In June, the Committee also agreed that the supervisory framework for the regulation of RDTs should be applied in full to credit unions, subject to further advice on satisfactory options for minimising the compliance costs of a ratings regime for RDTs.

12. The Committee agreed, subject to the RDT regulatory framework applying to credit unions, that the following changes to credit union regulation be adopted:

a. Credit unions be given the equivalent flexibility to borrow and invest surplus funds and to hold land as any other RDT if credit union rules allow and if trust deeds are amended accordingly.

b. Credit unions be allowed to raise capital by issuing securities to their members if their rules and trust deeds allow it.

c. Credit unions have legal status so that they can have limited liability, own property, have perpetual succession, and sue and be sued.

d. A mechanism be created to enable credit unions to convert to a limited liability company, provided that credit union reserves are locked up for a minimum of five years or are applied for charitable purposes, with restriction on the use of the moniker "credit union".

e. Require the members of a credit union's management committee to have the duties of directors.

FINAL PROPOSALS FOR CHANGES TO RDT REGULATION

Definition of Deposit-Taker

13. In the June paper to the Committee, the definition of deposit-taker was based on the concept of entities that offer deposits (mainly in the form of debt securities, as defined in the Securities Act) to the public and that lend money or provide other financial services.

14. This concept is broadly consistent with the definition of deposit-taker in many OECD countries and reflects the objective of targeting the regulatory requirements to entities that fund from ordinary, non-expert depositors. It would have the effect of including finance companies that fund from the public, building societies, credit unions, the PSIS and other such entities. The proposed concept has the intended effect of excluding finance companies and other entities that fund solely through non-public sources – eg those raising funds solely from related parties or from corporate or wholesale sources.

15. I am proposing that "deposit-taker" be defined in legislation as a person, other than a registered bank, which offers debt securities to the public, within the meaning of the Securities Act, and is in the business, directly or indirectly, of lending money or providing other financial services. The definition would explicitly include building societies and credit unions. The definition will need to be fine-tuned in the legislation drafting process, including possibly needing to distinguish between those entities that only issue discrete issues of debt securities (such as bonds) and those that are continuous issuers. It is the latter that are intended to be encapsulated in the definition of deposit-taker.

16. A Registered Deposit Taker would be defined as a person that is licensed by the Reserve Bank.

Power to designate entities as deposit-takers

17. Although the proposed definition of deposit-taker is broad, there is always a possibility that some entities may structure their business in ways that avoid their inclusion in the RDT regime or that financial market developments result in deposit-taking being in forms that are not caught by the proposed definition (eg where deposits may not necessarily always be in the form of debt securities). In order to ensure that entities which are, in substance, retail deposit-takers, but which avoid capture because of technicalities, are brought within the deposit taker regime, I am proposing that the legislation will empower the designation of an entity or a class of entities as deposit-takers by regulation made in Executive Council on the advice of the Minister of Finance in accordance with a recommendation from the Reserve Bank.

18. I propose that the legislation would specify the criteria on which such a regulation may be promulgated, where the criteria anchor to the concept that the entity meets an in-substance test for being a deposit-taker. I also propose that the legislation would require the Reserve Bank to consult interested parties and have regard to their views before making a recommendation for the promulgation of a regulation.

Power to exempt entities from the RDT regime

19. The proposed definition of deposit-taker is intended to apply to a wide range of retail deposit-taking entities. It is likely that the definition of deposit-taker may capture some entities that should not be brought within the deposit-taker regime – eg some charitable or religious organisations which have a small amount of deposit-taking business. In order to avoid the RDT requirements applying more widely than intended, there will need to be a power to exempt entities or classes of entity from the RDT arrangements.

20. I am therefore proposing that the legislation would empower the exemption of individual deposit-takers or classes or deposit-taker from the RDT regulatory regime, and that this be done by notice issued by the Reserve Bank, where the Bank would be empowered to issue a notice on conditions, and to amend or revoke a notice. The Bank would be required to consult interested parties, including the Securities Commission, before issuing, amending or revoking a notice of exemption.

21. I propose that the legislation would set out the criteria on which an exemption notice may be given, including where an entity's deposit-taking business is immaterial or is ancillary to its core business, and where it is not substantially in the business of lending or providing financial services.

Prohibition of deposit-taking by entities that are not RDTs

22. Under the proposed arrangements, it is intended that it would be an offence for an entity to be a deposit-taker, as defined, unless it is either an RDT or a registered bank, or has been exempted from the RDT regime. It would also be unlawful for an entity to hold itself out as an RDT unless licensed as an RDT.

Licensing of RDTs

23. As previously agreed by the Committee, it is intended that all deposit-takers, as defined, must be licensed by the Reserve Bank as RDTs unless exempted. I am proposing that the legislation would set out the criteria which the Reserve Bank must apply when determining an application to be licensed as an RDT, including the following:

    a. The applicant must be able to comply from the time of licensing with the requirements prescribed in or pursuant to the RDT legislation.

    b. The applicant must have a trust deed registered, or eligible to be registered, by the Companies Office that complies with the minimum prudential requirements of the RDT legislation.

    c. The applicant must have a prospectus and investment statement registered, or eligible to be registered, by the Companies Office that comply with the requirements of the Securities Regulations as they relate to RDTs.

    d. The applicant must have either been registered, or be eligible to be registered, by the Registrar of Financial Service Providers as a financial service provider.

    e. The applicant's directors and senior management must meet suitability and integrity criteria prescribed in legislation.

    f. The trustee of the applicant must have attested to the Reserve Bank that the trustee is satisfied that the applicant has sufficient capital relative to the size and nature of the applicant's business, governance, and risk management systems and internal controls to manage its proposed business, consistent with the level of risk represented to depositors in the prospectus and investment statement.

g. Unless exempted, the applicant must have obtained a credit rating from an approved rating agency, in accordance with requirements specified in regulation under the RDT legislation.

h. Such other matters as specified by regulation made under the RDT legislation.

24. The legislation would require the Reserve Bank to consult the Companies Office and Securities Commission before licensing or deciding not to license an RDT.

Transition period for existing RDTs

25. It is proposed that the legislation (either in whole or in parts) will be brought into force on a date or dates appointed by Order in Council or in regulation. I am proposing that all deposit-takers, including those in existence at the time the legislation comes into force, will be required to apply to the Reserve Bank to be licensed as an RDT, unless exempted. In order to allow time for this to occur, it is intended that a transition period will apply, such that deposit-takers in existence at the time the legislation comes into force will be given a specified period of time – possibly 12 to 24 months – to become licensed and to meet the RDT requirements. Exemptions issued by the Reserve Bank, to individual RDTs or classes of RDT, will also provide time for RDTs to come into compliance with the requirements.

De-licensing of RDTs

26. The legislation will need to make provision for the de-licensing of RDTs. De-licensing could either be voluntary – at the initiative of the RDT – or mandatory.

27. In the case of a voluntary de-licensing, I am proposing that the legislation would empower the Reserve Bank to de-license an RDT on its request, where this may only occur once all of the RDT's deposits have been repaid or transferred to a registered bank, another RDT, or to a non-RDT entity with the consent of depositors.

28. In the case of an RDT that wishes to cease taking new deposits, but needs to retain existing deposits on its books pending the repayment or transfer of the deposits to another entity, I am proposing that the legislation would empower the Reserve Bank, at the request of the RDT, to impose a condition on the RDT's license to prohibit it from taking new deposits, but to continue to have the ability to service existing deposits for a period agreed between the Bank and the RDT.

29. It will be necessary for the legislation to make provision for the suspension of a license, and for the de-licensing, of an RDT in circumstances where an RDT fails to comply with RDT requirements. These grounds would include:

a. serious or persistent failure to comply with the licensing requirements and obligations of an RDT, as set out in the Act;

b. failure to comply with conditions of a license;

c. failure to provide the Reserve Bank with information or providing false or misleading information to the Bank, when requested by the Bank pursuant to the powers in the legislation;

d. insolvency, receivership, liquidation, voluntary administration or statutory management under the Corporations (Investigation and Management) Act.

30. I am proposing that the legislation will require the Reserve Bank to issue a written notice to the RDT in question, stating the intention to suspend the license of an RDT, or de-license the RDT, the

grounds on which this is being given, and advising the RDT that it has a minimum period within which to rectify the situation in order to avoid de-licensing.

31. The legislation would also require the Bank to consult and have regard to the views of the Securities Commission, Companies Office and trustee of the RDT in question before de-licensing or suspending the license of an RDT.

Mechanism for imposing prudential requirements for RDTs

32. It has been agreed that RDTs will be required to comply with prudential and other requirements. The details of these requirements will need to be amended from time to time to take into account changes in the financial sector and developments in prudential standards. I am therefore persuaded that it would not be desirable to set the details of prudential or other requirements in legislation. Rather, I am proposing that the legislation would provide for RDT requirements to be specified in regulation, made in Executive Council on the advice of the Minister of Finance in accordance with a recommendation from the Reserve Bank. I note that this approach is consistent with international supervisory principles and practice.

33. In order to provide some certainty on the matters for which regulations may be made to apply to all RDTs or classes of RDT, I am proposing that the legislation will specify that regulations may be made in relation to the following matters in respect of the RDT and/or its borrowing group:

a. minimum amount and form of capital;

b. level and form of capital in relation to the size and nature of business of an RDT;

c. restrictions on exposures to parties related to an RDT;

d. liquidity requirements;

e. credit rating requirements, including requirements applying to RDTs exempted from a credit rating obligation (such as a requirement for the prominent disclosure that an RDT does not have an approved rating, prohibitions or restrictions on the disclosure of alternative ratings, and minimum prudential requirements);

f. size and composition of the board of directors (or equivalent); and

g. the management of financial risks, including interest rate risk, exchange rate risk and other market price risks.

34. In some cases, it is intended that the regulations will specify matters that must be included in, or implied into, trust deeds, such as minimum capital, capital adequacy and related party exposure requirements. I am therefore proposing that the legislation would empower the making of regulations to specify such matters. The legislation will also need to make provision for situations where trust deeds do not authorise amendments to be made, to ensure that matters prescribed in regulation can be incorporated into trust deeds.

35. In order to ensure that there is an appropriate level of transparency and accountability in the regulation-making process, I am proposing that the legislation will require the Reserve Bank to:

- consult interested persons, including the Securities Commission and trustees of RDTs, before making a recommendation to the Minister of Finance on regulations; and
- publish a Statement of Principles that explains the regulatory requirements for RDTs.

Power to exempt from regulations

36. There will be situations where particular RDTs or classes of RDT are, for varying reasons, unable to comply with regulatory requirements or where it would be inappropriate to require them to comply. I am therefore proposing that the legislation will empower the Reserve Bank to issue notices to exempt particular RDTs or classes of RDT from regulatory requirements, where such exemption notices may be issued with conditions, and may be amended or revoked by the Bank from time to time.

37. I propose that the legislation will set out some broad criteria for the making of exemptions and the types of matters which may be included as conditions to exemptions.

38. I propose that the legislation will require the Bank, before issuing, amending or revoking exemption notices, to:

- consult interested parties, including the Securities Commission and the trustee of the RDT in question; and
- publish in a Statement of Principles the general principles the Bank applies to the making, amending and revoking of exemption notices.

Minimum amount and form of capital

39. In June, the Committee agreed that RDTs should be required to have a minimum amount of capital (ie funding provided by the RDT's owners, such as shareholder equity). The purpose of a minimum capital level is to ensure that RDTs have sufficient capital to demonstrate serious shareholder commitment and to provide a minimum level of substance to the RDT.

40. The Discussion Document issued in 2006 proposed a minimum capital level in the range of $500,000 to $2 million. I am advised that most submissions favoured a minimum of at least $2 million and some argued for more.

41. I am proposing that the minimum amount of capital be prescribed in regulations made pursuant to the legislation, and that, subject to consultation with stakeholders at the time regulations are prepared, the minimum amount be set at $2 million, with a view to reviewing this level from time to time. It is proposed that the regulations would specify the form that the capital may take.

42. I am satisfied that $2 million is sufficient to require a reasonable level of shareholder commitment and to prevent insubstantial operators from entering the sector, while still keeping it sufficiently low to facilitate contestability and allow small niche operators.

43. As noted later in this paper, I am proposing that credit unions be exempted from the $2 million minimum as part of a special set of arrangements for credit unions.

Capital adequacy requirements

44. It is intended that all trust deeds for RDTs will be required to contain a minimum capital ratio relative to the size and nature of an RDT's business, set by the trustee, and measured on a framework set out in regulation. The purpose of the capital ratio is to ensure that all RDTs have a capital ratio measured on a standardised basis, where capital must meet defined standards and must be calculated in relation to risk-weighted on and off-balance sheet credit exposures, market risks and other risks.

45. The capital measurement framework will need to be developed in consultation with stakeholders at the time regulations are drafted. However, subject to the views of stakeholders, the intention is to

apply a simplified form of Basel 2 – the international standard for measuring capital adequacy for banks and deposit-takers. This would have the advantage of measuring capital adequacy in a relatively comprehensive way, taking into account on and off-balance sheet risks, and other risks, and would facilitate comparisons of RDTs' capital ratios with those of banks.

46. At this stage, it is not intended that the Reserve Bank would specify a standard minimum capital ratio. Setting a minimum capital ratio for RDTs creates a risk that the minimum would be seen as adequate for all RDTs even though it is likely to be insufficient for many of them. Specifying a standard minimum ratio also has the potential to dilute the responsibility of trustees to form their own view on what an appropriate capital ratio is for RDTs. However, in recognition that it may one day prove necessary to specify a minimum capital ratio for RDTs, I am proposing that the legislation would include provision for the making of regulations to specify a minimum capital ratio for all RDTs or classes of RDT.

47. The Bank would have the ability to issue guidelines to trustees and RDTs to assist them in determining an appropriate capital ratio.

Restriction on credit exposures to related parties

48. In June, the Committee agreed that there should be some form of restriction of lending or other business dealings with related parties (such as an RDT's subsidiaries and affiliates, major shareholders and directors). This was an issue on which I was asked to report back to the Committee.

49. Lending by RDTs to related parties is a major source of risk in any financial institution. It carries the risk that loans or other business dealings with related parties may be on non-commercial terms, to the possible detriment of the soundness of a financial institution. This risk is particularly significant in the RDT sector, given that RDTs are often part of a wider group of companies and that lending to related parties can involve very complex arrangements. The risks are compounded in situations where the boards of RDTs include directors or management of other group companies and where conflicts of interest are not always well identified or managed. A number of finance company failures, including in recent years, have involved related party lending that was detrimental to the interests of depositors.

50. Some form of restriction of related party lending is therefore important. I am proposing that the legislation would empower the making of regulations relating to the restriction of lending and other credit exposures to related parties. The details of the restriction will need to be developed at the time regulations are prepared, in consultation with stakeholders. At this stage, however, it is proposed that the regulations would require RDTs to include in their trust deeds a limit, set in relation to an RDT's capital, on exposures to related parties, where the limit is agreed by the trustee and RDT, and measured on the basis of a framework set out in the regulations. If it proves necessary, the regulations would enable a standard maximum limit to be imposed on all RDTs or classes of RDT. The Bank may also issue guidelines to assist trustees and RDTs in this area.

51. I am proposing that the definition of "related party" would be set out in legislation, with the scope for the definition to be amended by regulation.

Liquidity requirements

52. Liquidity is a major risk for RDTs. Financial distress or failure can be triggered or exacerbated by an RDT having too little liquidity to enable it to meet its obligations as they fall due. In recognition of this, and the need for a more standardised approach to liquidity risk management across the RDT sector, it is proposed that the legislation will empower the making of regulations to prescribe liquidity requirements for inclusion in RDTs' trust deeds. The nature of the liquidity requirements will need to be discussed with stakeholders at the time regulations are prepared, but may include

minimum liquid assets relative to short-term liabilities, maturity matching between assets and liabilities or other measures to ensure that RDTs maintain a liquidity buffer sufficient to enable them to withstand a plausible range of liquidity shocks.

Credit rating requirement

53. In June, the Committee agreed that RDTs should be required to obtain and publicly disclose a credit rating from a rating agency approved by the Reserve Bank, subject to further advice on options to minimise compliance costs, especially for small RDTs. It was agreed that a credit rating is the most effective way to inform depositors and financial advisers of an RDT's risk and to facilitate comparison of risks across RDTs. It was also recognised that credit ratings would strengthen the incentives for RDTs to develop and maintain sound governance and risk management practices and reduce the need for more comprehensive and expensive prudential regulation and supervision.

54. Officials have conducted further analysis on the ratings proposal and I am now in a position to propose details for the rating requirement.

Ratings requirement

55. I am proposing that the legislation will require RDTs to comply with requirements in relation to credit ratings prescribed in regulations. The details of the ratings requirements will need to be the subject of consultation with stakeholders at the time the regulations are prepared. However, subject to that consultation process, I am proposing that the regulations would have the following features:

a. ***Issuer rating.*** The credit rating would be a long-term "issuer rating" applicable to the RDT and would therefore measure the strength of the RDT's ability to meet its financial obligations.

b. ***Approved rating agency.*** The rating will need to be obtained from a rating agency approved by the Reserve Bank in order to ensure that ratings are of acceptable quality and that meaningful comparisons can be made between the ratings of different rating agencies. The legislation will empower the Bank to approve rating agencies for this purpose, and to withdraw such approvals. It will require the Bank to disclose in its Statement of Principles the criteria it applies in making rating agency approval decisions.

c. ***Disclosure of ratings.*** I am proposing that RDTs will be required to disclose their rating, and qualifications to the rating, in a manner prescribed in regulation made under the Securities Act. The details of disclosure requirements will need to be consulted on at the time regulations are prepared. However, the current intention is that the disclosure of ratings will:

   - be made in an RDT's offer documents and in all advertisements for its deposits or investments where these are offered to the public; and
   - require the disclosure of the current rating, the name of the rating agency, a description of the rating (based on the descriptors made available by the rating agency), the rating relative to the rating agency's rating scale, any qualifications to the rating, and any changes to the rating made in the preceding two years.

d. ***Prohibition or restriction on the use of alternative ratings.*** In order to reduce public confusion over ratings and the risk of misleading ratings information being disclosed, I am proposing that the regulations would prohibit or restrict an RDT from disclosing in advertisements or offer documents a rating, ranking or scoring from an entity not approved by the Reserve Bank.

Improving public understanding of ratings

56. In order to lift public understanding of credit ratings, and to encourage their use, there will be a need for various education and disclosure initiatives, from both the public and private sectors. The Reserve Bank, in conjunction with other government agencies and the private sector, will develop proposals for disclosure and public education to assist in this area and these will be reported to Cabinet in the course of implementing the RDT arrangements. This will be done in the wider context of developing a strategy to strengthen financial literacy and capacity in the public.

57. The options to be considered will include:

a. joint initiatives between the rating agencies and the Bank (among others) to promote explanatory material on ratings aimed at the non-expert depositor;

b. working with financial advisers, planners and brokers to make greater use of approved ratings when advising clients on their investment options;

c. briefings and explanatory material for the business news media to promote informed comment on financial institution risks and the role played by credit ratings in measuring risk;

d. educational initiatives in schools and universities to promote greater understanding of financial and investment issues, including financial risks and the role of credit ratings; and

e. disclosure of comparative information on ratings agencies' rating scales and guidance on how to interpret particular rating grades.

Cost of ratings – proposed exemption for small RDTs

58. Cabinet requested that I report back on options for the reduction of compliance costs associated with credit ratings. There are three main options available for reducing costs for small RDTs:

- Exempt small RDTs (with conditions).
- Provide a subsidy for small RDTs.
- Negotiate a standard base fee for small RDTs.

59. I am advised that the annual direct cost of a rating (ignoring management time and costs of providing information or changing systems) is an average of around $30,000 for a typical RDT. The rating fee will vary depending on the rating agency and the size and nature of the RDT. This cost is minor for most RDTs, relative to the size of their balance sheets and profits. However, the cost is higher for very small RDTs, including the costs of management time and information system changes.

60. Officials have assessed different options for reducing the cost of ratings, especially for small RDTs. The main option, and the one I am recommending, is that RDTs below a defined size be exempted from the rating requirement. This would avoid the direct and indirect cost of ratings for small RDTs, including credit unions, and would enable small niche players to continue to operate in the market. I note, however, that an exemption would also reduce the ability of depositors in small RDTs to understand the risks of the RDT and would reduce the incentives that ratings can create for sound governance and risk management.

61. Subject to the need to consult stakeholders at the time regulations are prepared, I am proposing that the regulations specifying ratings requirements would apply only to RDTs with total assets in an RDT's borrowing group of $10 million or above. I am advised that this will result in all of the small credit unions and a small number of other RDTs being exempted, representing around 1 per cent of total RDT deposits.

62. Under this proposal, an RDT would be exempted from the need to have a credit rating until its total assets (including those in its borrowing group) reach $10 million, at which point a rating will be required. Allowance would be made for an RDT to retain a temporary exemption (issued by the Bank by notice) where necessary to enable an RDT time to obtain the rating.

63. I propose that the exemption be reviewed after a period of three years, and if an exemption is retained, that the total asset level be reviewed from time to time, with a view to the threshold increasing in line with growth in RDT balance sheets.

64. In the case of exempted RDTs, I am proposing that the legislation would empower the making of regulations to:

a. require exempted RDTs to prominently disclose, in offer documents and advertisements, that the RDT is unrated;

b. prohibit or restrict the RDT's disclosure of ratings, gradings, scorings or rankings issued by non-approved agencies. A prohibition would avoid the risk of public confusion over the disclosure of alternative (non-approved) ratings, and reduce the risk of people being misled by ratings that can sometimes be of questionable accuracy. However, prohibition would also seriously impede the business of the New Zealand-based entities that provide such ratings and may discourage the emergence of an effective domestic rating agency. Equally, however, allowing the disclosure of non-approved ratings may give rise to confusion by depositors and result in misleading portrayals of RDT risk;

c. require the RDT to comply with additional prudential requirements prescribed in regulation, potentially including in relation to a minimum capital ratio, a maximum limit on exposures to related parties, liquidity requirements and restrictions on the nature of the RDT's operations.

Governance requirements

65. The Cabinet paper in June recommended that RDTs be subject to minimum governance requirements, mainly relating to the size and composition of the board of directors. These recommendations were made in recognition of the importance of sound governance and the risks for depositors and others when RDTs have inadequate governance arrangements.

66. Officials have further assessed the efficacy of prescribing minimum governance requirements for RDTs. They have noted that minimum requirements along the lines set out above might help to strengthen the corporate governance of RDTs, and thereby help to strengthen risk management and reduce reliance on prudential regulation. Minimum governance requirements can also assist to underpin or complement good disclosure practices by RDTs.

67. However, there are also arguments to suggest that it may not be necessary to impose minimum governance requirements on RDTs in order to achieve sound governance outcomes. The credit rating requirement could be expected to strengthen the incentives for most RDTs to maintain good standards of governance. Fit and proper checks on directors and senior managers might also assist in strengthening governance, as might the proposal for RDT directors and CEOs to sign regular attestations in RDT offer documents affirming the adequacy of their governance and risk management systems. Moreover, governance requirements (eg director duties and matters relating to director conflicts of interest) in company law, and the proposed strengthening of mutuals governance, also help to underpin sound governance practices.

68. I am proposing that, for the time being at least, there be no minimum corporate governance requirements for RDTs as part of the RDT regulatory framework. However, I think it is important that there be scope to prescribe governance requirements in the future if the need arises, given that governance can have a major effect on the soundness and risk management of RDTs. Hence, I am proposing that the legislation empower the making of regulations in this area, relating to board size and composition.

69. In order to prevent a situation where an RDT's constitution permits its directors to act in the interests of a holding company (even if this conflicts with the interests of the RDT), I propose that the

legislation will allow regulations to be made to prescribe matters in relation to the constitution of an RDT.

Fit and proper requirements

70. Cabinet has agreed, as part of the proposed financial service provider registration framework that RDTs will be subject to criminal and bankruptcy checks in respect of shareholders with control, directors, and senior managers. These will be part of the financial service registration framework administered by the Registrar of Financial Service Providers in the Companies Office.

71. In addition to the criminal and bankruptcy checks, the Committee agreed in June that fit and proper checks (relating to suitability and integrity) should be applied to an RDT's directors and senior managers to ensure an acceptable level of suitability and integrity for their role. Applying fit and proper checks to directors and senior management is consistent with international standards for the supervision of banks and deposit-takers, and with international practice, and was proposed in the Discussion Document issued in 2006. The application of such checks to directors and senior managers would also be consistent with FATF requirements for anti-money laundering supervision.

72. The objective is to ensure that primary responsibility rests with the RDT's owners and board for ensuring that directors and senior management have suitable skills and experience, and the integrity, to do their jobs effectively. The Reserve Bank's role should be limited to a "backstop" function to ensure that persons who do not meet the prescribed suitability criteria are not appointed or can be removed.

73. I am proposing a combination of policies that will achieve these objectives:

a. I propose that the legislation will require RDTs to maintain fit and proper policies and procedures for directors and senior management in accordance with regulations. Indicatively, the regulations would be likely to specify:

- The broad nature of the policies and procedures that RDTs should adopt in order to ensure that prospective directors and senior managers are subject to scrutiny prior to appointment, and are subject to periodic review thereafter, including as to their experience, qualifications and skills relevant to being a director or senior manager of an RDT, and their involvement in previous business operations.

- An obligation for the board of an RDT to attest to the Reserve Bank, at the time of referring to the Bank a prospective appointee, that the policies and procedures have been applied and that the board is satisfied that the appointee has the required level of suitability and integrity for the position in question.

b. I propose that the legislation will empower the Reserve Bank to dis-approve the appointment of directors and senior managers if the Bank is satisfied that the person does not meet the fit and proper requirements. I am also proposing that the legislation will empower the Bank to require the removal of a director or senior manager if the Bank is satisfied that the person no longer meets the fit and proper requirements. The Bank may set a term and other conditions on the period of disqualification. Legislation will include appropriate natural justice requirements including appeal rights.

c. I propose that the fit and proper criteria will be prescribed in legislation or regulation.

74. There will need to be appropriate coordination between the application of fit and proper requirements under the RDT legislation and the criminal vetting functions to be performed by the Registrar of Financial Service Providers.

Disclosure and director/CEO attestation requirements

75. RDTs will continue to be covered by the disclosure and advertising requirements of the Securities Act as debt issuers. It is proposed that amendments to the Securities Act will be made in the second phase of the RFPP reform legislation to strengthen and simplify disclosure requirements for issuers, including RDTs. Proposals on these matters are expected to be brought to the Committee in November this year.

76. In addition to the proposed changes to disclosure requirements for debt issuers, I am proposing that the disclosure requirements for application to RDTs, contained in the relevant Securities Regulations, will require the following:

a. Disclosure at six monthly intervals of a brief Key Information Summary, either as part of or a supplement to, an RDT's offer document, which must contain information prescribed in regulation, including in relation to:

- an RDT's credit rating, the name of the rating agency, a description of the rating (as used by the rating agency), where the rating sits on the agency's rating scale, qualifications to the rating, and changes to the rating in the preceding two years;
- the capital ratio of the RDT;
- the level of related party exposures relative to capital and relative to the limit in the trust deed.

b. Attestations signed by the directors and CEO of the RDT in offer documents, including in relation to:

- whether the RDT is complying with its trust deed and regulatory requirements;
- whether they are satisfied that the RDT has sufficient capital and adequate governance and risk management systems for the nature of the RDT's business;
- whether credit exposures and other business dealings with related parties have been entered into and conducted on commercial terms and are not contrary to the interests of the RDT's depositors.

c. Disclosure in the RDT's offer document of a summary of the terms and conditions of its trust deed.

77. It is proposed that the Securities Commission will be required by that Act to consult with the Reserve Bank in preparing disclosure regulations. It is also proposed that the Securities Act will require the Securities Commission to consult and have regards to the views of the Reserve Bank in the preparation of any exemption notices in respect of RDTs and on any enforcement actions taken in relation to disclosure or advertising matters.

Guidelines issued by the Reserve Bank

78. It is intended that the Reserve Bank will be able to issue guidelines, of a non-binding nature, to RDTs and trustees to assist them to interpret prudential or other requirements promulgated under the RDT legislation. Guidelines could be issued in relation to a number of matters, including the capital adequacy framework, which is technical in nature and where explanatory guidance may be useful to stakeholders. Guidelines in other areas may also be helpful, potentially including corporate governance, liquidity, related party dealings, fit and proper requirements and other matters.

RDT distress and failure

79. In June, the Committee agreed to a proposal that the Reserve Bank should have the statutory powers to respond to RDT financial distress and failure in situations where the Bank is satisfied that its intervention is required in order to maintain the soundness and efficiency of the financial system or to avoid significant damage to the financial system resulting the distress or failure of the RDT.

80. I am proposing that the RDT legislation will include powers for the Reserve Bank to intervene in an RDT distress or failure situation where the Bank considers this necessary for maintaining the soundness and efficiency of the financial system or for avoiding significant damage to the financial system resulting from the failure of an RDT by extending the application of crisis management powers under the Reserve Bank of New Zealand Act to RDTs. In these circumstances, it is proposed that:

a. The Bank would be empowered to recommend to the Minister of Finance that, by notice issued by the Minister, an RDT (and any of its subsidiaries or associated persons) be made subject to the Reserve Bank of New Zealand Act for the purposes of exercising powers under that Act to give directions to the RDT (under section 113 of that Act) or to recommend that the RDT be placed into statutory management (under section 117 of that Act), on the basis that the Act would apply to the RDT as if it were a registered bank.

b. Once a notice has been issued declaring that the RDT (and any of its subsidiaries or associated persons) is subject to the Reserve Bank of New Zealand Act for crisis management purposes, the Bank would then be able to exercise crisis management powers in that Act as if the RDT were a registered bank. With the consent of the Minister of Finance, the Bank would be empowered to suspend all or some the powers of the trustee of the RDT in question, on the basis that the trustee is exempted from liability as a result of being unable to exercise powers.

c. The Bank would be required by the RDT legislation to consult with the trustees, Securities Commission and Companies Office before making a recommendation to the Minister of Finance that the RDT be declared by the Minister to be brought under the Reserve Bank of New Zealand, and before exercising any powers under the Reserve Bank of New Zealand Act in relation to the RDT.

Treatment of credit unions

81. In June, the Committee agreed that credit unions should be regulated as RDTs and, to the extent that they are subject to the full set of requirements for RDTs, the prudential constraints in the Friendly Societies and Credit Unions Act (FSCU Act) that impede the ability of credit unions to conduct the business of an RDT should be repealed.

82. The case for credit unions being regulated as RDTs on much the same terms as other RDTs is strong, given that credit unions perform many of the functions of other RDTs, including deposit-taking, provision of transaction services, lending and other financial services. Although some credit unions are relatively low-risk in nature, they nonetheless expose their members – depositors – to risks that are similar in nature to the kinds of risks that depositors in other RDTs face. Depositors in credit unions are therefore in as much need of the protection measures being proposed in this paper as are depositors of other RDTs. Moreover, in a situation where credit unions are increasingly competing with other RDTs and are wanting greater operational freedom to extend their areas of competition, there is a strong case for a competitively neutral approach to regulation of credit unions.

83. I am therefore satisfied that, to the extent practicable, credit unions should be regulated on the same basis as other RDTs, and that further relaxation of operational constraints on credit unions should be contingent on them being brought under the RDT requirements. However, I wish to ensure that the regulatory arrangements for credit unions do not prevent small credit unions from operating effectively or new credit unions being created.

84. The FSCU Act will need to be substantially amended to implement proposed liberalisation of credit union regulation, and to give effect to the proposed mutuals governance reforms. It is intended that the Minister of Commerce will report to the Committee at a later date on the scope and nature of the proposed changes to the FSCU Act. This will be progressed separately from the RDT reforms, but it will need to be taken into account when bringing credit unions under the RDT framework.

85. I am therefore proposing that the Committee agree to the following proposals in respect of credit unions:

a. Credit unions will be subject to the RDT requirements. It may be necessary to exempt credit unions from some of the RDT arrangements until the FSCU Act has been amended. These exemptions can be effected through the proposed general exemption power available to the Reserve Bank.

b. Small credit unions – those with total assets under $10 million – will be exempted from the credit rating requirement, as is proposed for all NBDTs under this size threshold. This will avoid the imposition of compliance costs on these credit unions arising from a credit rating. Exempt credit unions would be subject to conditions, including a requirement to prominently disclose in offer documents and advertisements that they do not have a credit rating, and restrictions on their ability to disclose alterative ratings, scorings or rankings provided by non-approved agencies. The exemption would also appropriately be conditional on additional prudential requirements imposed by regulation.

   The details of these restrictions will be the subject of consultation at the time regulations are drafted, but are likely to include a minimum capital ratio, a limit on related party exposures and potentially restrictions on the nature of business activities that exempt credit unions may undertake.

c. I am proposing that credit unions be exempted from the minimum capital amount on the basis that they comply with a minimum capital ratio set in regulation, with the level of this ratio being the subject of consultation at the time regulations are prepared.

d. Some credit unions operate within groups, as opposed to being stand-alone. The main credit union group is that represented by the New Zealand Association of Credit Unions (NZACU). The NZACU has requested that consideration be given to the option of applying regulatory requirements – including the need for a credit rating and possibly trust deed and offer document obligations – to the group, rather than on an individual credit union basis.

   I am advised that a group approach to regulation would be appropriate in circumstances where the risks to depositors are spread across the group, such that their deposits can be repaid from the assets of any part of that group. This would require, among other matters, unconditional and irrevocable cross guarantees within the group.

   I have asked officials to explore this matter further and revert with their advice. In the meantime, I am persuaded that the legislation should be drafted to enable RDT requirements to be applied on a group, rather than individual entity, basis, where this can be effected by regulation, but only where the Reserve Bank and Minister of Finance are satisfied that a group approach provides the same level of protection to depositors as would be the case for a single entity approach.

Powers of Reserve Bank and trustees to take enforcement actions

Trustee obligations and powers

86. In the case of requirements that must be included in trust deeds (such as minimum capital, capital adequacy ratio, a related party exposure limit and liquidity requirements), it is proposed that the trustee would be responsible for enforcing compliance with requirements and will have additional obligations and powers imposed under the RDT legislation for that purpose. I am proposing that:

a. The trustees will be required by the legislation to ensure that trust deeds of RDTs comply with the requirements set in regulation under the RDT legislation.

b. The legislation will empower the trustees (either directly or by requiring trust deeds to contain the powers) to require RDTs to provide them with information sufficient to enable the trustee to monitor compliance with the regulatory requirements, to appoint a person (at the expense of the RDT) to verify compliance, and to investigate the affairs of the RDT for the purpose of ascertaining compliance.

c. The trustee of an applicant for licensing as an RDT will be required by the legislation to attest to the Reserve Bank, prior to an RDT being licensed, whether the trustee is satisfied that the applicant has sufficient capital relative to its size and nature, risk management systems and internal controls, and governance to manage its proposed or actual business, consistent with the level of risk represented to depositors in the prospectus and investment statement. The legislation will empower the Reserve Bank to require trustees of RDTs to attest to these matters at intervals specified by the Bank.

I note that the trustees appear to be resistant to this proposal. At this stage, however, I am satisfied that it should be included in the RDT legislation. The RDT regime places a great deal of reliance on the role of trustees. I am therefore keen to ensure that they have strong incentives to reach a view, and convey that view to the Reserve Bank, as to whether they are satisfied that the key financial covenants in the trust deed are consistent with protecting depositors in a manner consistent with the risk profile represented to depositors in the prospectus and investment statement. If trustees remain concerned, their concerns can be discussed at the select committee process.

d. The legislation will empower the Bank to require the trustees of an RDT to attest to the Bank, at intervals specified by the Bank, whether the trustee is satisfied that the RDT is complying with the requirements specified in the legislation or in regulations. It is also proposed that the trustees will be under a statutory obligation to advise the Bank as soon as practicable if an RDT has failed or is expected to fail to comply with a requirement of the legislation or regulation, or where the trustee has reasonable cause to believe that non-compliance may have occurred.

e. The legislation will empower the Bank to require the trustees of an RDT to provide the Bank with information to enable the Bank to determine whether an RDT is complying with the requirements of the legislation and regulations.

Reserve Bank

87. The Reserve Bank would directly take enforcement actions in respect of matters that are not included in trust deeds or offer documents and are imposed by regulation – such as breaches of fit and proper requirements. The Bank would also take enforcement actions in the case of criminal sanctions. In addition, it is intended that the Bank would take enforcement action in situations where it is not satisfied with actions taken (or not taken) by a trustee in relation to RDT requirements set out in legislation or regulation.

88. Enforcement powers will include:

- The ability to obtain information from an RDT and its trustee to ascertain whether the RDT is in compliance with regulatory requirements.

- The ability to appoint a third party (such as an audit firm) to investigate an RDT to ascertain whether it is in compliance with regulatory requirements.
- The ability to issue a notice to the RDT advising of non-compliance and requiring the RDT to explain how and when it plans to come into compliance.
- Prosecutions for offences.
- The ability to suspend the license of or to de-license an RDT.

89. It will be important for the regulatory agencies responsible for the RDT sector to cooperate and coordinate regulatory actions where appropriate. In order to facilitate this, it is intended that the legislation will empower information-sharing between the Reserve Bank, Securities Commission, Companies Office and trustees for the purpose of enabling each regulatory agency to perform its responsibilities effectively. The legislation will also set out confidentiality requirements for information exchange.

90. It is likely that the regulatory agencies will enter into a Memorandum of Understanding (MOU), documenting the respective responsibilities and accountabilities of each agency, and setting out the framework for cooperation and coordination. It is intended that this MOU will be publicly disclosed.

Offences and penalties for non-compliance with RDT requirements; enforcement powers

91. I am proposing that the offences under the RDT legislation will include the following:

- Provision of false or misleading information by an applicant or their agent in respect of an application to be licensed as an RDT.
- Falsely holding out to be an RDT.
- Conducting the business of a deposit-taker if not licensed as an RDT (unless a registered bank or an exempt entity).
- In the case of an RDT or its directors or CEO, failing to comply with regulatory requirements imposed under the Act or with conditions attaching to an exemption notice issued by the Reserve Bank.
- In the case of an RDT or its directors or CEO, failing to comply with a request from the Bank to provide the Bank with information, or providing false or misleading information.
- In the case of an RDT, failure to notify to the Reserve Bank a change in director or senior manager.
- Failure by a trustee to provide the Bank with information as requested, providing false or misleading information to the Bank, failing to notify the Bank of a material breach of regulatory requirements as soon as the trustee becomes aware of the breach, failing to make a required attestation to the Bank or making a false or misleading attestation to the Bank.

Penalties

92. I am proposing that the legislation will set out penalties for offences and that these be modelled on those in the Reserve Bank of New Zealand Act and Securities Act, in terms of fines and imprisonment terms, as the case may be, for RDTs, trustees, RDT directors and CEOs, and other persons committing offences. On this basis, I am proposing that officials work with PCO to draft

legislation which incorporates penalties that are appropriately calibrated to the seriousness of offences, and maintain a consistency with Reserve Bank Act and Securities Act equivalents.

93. Indicatively, but subject to officials undertaking more work on this, I am proposing that fines on deposit-takers and RDTs be prescribed in a range between $500,000 and $2 million; fines for RDT directors and CEOs ranging between $50,000 and $200,000, and imprisonment terms for directors and CEOs ranging between 3 months and 18 months.

LEGISLATIVE IMPLICATIONS

94. Legislation is required to enact the proposals in this paper. The proposals relating to licensing of RDTs will contain cross references to the Financial Providers Bill being drafted by MED, as the licensing and fit and proper regime is interconnected with the registration process to be implemented under that bill. The consequence of this is that proposals relating to licensing will be unable to proceed ahead of the Financial Providers Bill. Officials advise that the consequence of this is that the legislation providing the licensing regime cannot be introduced until next year.

95. However, other proposals are not dependent on the licensing regime and on the Financial Providers Bill. This includes credit rating requirements and the new requirements to be included in trust deeds (such as minimum capital, a capital adequacy ratio, a limit on exposures to related parties and possibly liquidity requirements). I propose that those proposals should be enacted separately from the licensing-related proposals and proceed in advance, with the aim of introduction into the House before the Christmas recess this year, with the aim of passage during 2008. The licensing related proposals should proceed in a separate bill to be introduced by March/April 2008.

96. Each bill would commence on separate dates. This means that the credit rating proposals and trust deed requirements could be introduced ahead of the requirement for deposit-takers to be licensed as RDTs.

97. To enable two bills to be introduced and to proceed through Parliament separately, it is proposed that the bills will amend the Reserve Bank of New Zealand Act 1989, rather than create new RDT-specific statutes. The first bill will also contain the transparency and accountability amendments to the Reserve Bank of New Zealand Act, which were approved by Cabinet in June. This bill holds a category 4 priority on the 2007 Legislation Programme (to proceed to a select committee in 2007). I will seek a priority 5 for the second Bill to acknowledge that drafting instructions are intended for later this year.

REGULATORY IMPACT ANALYSIS

98. The Regulatory Impact Statement is attached. I confirm that the principles of the Code of Good Regulatory Practice and the regulatory impact analysis requirements, including the consultation RIS requirements, have been complied with.

IMPLICATIONS FOR THE TREATY OF WAITANGI

99. There are no implications for the Treaty of Waitangi.

HUMAN RIGHTS

100. There are no implications in relation to the Human Rights Act or the New Zealand Bill of Rights Act.

FISCAL IMPLICATIONS

101. As agreed by Cabinet in June, the Reserve Bank will fund its costs associated with RDT regulation through its Funding Agreement, on the same basis as it is currently funded for its other regulatory activities, rather than through charging fees to RDTs. However, it is proposed that a cost-recovery fee will be charged for licensing an RDT, as is the case with registered banks. I am proposing that the fee would be prescribed by regulation and able to be revoked or amended from time to time.

PUBLICITY

102. It is proposed that this paper will be publicly released if approved by Cabinet.

CONSULTATION

103. The proposals in this paper closely reflect the proposals set out in the RDT Discussion Document released in 2006, in respect of the "Tier 2 RDTs". They are also substantially consistent with the decisions publicly announced by the government in June this year, following the Cabinet decisions made on 18 June.

104. The following government agencies were consulted in the preparation of this paper: Treasury, Ministry of Economic Development, Securities Commission, Parliamentary Counsel Office, Ministry of Justice and the Department of Prime Minister and Cabinet. In addition, selected stakeholders have been consulted on this paper on a limited basis, including trustee corporations with responsibilities for RDTs, credit unions and two private sector experts on securities law.

RECOMMENDATIONS

It is recommended that the Committee:

1. **Note** that, in June this year, the Cabinet Economic Development Committee agreed to proposals for the regulation of Non-Bank Deposit-Takers (NBDTs) – referred to in this paper as Registered Deposit Takers (RDTs) - and that these proposals were confirmed by Cabinet on 18 June (CAB Min (07) 21/10).

2. **Note** that the proposed regulation of RDTs includes the following main features:

   a. RDTs will continue to be subject to regulation under the Securities Act in their capacity as issuers of securities to the public, and will therefore continue to be required to have offer documents and trust deeds. Trustees will continue to have responsibility for agreeing the terms and conditions of trust deeds with RDTs, and for monitoring and enforcing trust deed requirements.

   b. RDTs will be subject to the enhanced trustee arrangements agreed to by the Committee in June, whereby trustees are subject to authorisation and supervision by the Securities Commission.

   c. All RDTs will be required to be licensed by the Reserve Bank and to comply with minimum prudential and other requirements prescribed in regulation. Some of these requirements will be required to be incorporated into RDT trust deeds and enforced by trustees; others will be enforced directly by the Reserve Bank.

   d. RDTs will be subject to enhanced public disclosure requirements in their offer documents, including in respect of their credit rating, capital position, lending to related parties and key risk information. These requirements will be enforced by the Securities Commission. The disclosure proposals set out in these recommendations may only be a subset of the disclosure requirements to be prescribed for RDTs.

e: Trustees will have the principal responsibility for responding to RDT financial distress. However, it is proposed that the Reserve Bank will have powers of intervention, with the agreement of the Minister of Finance, in situations where an RDT poses a threat to the soundness or efficiency of the financial system.

3. **Note** that the Committee invited me to report back on details of the proposed RDT regulatory arrangements, including in respect of the definition of RDT, ratings requirements for RDTs (and the means of avoiding excessive compliance costs for smaller RDTs), prudential requirements and the legislative vehicle for the proposed arrangements.

4. **Note** that, in June, the Committee agreed that the supervisory framework for the regulation of RDTs should be applied in full to credit unions, subject to satisfactory options for minimising the compliance costs for ratings for credit unions.

5. **Note** my desire to have as much as possible of the legislation required to implement the RDT proposals introduced into Parliament this year in order to facilitate enactment in 2008, but that in order to achieve this, it will be necessary to implement the proposals in two phases, in separate bills, given the inability to advance some of the RDT proposals ahead of other financial sector reforms (such as those relating to financial service provider registration).

6. **Agree** that the proposals in this paper be enacted in two separate bills, each amending the Reserve Bank of New Zealand Act, as follows:

   i. The first bill – Reserve Bank of New Zealand Amendment Bill (No. 1) – will contain required definitions and the provisions permitting regulations to be promulgated to prescribe requirements for credit ratings, minimum capital, capital adequacy, limits on exposures to related parties, board composition and size, and liquidity, and associated offences, penalties and enforcement powers, as specified in the recommendations below.

   ii. The second bill – A Registered Deposit Takers Bill – will contain all remaining amendments to the Reserve Bank required to implement the RDT regime, including licensing and fit and proper requirements.

7. **Note** that the Reserve Bank of New Zealand Amendment Bill (No. 1) is intended to include the transparency and accountability amendments to the Reserve Bank of New Zealand Act, as agreed by Cabinet in June, and that this bill holds a category 4 priority on the 2007 Legislation Programme (to proceed to a select committee in 2007).

8. **Agree** that a Registered Deposit Takers Bill be added to the 2007 Legislation Programme with a category 5 priority (instructions to Parliamentary Counsel in 2007)

9. **Note** that I am intending that the Registered Deposit Takers Bill will be introduced by March/April 2008, subject to obtaining the required approvals from the Cabinet Legislation Committee.

10. **Agree** to the following proposals to be included in the Reserve Bank of New Zealand Amendment Bill (No. 1), subject to appropriate drafting by PCO:

    a. "Deposit-takers" be defined in the RDT legislation as entities, other than registered banks and other specified categories, that offer debt securities to the public and that are in the business of lending money or providing other financial services, and include building societies and credit unions.

    b. Legislation empower the designation of an entity as a deposit-taker, by regulation and set out broad criteria for the making of this regulation.

c. The Reserve Bank be empowered to exempt deposit-takers from the requirements applicable to RDTs, with conditions, and to amend or revoke an exemption, where the legislation sets out the broad matters to which conditions may be applied.

d. The purposes for which powers may be exercised under the legislation governing RDTs be:

- to promote the maintenance of a sound and efficient financial system; and
- to avoid significant damage to the financial system resulting from the failure of an RDT.

e. The RDT legislation empower the making of regulations by the Governor General, in accordance with advice from the Minister of Finance on the recommendation of the Reserve Bank, prescribing requirements for all RDTs or classes of RDT, in respect of an RDT and/or its borrowing group, in relation to:

i. minimum amount and form of capital, to be included in trust deeds;

ii. level and form of capital in relation to the size and nature of business of an RDT and its borrowing group, to be included in trust deeds;

iii. liquidity requirements, to be included in trust deeds;

iv. restrictions on exposures to parties related to an RDT and its borrowing group, to be included in trust deeds;

v. credit ratings and the matters applying to RDTs exempted from a credit rating (including a requirement to disclose that the RDT is unrated, prohibitions or restrictions on the disclosure by an RDT of ratings from non-approved agencies, and minimum prudential requirements);

vi. the size and composition of an RDT's board of directors (or its equivalent governing body), and the constitution of the RDT; and

vii. the systems for identifying and managing interest rate risk, exchange rate risk and other market price risks.

f. The legislation provide that the regulations may specify a minimum capital ratio and a maximum limit of exposures to related parties for RDTs or classes of RDT.

g. The RDT legislation require the Reserve Bank to consult interested parties, including the Securities Commission and trustees, before making recommendations to the Minister of Finance for the promulgation of regulations.

h. The Reserve Bank be empowered to exempt, by notice, an individual RDT, a class of RDT or all RDTs from any or all RDT requirements, to issue exemption notices subject to conditions, and to amend or revoke exemption notices, based on the equivalent power of the Securities Commission provided in s 5(5) of the Securities Act.

i. RDTs and trustees be required to amend trust deeds to incorporate matters required by regulations.

j. RDTs be required to include in their trust deed a minimum level of capital, of an amount and in a form prescribed by regulation, with the minimum level of capital being initially set at $2 million in regulation.

k. RDTs be required to have a trust deed that specifies a minimum ratio of capital relative to the size and nature of an RDT and its borrowing group, in accordance with a capital adequacy framework prescribed by regulation.

l. RDTs be required to have a trust deed that specifies a limit on exposures of the RDT and its borrowing group to related parties, in accordance with a framework prescribed by regulation, and on the basis of a definition of related party set in legislation, where the definition may be varied by regulation.

m. RDTs be required to have a trust deed that specifies minimum liquidity requirements, in accordance with a framework prescribed in regulation.

n. RDTs be required to have and to disclose a credit rating in accordance with requirements prescribed by regulation, but where RDTs with total assets of less than $10 million be exempted from the rating requirement,.

o. RDTs exempted from a credit rating requirement be subject to conditions imposed by the Reserve Bank including disclosure requirements and additional prudential requirements relating to minimum capital, capital ratio, liquidity requirements and related party exposures.

p. The Reserve Bank be empowered to approve rating agencies for the purpose of the RDT rating requirement, and be empowered to revoke an approval or issue and approval with conditions.

q. The legislation place an obligation on trustees:

   i. to ensure that trust deeds of RDTs comply with the requirements set in regulation under the RDT legislation;

   ii. to provide to the Reserve Bank information in relation to RDT compliance with requirements and financial condition as requested by the Bank;

   iii. to disclose as soon as practicable to the Bank any failure or expected failure by an RDT to comply with requirements imposed under the RDT legislation, any other significant breach of a trust deed and where it has cause to believe that a RDT is insolvent or about to become insovlent; and

   iv. to make attestations to the Bank in relation to RDT compliance and financial condition as requested by the Bank from time to time.

r. Trustees be given the powers to take actions to ensure RDT compliance with requirements prescribed under the RDT legislation, including the powers to:

   i. obtain information from RDTs as necessary for the trustee to perform its functions under the regulations and the trust deed;

   ii. require amendments to the trust deed to enable trust deeds to comply with regulatory requirements; and

   iii. require the RDT to come into compliance with trust deed requirements.

s. The legislation empower the Reserve Bank to:

   i. obtain information from an RDT and its trustee to ascertain whether the RDT is in compliance with regulatory requirements;

   ii. appoint a third party (such as an audit firm) to investigate an RDT to ascertain whether it is in compliance with regulatory requirements, and oblige the DT to provide access to relevant records;

   iii. issue a notice to the RDT advising of non-compliance with RDT regulatory requirements and requiring the RDT to explain how and when it plans to come into compliance.

t. The legislation to contain information-sharing powers between the Reserve Bank, Securities Commission, trustees and the Companies Office to enable information gathered by any of these parties to be shared with each other for the purposes of exercising their regulatory responsibilities, subject to maintaining confidentiality of the information.

u. The legislation to require the Reserve Bank to publish a Statement of Principles and guidelines setting out the framework for regulating RDTs and explaining the requirements applicable to RDTs and trustees under this framework.

v. The legislation commences at a date or dates set by Order in Council providing sufficient time for RDTs to come into compliance with the credit rating and other requirements of this legislation and for the Reserve Bank to prepare regulations that are required.

11. **Agree** to the following proposals to be included in the Registered Deposit Takers Bill (No. 2), subject to appropriate drafting by PCO:

a. The purposes for which powers may be exercised under the legislation governing RDTs be:

- to promote the maintenance of a sound and efficient financial system; and
- to avoid significant damage to the financial system resulting from the failure of an RDT.

b. "Registered Deposit Taker" be defined as a deposit-taker licensed by the Reserve Bank.

c. It be unlawful for a person to conduct the business of a deposit-taker unless it has been licensed as an RDT, or is a registered bank or has been exempted from the RDT requirements.

d. It be unlawful for an entity to hold itself out as an RDT unless it has been licensed as an RDT by the Reserve Bank.

e. The Reserve Bank be empowered by legislation to license entities as RDTs where:

i. The applicant is able to comply with the requirements applied to RDTs, including the prudential and other requirements prescribed in regulations under the RDT legislation.

ii. The applicant has a trust deed registered or eligible to be registered by the Companies Office that complies with regulatory requirements for RDTs.

iii. The applicant has a prospectus and investment statement registered or eligible to be registered by the Companies Office that comply with the requirements of the Securities Regulations as they relate to RDTs.

iv. The applicant has either been registered or is eligible for registration by the Registrar of Financial Service Providers under the proposed Financial Services Providers Bill as a financial service provider.

v. The applicant's directors and senior management meet suitability and integrity criteria prescribed under the legislation or in regulation.

vi. The trustee of the applicant has attested to the Reserve Bank that the applicant has sufficient capital relative to the size and nature of its business, governance, and risk management systems and controls to manage its proposed business, consistent with the level of risk represented to depositors in the prospectus and investment statement

vii. Unless exempted, the applicant has a credit rating from a rating agency approved by the Reserve Bank that meets requirements prescribed in regulations.

f. The RDT legislation provide a transition period, of a length specified by Order in Council, during which deposit-takers, other than those exempted by the Reserve Bank, must apply to be licensed as RDTs and to enable RDTs to come into compliance with RDT requirements.

g. The Reserve Bank be empowered, after consultation with the Securities Commission and trustee, to de-license an RDT, on the request of the RDT, where the legislation sets out the matters on which the Bank must be satisfied before agreeing to the de-licensing.

h. The Reserve Bank be empowered, after consultation with the Securities Commission and trustee, and, upon the request of an RDT, to prohibit the RDT from taking new deposits, but to enable the RDT to continue to service existing deposits.

i. The Reserve Bank be empowered, after consultation, Securities Commission, Companies Office and trustee, to de-license or suspend the license of an RDT on grounds set out in the RDT legislation, including:

    i. serious or persistent failure to comply with the licensing requirements and obligations of an RDT;

    ii. where an RDT is about to become or is insolvent, or has been placed into receivership, liquidation, voluntary administration or statutory management.

j. RDTs to be required to have trust deeds that include provisions requiring RDTs to establish and maintain policies and procedures relating to fit and proper assessments of directors and senior managers, in accordance with standards prescribed in legislation or regulations.

k. The Reserve Bank be empowered to disallow the appointment of a director or senior manager of an RDT, or to require the removal of such person, where the Bank is satisfied that the person does not meet fit and proper requirements prescribed by legislation or regulation, subject to appropriate natural justice requirements.

l. The Reserve Bank may recommend to the Minister of Finance that an RDT (including its subsidiaries or associated persons) be given directions (with the consent of the Minister of Finance), under section 113 of the Reserve Bank of New Zealand Act, or to recommend to the Minister of Finance that the RDT be placed into statutory management, under section 117 of that Act, where an RDT:

    i. is insolvent or about to become insolvent; or

    ii. has failed to comply with RDT regulatory requirements; and

    iii. the failure of the RDT could impede the maintenance of a sound and efficient financial system or cause significant damage to the financial system.

m. The Reserve Bank be required to consult the Securities Commission, Companies Office and trustee before exercising the powers in the preceding recommendation.

n. The Reserve Bank be empowered to suspend all or some of the powers of a trustee in situations where an RDT has been brought under the Reserve Bank of New Zealand Act.

o. The RDT legislation make provision for trustees to be relieved of liability resulting from the suspension of their powers or from any actions taken by the Reserve Bank in a situation where an RDT has been given directions or placed into statutory management under the Reserve Bank of New Zealand Act.

12. Agree that credit unions be subject to the legislation applying to RDTs on the basis that:

a. the Friendly Societies and Credit Unions Act will be amended to remove existing prudential and operational constraints on credit unions in accordance with previous Cabinet decisions;

b. credit unions with total assets of less than $10 million be exempted from the need for a credit rating, subject to requirements being prescribed by regulation or as a condition to the exemption, including a requirement for the RDT to disclose prominently that it is not rated by an approved rating agency, a requirement for the RDT to be prohibited or restricted from disclosing ratings or rankings from agencies not approved by the Reserve Bank, and a requirement for the RDT to comply with minimum prudential requirements, where the $10 million asset threshold be prescribed in regulation;

c. credit unions be exempted from the need for a minimum amount of capital of $2 million on the basis that they comply with a minimum capital ratio prescribed in regulation;

d. credit unions be exempted by the Reserve Bank from other elements of the RDT requirements where this is required by their mutual form.

e. The general power to provide exemptions from requirements under the RDT legislation provides adequate flexibility to deal with the special characteristics of credit unions.

13. **Agree** that both bills set out offences that may be committed by either RDTs or trustees for failure to comply with regulatory requirements to be imposed under the particular Bill, including:

a. Failure by RDTS to comply with the obligations imposed upon RDTs by regulation, such as to have a credit rating and failure to incorporate minimum regulatory requirements into trust deeds.

b. Failure to comply with fit and proper requirements, such as employing a senior manager who has been disallowed by the Reserve Bank.

c. Failure by trustees to meet statutory obligations to the Reserve Bank, such as failure to provide information requested by the Bank.

14. **Agree** to both bills to prescribe penalties for offences, on the basis that:

a. Fines on deposit-takers and RDTs be prescribed in a range of $500,000 to $2 million, depending on the severity of the offence.

b. Fines for directors and the CEO of RDTs, and trustees, be prescribed in the range of $50,000 to $200,000, depending on the severity of the offence.

c. Imprisonment terms for directors and senior managers be prescribed in the range of 3 months to 18 months, depending on the severity of the offence.

d. Fines in the range of $10,000 to $50,000 for lower level offences such as failure to provide information requested by the Reserve Bank within required timeframes.

15. **Agree** that, at the time that new disclosure requirements are introduced for debt issuers under the Securities Act, specific requirements be applied to RDTs by regulation made under that Act, including (but not limited to) the following matters:

a. disclosure at six monthly intervals of a brief key Information Summary, either as part of or a supplement to, an RDT's offer document, containing information on an RDT's credit rating, capital ratio and exposures to related parties;

b. a requirement that the directors and Chief Executive Officer of an RDT sign attestations in offer documents in relation to whether:

- the RDT and its borrowing group are complying with its trust deed and all RDT requirements;
- the RDT and its borrowing group have sufficient capital, and adequate governance, risk management systems and internal controls for the nature of the RDT's business; and
- exposures to, and dealings with, related parties have been entered into, and conducted on, commercial terms and are not contrary to the interests of the RDT's depositors.

c. disclosure of a summary of the RDT's trust deed terms and conditions.

d. RDTs exempted from a credit rating requirement to disclose prominently that they do not have a rating from an approved rating agency, and prohibitions or restrictions on the disclosure of ratings or rankings from agencies not approved by the Reserve Bank.

16. **Invite** the Minister of Finance to issue drafting instructions to Parliamentary Counsel Office.

s9(2)(k)

Hon Dr Michael Cullen
Minister of Finance

Date: 28/08/07

Regulatory Impact Statement

Proposal for the regulation of Non-Bank Deposit-Takers

27 August 2007

This Regulatory Impact Statement assesses the costs and benefits of the main options considered in finalising proposals for the regulation of Non-Bank Deposit-Takers. It should be read in conjunction with the associated paper to the Cabinet Economic Development Committee.

Executive Summary

In June this year, Cabinet agreed to a new regulatory framework for Non-Bank Deposit-Takers (NBDTs) - referred to in this paper as Registered Deposit Takers (RDTs). These include finance companies, building societies and credit unions. Under the proposed arrangements, all deposit takers will need to be licensed by the Reserve Bank and comply with prudential and other requirements prescribed in regulation. Most of these prudential requirements will be incorporated into trust deeds. Trustees will continue to supervise RDTs under trust deeds, pursuant to the Securities Act. RDTs will continue to be subject to disclosure requirements under the Securities Act, with enhancements. The Minister of Finance was invited to report back to Cabinet on the details of these proposals.

This Regulatory Impact Statement focuses mainly on the areas where options needed to be assessed in finalising proposals for RDT regulation. It does not repeat the cost/benefit assessment undertaken at the time that the RDT proposals were submitted to Cabinet in June this year.

Adequacy Statement

Given that Cabinet has already made decisions on the proposed regulatory framework for RDTs, and that the paper for Cabinet largely sets out details in relation to those decisions, the Regulatory Impact Assessment Unit (RIAU) in MED has advised that this Regulatory Impact Statement is not required to be (and has not been) reviewed by the RIAU. However, as the agency responsible for the preparation of the Regulatory Impact Statement, the Reserve Bank attests to its adequacy.

Status Quo and Problem

There are deficiencies in the existing regulation of RDTs, including the absence of minimum entry requirements for RDTs, inconsistency in governance and prudential requirements across RDTs, inadequate official oversight of trustee supervision, inadequacies in public disclosures, and insufficient means for investors to assess and compare RDT risk profiles. These deficiencies impede the ability to maintain a sound and efficient financial system, undermine competitive neutrality in the sector and have the potential to lead to a misallocation of resources and potential instability in the sector. To some degree, these deficiencies are reflected in the current weakness in the RDT sector.

Objectives

The proposals seek to promote a sound and efficient financial system by:

- ensuring that all RDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in RDTs and to promote depositor confidence;
- providing depositors with a clearer basis for distinguishing between lower-risk and higher-risk RDTs; and
- resolving RDT distress or failure in an orderly and timely manner, with minimum disruption to depositors and the financial system.

Summary of regulatory framework agreed by Cabinet

Cabinet has agreed to a framework in which all deposit-takers, other than registered banks and those exempted by the Reserve Bank, must be licensed (as RDTs) by the Reserve Bank, unless exempted, and which must comply with requirements prescribed in regulation. RDTs will continue to be subject to trust deeds as issuers of securities under the Securities Act, whereby trustees and RDTs determine financial and other covenants relating to issues of debt securities to the public. Trustees will continue to have responsibility for monitoring RDTs and enforcing compliance with trust deed covenants, under the enhanced trust deed arrangements being proposed in the Review of Financial Products and Providers. Under the new arrangements, trust deeds for RDTs will have to comply with regulatory requirements, including a minimum amount of capital specified in regulation, a capital ratio set by the trustee and measured by a standardised framework, a restriction on lending to parties related to an RDT and liquidity requirements. RDTs will also be required to comply with a mandatory credit rating regime, with ratings being obtained from an agency approved by the Reserve Bank.

Cabinet has invited the Minister of Finance to report back on details of these arrangements, including in respect of:

- minimum capital;
- capital adequacy framework;
- restrictions on lending to related parties;
- credit ratings (including options for reducing the compliance costs of ratings); and
- requirements for credit unions.

The alternative and preferred options in each area are summarised below.

Alternative and Preferred Options

The main criteria against which the options have been assessed are:

- Effectiveness in meeting policy objectives
- Compliance costs
- Administration costs and risks to government
- Competitive neutrality and impact on market efficiency

Minimum capital

It has been agreed by Cabinet that RDTs should be required to have a minimum amount of capital (ie shareholders' equity) in order to ensure a reasonable level of RDT shareholder commitment and financial substance.

Alternative options

The main alternatives considered were:

- Minimum capital of $500,000.
- Minimum capital of $2 million.
- Minimum capital of $5 million.

The minimum level of capital needs to be sufficient to ensure a reasonable level of shareholder commitment and financial substance for an RDT, while not so high as to impede contestability and competitiveness in the deposit-taking sector.

A minimum capital level of $500,000 is considered insufficient for an RDT, given the need for financial substance and serious commitment by shareholders, and the risks to depositors. Most submissions on the Discussion Document issued in 2006 concurred with this view.

A minimum capital level of $5 million would provide a reasonably strong measure of shareholder commitment and financial substance, but would reduce the contestability and competitiveness of the deposit-taking sector, particularly in niche markets. It would require a significant number of existing RDTs to inject capital and could result in some otherwise financially sound RDTs leaving the market.

Preferred Option

The preferred option is a minimum capital level of $2 million, in the form of equity (ie share capital) or a similar form of "permanent" funding from owners, with this amount to be reviewed from time to time. This was the upper limit of the range proposed in the Discussion Document for RDTs in 2006. Many submissions on that Discussion Document favoured this figure. This amount of capital would provide some assurance that owners of RDTs are committing a reasonable level of resource to the entity prior to obtaining funds from the public, while not overly constraining the entry of small RDTs. Only a small number of RDTs are likely to have to increase their capital if a $2 million minimum is specified. A transition period will be adopted to give RDTs time to comply with minimum capital and other prudential requirements.

It is proposed that credit unions be exempted from this requirement on the basis that they be subject to a minimum capital ratio relative to the size and nature of their assets and other exposures, with the level of ratio to be determined by regulation after consultation with the industry.

Capital Measurement Framework

Cabinet has agreed that all RDTs should be required to have a capital ratio in their trust deed, with the level of the ratio determined by agreement between trustees and each RDT, but measured on a framework prescribed in regulation. This will ensure that capital adequacy is measured on a consistent basis across the industry and in a manner that takes into account the nature of exposures and risks of an RDT.

Alternative options

The main alternatives considered were:

- Option 1 - A capital ratio based on the proportion of shareholders' equity to total assets (ie a simple equity ratio).

- Option 2 - A capital ratio based on a broader category of capital (including shareholders' equity and some forms of subordinated debt) in relation to risk-weighted assets and off-balance sheet exposures (such as the international "Basel I" Capital Framework currently applied to banks and other deposit-takers internationally and to banks in New Zealand).

- Option 3 - A capital ratio based on a broader category of capital (including shareholders' equity and some forms of subordinated debt) in relation to risk-weighted assets and off-balance sheet exposures, plus market risk and operational risk exposures (such as a simplified form of the "Basel II" Capital Framework soon to be applied to banks and deposit-takers internationally and to banks in New Zealand).

Preferred option

It is proposed that the details of the capital framework be developed in consultation with stakeholders, particularly RDTs and their trustees, in the course of preparing regulations. Subject to that consultation, the current preference is for Option 3 above – a simplified form of the new Basel II framework. This would ensure that RDT capital calculations are made on a similar basis as for banks, and thereby facilitate comparisons between RDTs and banks. It would also be consistent with the Australian approach and with that proposed in many other countries. A simplified form of Basel II would also provide a relatively comprehensive framework for assessing capital relative to assets and other risk exposures – more so than the alternative options. It would also assist in encouraging better identification and management of risks by RDTs.

Although it is proposed that a simplified version of Basel II would be adopted, the new framework would nonetheless require trustees and RDTs to develop their understanding of the arrangements. This will take time. It will also require some compliance costs for RDTs, potentially including the cost of new or modified information systems, and in some cases an increase in capital. The capital framework may also have implications for the types of lending and other activities conducted by RDTs, including making some forms of business more capital-demanding and therefore potentially more costly.

In order to avoid excessive compliance costs and facilitate a smooth adjustment to the new framework, it is intended that RDTs would be given time to come into compliance and that the Reserve Bank would issue guidelines and provide assistance to RDTs and their trustees to understand the arrangements. A full consultation process will be adopted before any decisions are made on the capital framework.

Restrictions on lending to related parties

Cabinet has agreed that there should be some form of restriction on lending and other business dealings with parties that are related to RDTs (eg entities or persons with the capacity to control or significantly influence the RDT and other affiliated persons or entities). This is because related party lending and other business dealings can be a major source of risk – such as lending on non-commercial terms or effectively denuding the RDT of its capital – to the detriment of depositors.

Alternative Options

The following options for restricting lending and other dealings with related parties have been considered:

- Option 1 – require RDTs to have a limit on related party lending, where the trustee sets the limit, and the exposure is calculated on a basis prescribed in regulation.

- Option 2 – require RDTs to have a limit on related party lending, where a maximum limit is prescribed in regulation.

- Option 3 – no limit, but require disclosure of exposures to related parties.

- Option 4 – require deductions of lending to related parties from an RDT's capital.

In each of the above options, it would also be a requirement for an RDT's directors and CEO to attest in offer documents that they are satisfied that lending to related parties is on commercial terms and not contrary to the interests of the RDT's depositors. It would also be a requirement for related party lending to be publicly disclosed in offer documents. Each option would also involve a standardised definition of related party and standardised measurement of lending and exposure.

All options have benefits and costs. Option 1 provides flexibility for the trustee and RDT to agree on the limit, while still ensuring a consistency of approach in the definition of related party and exposure to related parties. It would avoid the costs associated with a standard limit (ie Option 2), but would create a risk of some RDTs having excessively high limits, to the detriment of depositors. Option 2 overcomes that disadvantage, but would be inflexible and entail compliance and efficiency costs unless applied with exemptions. Applying exemptions would then create moral hazard risks and introduce inconsistency in approach.

Option 3 would rely solely on disclosure and market discipline. It would also place reliance on credit rating agencies to assess the risks associated with related party lending and factor that into the RDT rating. While it would avoid compliance and efficiency costs associated with a limit, it would also create a significant risk of excessive related party lending.

Option 4 would be an effective means of reducing the incentives for related party lending, given that all such lending would have to be deducted from capital for the purpose of determining the capital ratio. However, it would be a harsh treatment of related party lending, presuming, as it does, that any such lending is irrecoverable. (Note, however, that any sensible capital adequacy regime will require deduction of equity investments or subordinated debt exposures to related parties.)

Preferred Option

The preferred option is Option 1, subject to consultation with stakeholders at the time regulations are prepared. Option 1 allows for flexibility across RDTs, while still providing an assurance that trustees will specify a limit at some level on related party exposures, and on the basis of a standardised measurement framework. There is a risk that some RDTs will have excessively high limits, permitting a denudation of capital. That risk is countered to some degree by the proposal for public disclosure by RDTs of their related party exposures and RDT director and CEO attestations as to the nature of related party dealings, and for credit ratings. It is also proposed that the legislation will enable regulations to be made to prescribe a maximum limit on related party exposures if this proves to be necessary.

Credit Ratings – options for reducing compliance costs

Cabinet has agreed that RDTs should be required to have and to disclose a credit rating from an approved rating agency, subject to being satisfied on cost-reduction options, especially for small RDTs.

Alternative options

Three options have been considered for reducing compliance costs for credit ratings:

- Option 1 - Exempting small RDTs from a rating.
- Option 2 - A government subsidy for small RDTs to defray some or all of the costs of a rating; no exemptions.
- Option 3 - All RDTs to be subject to a rating, but on the basis of a concessional rating fee negotiated with rating agencies.

The typical annual fee for a credit rating from one of the major rating agencies for an RDT is around $30,000, although the fee will vary depending on the rating agency and the size and nature of the RDT. Although this cost is significant in dollar terms, it is generally only a very small proportion of an RDT's revenue or deposit base. However, the cost is proportionately higher for small RDTs, especially when the indirect costs are taken into account, such as management time, data system costs, etc. In the case of very small RDTs, such as some credit unions, the total costs may be substantial relative to their revenue, deposit base and management capacity.

Option 1 would avoid the direct and indirect costs of a rating by exempting small RDTs from the need for a rating. Different size thresholds have been considered, including total assets of $10 million, $20 million and $50 million. The higher the threshold for exemption, the more RDTs would be exempted from the need for rating. For example, a $10 million total asset threshold would result in approximately 30 credit unions and 10 other RDTs being exempted from the need for a rating. That number increases significantly if the threshold is set at $20 million. A higher threshold would undermine the effectiveness of mandatory credit ratings by making it more difficult for investors to compare risk/return profiles across RDTs.

Option 2 would require all RDTs to have a rating, but would involve partial or full government-funded subsidies for the direct costs of a rating for small RDTs. Based on a threshold of $10 million of total assets, and full subsidy for the annual rating fee, the cost to government is estimated at around $300,000 per annum, with the potential for it to be significantly higher depending on whether credit unions operate as individual entities or in consolidated groups. A subsidy would not insulate small RDTs from the indirect compliance costs of a rating.

Option 3 has been assessed and, although there may be scope for negotiating concessional fees for small RDTs on a package basis, preliminary assessments suggest that the cost savings are unlikely to be substantial. Again, this option would not insulate small RDTs from the indirect compliance costs of a rating.

Under Option 1, depositors of exempted RDTs are denied the benefit of a rating, whereas that is not the case under the other two options. However, there would be scope to provide some protection to depositors under Option 1 by requiring exempted RDTs to disclose the absence of a rating, to prohibit or restrict alternative ratings and to require some minimum prudential requirements (eg minimum capital adequacy ratios and maximum related party exposure limits).

Preferred Option

The preferred option is to exempt RDTs with total assets of less than $10 million. This is considered to be the most cost-effective means of reducing compliance costs for small RDTs, while still providing some protection to depositors of exempted RDTs (through the measures referred to above). It will result in most RDTs being required to have a rating, while still enabling very small RDTs to operate without one.

Treatment of credit unions

Cabinet has agreed that credit unions should be subject to the RDT regime on the same basis as other RDTs, subject to being satisfied that compliance costs will not be excessive and that small credit unions will still be able to operate effectively and new ones to be established. On that basis, Cabinet has agreed to the removal of many existing prudential restrictions on credit unions to enable them to operate more flexibly.

Alternative options

The options considered are:

- Option 1 - Require all credit unions to come under the RDT regime on the same basis as other RDTs, with no exemptions (other than the proposed exemption from a credit rating for all RDTs with total assets of less than $10 million). Under this option, the current prudential restrictions on credit unions under the Friendly Societies and Credit Unions Act (FSCU Act) would be removed, as agreed by Cabinet.

- Option 2 – Require all credit unions to come under the RDT regime, but with exemptions from ratings for small credit unions (eg those with total assets under $10 million), exemptions from the minimum capital level (subject to compliance with a minimum capital ratio) and exemptions in other areas where appropriate. In the case of credit unions exempted from a rating requirement, there would be a requirement to disclose that they are unrated, prohibitions or restrictions on the disclosure of unapproved ratings and some prudential restrictions – eg a higher minimum capital ratio and possibly restrictions on

some types of business. Under this option, the current prudential restrictions on credit unions under the FSCU Act would be removed, as agreed by Cabinet.

The asset threshold for the rating exemption could be set at a higher level than $10 million – eg total assets of $20 million or $50 million.

- Option 3 – Allow credit unions that do not wish to come under the RDT regime (and to enjoy the benefits of fewer constraints on their operations) to remain under the existing regulatory arrangements in the FSCU Act.

In addition to these options, consideration has been given to allowing credit unions to be regulated as a group, rather than individually, if the group involves all member credit unions cross-guaranteeing each other and being subject to effective group control. This remains a possibility, but requires further consideration in the development of the regulatory arrangements. It is proposed that the RDT legislation will empower the making of regulations to enable the RDT requirements to be imposed on a group basis where group arrangements result in depositor claims on a member credit union being treated as claims on a pari passu basis on the assets of all other members of the group.

Option 1 would be consistent with the principle of competitive neutrality – ie regulating all RDTs on the same basis. Under this option, credit unions would have the benefit of an exemption from the rating requirement if they have assets under $10 million, but would otherwise be subject to all the standard RDT requirements. However, given the small size of many credit unions and their mutual nature, it is not practicable to apply all RDT requirements –especially the minimum capital amount of $2 million – to credit unions. This would force many credit unions to close or merge, and impede the establishment of new ones, to the detriment of the credit union movement and the market niches to which they cater.

Option 2 has the merit of exempting credit unions from the minimum capital amount, provided that they have a minimum capital ratio (ie capital relative to assets and other exposures) prescribed by regulation, and would therefore enable small credit unions to continue and new ones to be established. The rating exemption would apply to small credit unions and the threshold could be applied at total assets of $10 million or at a higher level. With a $10 million threshold, around 30 of the 50 credit unions would be exempted from the need for a rating. If the threshold is set at $20 million, around 40 credit unions would be exempted. A $50 million threshold would result in all but around 4 or 5 of the credit unions being exempted. If exempted, credit unions would need to be subject to some prudential restrictions – and hence costs - in order to maintain a reasonable level of depositor protection.

Option 3 would enable those credit unions that wish to remain under existing FSCU Act restrictions to do so, while those that wish to enjoy more operational freedom could come under the RDT regime as per Option 1. This option has the disadvantage of introducing greater regulatory complexity. It would also be inconsistent with the principle of competitive neutrality.

Preferred Option

The preferred option is Option 2, with a total asset threshold of $10 million for ratings exemptions, given that it preserves the ability of small credit unions to remain in operation and new ones to be established, keeps compliance costs relatively low and enables credit unions to be brought into the RDT regime on a broadly competitively neutral basis.

Implementation and Review

Legislation will be required to implement the RDT arrangements. The legislation is likely to take the form of an amendment to the Reserve Bank of New Zealand Act. An initial amendment, scheduled for introduction in 2007, would implement the credit rating and other prudential requirements, among other matters. A second amendment bill, also to the RBNZ Act, is proposed to be introduced in March/April 2008,

and would implement the remaining RDT measures, such as the licensing regime and fit and proper requirements.

A separate bill is required to remove restrictions under the FSCU Act. A transition period of 12 to 24 months is being considered, and there will be scope for temporary exemptions from regulatory requirements under the proposed arrangements to enable effective transition.

Implementation of the arrangements will include the development of appropriate and transparent coordination arrangements between the Reserve Bank, Securities Commission and trustees. Regulations made under the RBNZ Act would be subject to full consultation with stakeholders.

Consultation

Stakeholder Consultation

In 2006, the review of RDT regulation was subject to extensive consultation with stakeholders, including many RDTs, industry associations, trustees and consumer bodies. The decisions made by Cabinet in June this year were publicly released and appear to have been well received by most stakeholders. In developing the further details of the proposals, as set out in the current Cabinet paper, there has been limited consultation with stakeholders, including trustees and credit unions.

Given that the detailed regulatory requirements are intended to be set out in regulations, there will be thorough consultation with stakeholders at the time those regulations are prepared.

Government Departments/Agencies Consultation

This paper was prepared by the Reserve Bank. The following government agencies have been consulted on the proposals in this paper: Ministry of Economic Development, Treasury, Ministry of Justice, Securities Commission and PCO. DPMC has also been consulted.

CAB 100/2006/1

Consultation on Cabinet and Cabinet Committee Submissions

Certification by Department

Guidance on the consultation requirements for Cabinet and Cabinet committee papers is provided in chapter 11 of the Step by Step Guide: Cabinet and Cabinet Committee Processes, available at http://www.dpmc.govt.nz/cabinet/guide/11.html.

Departments/agencies consulted: The attached submission has implications for the following departments/agencies whose views have been sought and are accurately reflected in the submission:

Ministry of Economic Development, Securities Commission, Treasury, Ministry of Justice, DPMC, PCO.

Departments/agencies informed: In addition, the following departments/agencies have an interest in the submission and have been informed: ~~Department of Prime Minister and Cabinet~~

Others consulted: Other interested groups have been consulted as follows:

Trustee corporations, experts on the Securities Act and securities markets, credit unions, and some non-bank deposit-takers

s9(2)(k)

Geof Mortlock, Manager, Special Issues, Financial Stability Department, Reserve Bank

Date 27 / 8 / 2007

Certification by Minister

Ministers should be prepared to update and amplify the advice below when the submission is discussed at Cabinet/Cabinet committee. The attached submission/proposal:

Consultation at Ministerial level	☐ did not need consultation with other Ministers ☐ has been consulted with the Minister of Finance *[required for all submissions seeking new funding]* ☐ has been consulted with the following Minister(s) Commerce
Consultation with Labour/ Progressive caucuses	☐ does not need consultation with the government caucuses ☐ **has been** or ☑ **will be** consulted with the government caucuses
Consultation with other parties	☐ does not need consultation at parliamentary level ☐ **has been** consulted with the following other parties represented in Parliament: ☐ New Zealand First ☐ United Future ☐ Green Party ☐ Other [specify] ☑ **will be** consulted with the following other parties represented in Parliament: ☑ New Zealand First ☑ United Future ☑ Green Party ☑ Other [specify] Maori, Nahi

s9(2)(k)

Portfolio Finance

Date 29/8/07

In Confidence

EDC Min (07) 19/1

Cabinet Economic Development Committee

Minute of Decision

Copy Number: 20

Review of Financial Products and Providers: Regulation of Non-Bank Deposit-Takers - Further Details

On 5 September 2007, the Cabinet Economic Development Committee (EDC):

Background

1 **noted** that in June 2007 the Cabinet Economic Development Committee agreed to proposals for governance and accountability arrangements for prudential regulation for the financial sector [EDC Min (07) 11/14];

2 **noted** that in June 2007 Cabinet agreed to proposals for the regulation of Non-Bank Deposit-Takers, which are referred to in this paper as Registered Deposit Takers (RDTs), and invited the Minister of Finance to report to the Cabinet Economic Development Committee with further detail on the proposals and with any outstanding matters [CAB Min (07) 21/10];

Summary of main features

3 **noted** that the paper under EDC (07) 160 sets out the details of the proposed regulation of RDTs, which includes the following main features:

3.1 RDTs will continue to be subject to regulation under the Securities Act 1978 in their capacity as issuers of securities to the public, and will therefore continue to be required to have offer documents and trust deeds. Trustees will continue to have responsibility for agreeing the terms and conditions of trust deeds with RDTs, and for monitoring and enforcing trust deed requirements;

3.2 RDTs will be subject to the enhanced trustee arrangements previously agreed in CAB Min (07) 21/10, whereby trustees are subject to authorisation and supervision by the Securities Commission;

3.3 all RDTs will be required to be licensed by the Reserve Bank and to comply with minimum prudential and other requirements prescribed in regulation. Some of these requirements will be required to be incorporated into RDT trust deeds and enforced by trustees, and others will be enforced directly by the Reserve Bank;

3.4 RDTs will be subject to enhanced public disclosure requirements in their offer documents, including in respect of their credit rating, capital position, lending to related parties and key risk information. These requirements will be enforced by the Securities Commission. The disclosure proposals set out below may only be a subset of the disclosure requirements to be prescribed for RDTs;

3.5 trustees will have the principal responsibility for responding to RDT financial distress, however, it is proposed that the Reserve Bank will have powers of intervention, with the agreement of the Minister of Finance, in situations where an RDT poses a threat to the soundness or efficiency of the financial system;

4 **noted** that in June 2007 Cabinet invited the Minister of Finance to report on details of the proposed RDT regulatory arrangements, including in respect of:

4.1 the definition of RDTs;

4.2 ratings requirements for RDTs (and the means of avoiding excessive compliance costs for smaller RDTs);

4.3 prudential requirements;

4.4 the legislative vehicle for the proposed arrangements;

[CAB Min (07) 21/10]

5 **noted** that in June 2007 Cabinet agreed that the supervisory framework for the regulation of RDTs should be applied in full to credit unions, subject to satisfactory options for minimising the compliance costs for ratings for credit unions [CAB Min (07) 21/10];

Legislative structure

6 **noted** that the Minister of Finance would like to introduce into the House in 2007 as much as possible of the legislation required to implement the decisions on RDTs in order to facilitate enactment in 2008;

7 **noted** that in order to introduce as much as possible of the legislation it will be necessary to implement the proposals in two phases, in separate bills; given the inability to advance some of the RDT proposals ahead of other financial sector reforms (such as those relating to financial service provider registration);

8 **agreed** that the decisions below be enacted in two separate bills, each amending the Reserve Bank of New Zealand Act 1989, as follows:

8.1 the first bill – Reserve Bank of New Zealand Amendment Bill – will contain required definitions and the provisions permitting regulations to be promulgated to prescribe requirements for credit ratings, minimum capital, capital adequacy, limits on exposures to related parties, board composition and size, liquidity, and associated offences, penalties and enforcement powers, as specified in paragraph 12 below;

8.2 the second bill – a Registered Deposit Takers Bill – will contain all remaining amendments to the Reserve Bank of New Zealand Act required to implement the RDT regime, including licensing and fit and proper requirements;

9 **noted** that the Reserve Bank of New Zealand Amendment Bill will also include the transparency and accountability amendments to the Reserve Bank of New Zealand Act, as agreed in CAB Min (07) 21/10, and that this Bill holds a category 4 priority on the 2007 Legislation Programme (to be referred to a select committee in 2007);

10 **agreed** that a Registered Deposit Takers Bill be added to the 2007 Legislation Programme with a category 5 priority (instructions to Parliamentary Counsel to be provided in 2007);

11 **noted** that that the Minister of Finance intends to introduce the Registered Deposit Takers Bill by March/April 2008,;

Reserve Bank of New Zealand Amendment Bill

12 **agreed** that the following decisions be included in the Reserve Bank of New Zealand Amendment Bill ;

Definition of deposit-taker

12.1 "deposit-takers" be defined as entities, other than registered banks and other specified categories, that offer debt securities to the public and that are in the business of lending money or providing other financial services, and include building societies and credit unions;

Power to designate entities as deposit-takers

12.2 the legislation empower the designation of an entity as a deposit-taker by regulation and set out broad criteria for the making of this regulation;

Power to exempt entities from the RDT regime

12.3 the Reserve Bank be empowered to exempt deposit-takers from the requirements applicable to RDTs, with conditions, and to amend or revoke an exemption, where the legislation sets out the broad matters to which conditions may be applied;

Purposes for which powers may be exercised

12.4 the purposes for which powers may be exercised under the legislation governing RDTs be:

12.4.1 to promote the maintenance of a sound and efficient financial system;

12.4.2 to avoid significant damage to the financial system resulting from the failure of an RDT;

Prudential requirements for RDTs

12.5 the legislation empower the making of regulations by the Governor General, in accordance with advice from the Minister of Finance on the recommendation of the Reserve Bank, prescribing requirements for all RDTs or classes of RDT, in respect of an RDT and/or its borrowing group, in relation to:

12.5.1 minimum amount and form of capital, to be included in trust deeds;

12.5.2 level and form of capital in relation to the size and nature of business of an RDT and its borrowing group, to be included in trust deeds;

12.5.3 liquidity requirements, to be included in trust deeds;

12.5.4 restrictions on exposures to parties related to an RDT and its borrowing group, to be included in trust deeds;

12.5.5 credit ratings and the matters applying to RDTs exempted from a credit rating (including a requirement to disclose that the RDT is unrated, prohibitions or restrictions on the disclosure by an RDT of ratings from non-approved agencies, and minimum prudential requirements);

12.5.6 the size and composition of an RDT's board of directors (or its equivalent governing body), and the constitution of the RDT;

12.5.7 the systems for identifying and managing interest rate risk, exchange rate risk and other market price risks;

12.6 the legislation provide that the regulations may specify a minimum capital ratio and a maximum limit of exposures to related parties for RDTs or classes of RDT;

12.7 the legislation require the Reserve Bank to consult interested parties, including the Securities Commission and trustees, before making recommendations to the Minister of Finance for the promulgation of regulations;

Power to exempt RDTs from regulatory requirements

12.8 the Reserve Bank be empowered to exempt, by notice, an individual RDT, a class of RDT or all RDTs from any or all RDT requirements, to issue exemption notices subject to conditions, and to amend or revoke exemption notices, based on the equivalent power of the Securities Commission provided in section 5(5) of the Securities Act 1978;

Obligations to amend RDT trust deed to incorporate regulatory requirements

12.9 RDTs and trustees be required to amend trust deeds to incorporate matters required by regulations;

Minimum amount and form of capital

12.10 RDTs be required to include in their trust deed a minimum level of capital, of an amount and in a form prescribed by regulation, with the minimum level of capital being initially set at $2 million in regulation;

Capital adequacy requirements

12.11 RDTs be required to have a trust deed that specifies a minimum ratio of capital relative to the size and nature of an RDT and its borrowing group, in accordance with a capital adequacy framework prescribed by regulation;

Restrictions on credit exposures to related parties

12.12 RDTs be required to have a trust deed that specifies a limit on exposures of the RDT and its borrowing group to related parties, in accordance with a framework prescribed by regulation, and on the basis of a definition of related party set in legislation, where the definition may be varied by regulation;

Liquidity requirements

12.13 RDTs be required to have a trust deed that specifies minimum liquidity requirements, in accordance with a framework prescribed in regulation;

Credit rating requirement

12.14 RDTs be required to have and to disclose a credit rating in accordance with requirements prescribed by regulation, but that RDTs with total assets of less than $10 million be exempted from the rating requirement;

12.15 RDTs exempted from a credit rating requirement be subject to conditions imposed by the Reserve Bank, including disclosure requirements and additional prudential requirements relating to minimum capital, capital ratio, liquidity requirements and related party exposures;

12.16 the Reserve Bank be empowered to approve rating agencies for the purpose of the RDT rating requirement, and be empowered to revoke an approval or issue an approval with conditions;

Obligations on trustees of RDTs

12.17 the legislation place an obligation on trustees:

12.17.1 to ensure that trust deeds of RDTs comply with the requirements set in regulation under the RDT legislation;

12.17.2 to provide to the Reserve Bank information in relation to RDT compliance with requirements and financial condition as requested by the Bank;

12.17.3 to disclose as soon as practicable to the Reserve Bank any failure or expected failure by an RDT to comply with requirements imposed under the legislation, any other significant breach of a trust deed and where it has cause to believe that a RDT is insolvent or about to become insolvent;

12.17.4 to make attestations to the Reserve Bank in relation to RDT compliance and financial condition as requested by the Bank from time to time;

Powers of trustees

12.18 trustees be given powers to take actions to ensure RDT compliance with requirements prescribed under the legislation, including the powers to:

12.18.1 obtain information from RDTs as necessary for the trustee to perform its functions under the regulations and the trust deed;

12.18.2 require amendments to the trust deed to enable trust deeds to comply with regulatory requirements;

12.18.3 require the RDT to come into compliance with trust deed requirements;

Powers of Reserve Bank

12.19 the legislation empower the Reserve Bank to:

12.19.1 obtain information from an RDT and its trustee to ascertain whether the RDT is in compliance with regulatory requirements;

12.19.2 appoint a third party (such as an audit firm) to investigate an RDT to ascertain whether it is in compliance with regulatory requirements, and oblige the RDT to provide access to relevant records;

12.19.3 issue a notice to the RDT advising of non-compliance with RDT regulatory requirements and requiring the RDT to explain how and when it plans to come into compliance;

Information-sharing powers

12.20 the legislation to contain information-sharing powers between the Reserve Bank, Securities Commission, trustees and the Companies Office to enable information gathered by any of these parties to be shared with each other for the purposes of exercising their regulatory responsibilities, subject to maintaining confidentiality of the information;

Reserve Bank statement of principles

12.21 the legislation to require the Reserve Bank to publish a Statement of Principles and guidelines setting out the framework for regulating RDTs and explaining the requirements applicable to RDTs and trustees under this framework;

Commencement date for legislation

12.22 the legislation commences at a date or dates set by Order in Council providing sufficient time for RDTs to come into compliance with the credit rating and other requirements of this legislation and for the Reserve Bank to prepare regulations that are required;

Registered Deposit-Takers Bill

13 **agreed** that the following decisions be included in the Registered Deposit Takers Bill;

Purposes for which powers may be exercised

13.1 the purposes for which powers may be exercised under the legislation governing RDTs be:

13.1.1 to promote the maintenance of a sound and efficient financial system;

13.1.2 to avoid significant damage to the financial system resulting from the failure of an RDT;

Definition of registered deposit-taker

13.2 "Registered Deposit Taker" be defined as a deposit-taker licensed by the Reserve Bank;

Prohibition on deposit-taking and other restrictions on entities that are not RDTs

13.3 it be unlawful for a person to conduct the business of a deposit-taker unless it has been licensed as an RDT, or is a registered bank or has been exempted from the RDT requirements;

13.4 it be unlawful for an entity to hold itself out as an RDT unless it has been licensed as an RDT by the Reserve Bank;

Licensing of RDTs

13.5 the Reserve Bank be empowered by legislation to license entities as RDTs where:

13.5.1 the applicant is able to comply with the requirements applied to RDTs, including the prudential and other requirements prescribed in regulations under the legislation;

13.5.2 the applicant has a trust deed registered or eligible to be registered by the Companies Office that complies with regulatory requirements for RDTs;

13.5.3 the applicant has a prospectus and investment statement registered or eligible to be registered by the Companies Office that comply with the requirements of the Securities Regulations as they relate to RDTs;

13.5.4 the applicant has either been registered or is eligible for registration by the Registrar of Financial Service Providers under the proposed Financial Services Providers (Registration and Dispute Resolution) Bill as a financial service provider;

13.5.5 the applicant's directors and senior management meet suitability and integrity criteria prescribed under the legislation or in regulation;

13.5.6 the trustee of the applicant has attested to the Reserve Bank that the applicant has sufficient capital relative to the size and nature of its business, governance, and risk management systems and controls to manage its proposed business, consistent with the level of risk represented to depositors in the prospectus and investment statement;

13.5.7 unless exempted, the applicant has a credit rating from a rating agency approved by the Reserve Bank that meets the requirements prescribed in regulations;

Transition period for existing RDTs

13.6 the legislation provide a transition period, of a length specified by Order in Council, during which deposit-takers, other than those exempted by the Reserve Bank, must apply to be licensed as RDTs and to enable RDTs to come into compliance with RDT requirements;

De-licensing of RDTs

13.7 the Reserve Bank be empowered, after consultation with the Securities Commission and trustee, to de-license an RDT, on the request of the RDT, where the legislation sets out the matters on which the Bank must be satisfied before agreeing to the de-licensing;

13.8 the Reserve Bank be empowered, after consultation with the Securities Commission and trustee, and, upon the request of an RDT, to prohibit the RDT from taking new deposits, but to enable the RDT to continue to service existing deposits;

13.9 the Reserve Bank be empowered, after consultation with the Securities Commission, Companies Office and trustee, to de-license or suspend the license of an RDT on grounds set out in the RDT legislation, including:

13.9.1 serious or persistent failure to comply with the licensing requirements and obligations of an RDT;

13.9.2 where an RDT is about to become or is insolvent, or has been placed into receivership, liquidation, voluntary administration or statutory management;

Fit and proper requirements

13.10 RDTs be required to have trust deeds that include provisions requiring RDTs to establish and maintain policies and procedures relating to fit and proper assessments of directors and senior managers, in accordance with standards prescribed in legislation or regulations;

13.11 the Reserve Bank be empowered to disallow the appointment of a director or senior manager of an RDT, or to require the removal of such a person, where the Bank is satisfied that the person does not meet fit and proper requirements prescribed by legislation or regulation, subject to appropriate natural justice requirements;

RDT distress and failure

13.12 the Reserve Bank may recommend to the Minister of Finance that an RDT (including its subsidiaries or associated persons) be given directions (with the consent of the Minister of Finance), under section 113 of the Reserve Bank of New Zealand Act, or to recommend to the Minister of Finance that the RDT be placed into statutory management, under section 117 of that Act, where an RDT:

13.12.1 is insolvent or about to become insolvent; or

13.12.2 has failed to comply with RDT regulatory requirements; and

13.12.3 the failure of the RDT could impede the maintenance of a sound and efficient financial system or cause significant damage to the financial system;

13.13 the Reserve Bank be required to consult the Securities Commission, Companies Office and trustee before exercising the powers in paragraph 13.12 above;

13.14 the Reserve Bank be empowered to suspend all or some of the powers of a trustee in situations where an RDT has been brought under the Reserve Bank of New Zealand Act;

13.15 the legislation make provision for trustees to be relieved of liability resulting from the suspension of their powers or from any actions taken by the Reserve Bank in a situation where an RDT has been given directions or placed into statutory management under the Reserve Bank of New Zealand Act;

Treatment of credit unions

14 **agreed** that credit unions be subject to the legislation applying to RDTs on the basis that:

14.1 the Friendly Societies and Credit Unions Act 1982 will be amended to remove existing prudential and operational constraints on credit unions as previously agreed;

14.2 credit unions with total assets of less than $10 million be exempted from the need for a credit rating (where the $10 million asset threshold be prescribed in regulation), subject to requirements being prescribed by regulation or as a condition to the exemption, including a requirement for:

14.2.1 the credit union to disclose prominently that it is not rated by an approved rating agency;

14.2.2 the credit union to be prohibited or restricted from disclosing ratings or rankings from agencies not approved by the Reserve Bank

14.2.3 the credit union to comply with minimum prudential requirements;

14.3 credit unions be exempted from the need for a minimum amount of capital of $2 million on the basis that they comply with a minimum capital ratio prescribed in regulation;

14.4 credit unions be exempted by the Reserve Bank from other elements of the RDT requirements where this is required by their mutual form;

14.5 the general power to provide exemptions from requirements under the RDT legislation provides adequate flexibility to deal with the special characteristics of credit unions;

14.6 regulatory requirements, including requirements relating to credit ratings, may be applied to a group of credit unions, rather than to individual credit unions, where the Reserve Bank is satisfied that depositors of a credit union in that group have a claim on the assets of the group as a whole on equal terms to the assets of the credit union, and that the group has a robust structure to ensure a satisfactory control of each member credit union;

Offences

15 **agreed** that both the Reserve Bank of New Zealand Amendment Bill and the Registered Deposit Takers Bill set out offences that may be committed by either RDTs or trustees for failure to comply with regulatory requirements to be imposed under the particular Bill, including:

15.1 failure by RDTs to comply with the obligations imposed upon RDTs by regulation, such as to have a credit rating and failure to incorporate minimum regulatory requirements into trust deeds;

15.2 failure to comply with fit and proper requirements, such as employing a senior manager who has been disallowed by the Reserve Bank.;

15.3 failure by trustees to meet statutory obligations to the Reserve Bank, such as failure to provide information requested by the Bank;

Penalties

16 **agreed** that both the Reserve Bank of New Zealand Amendment Bill and the Registered Deposit Takers Bill prescribe penalties for offences, on the basis that:

16.1 fines on deposit-takers and RDTs be prescribed in a range of $500,000 to $2 million, depending on the severity of the offence;

16.2 fines for directors and the chief executive officer of RDTs, and trustees, be prescribed in the range of $50,000 to $200,000, depending on the severity of the offence;

16.3 imprisonment terms for directors and senior managers be prescribed in the range of 3 to 18 months, depending on the severity of the offence;

16.4 fines in the range of $10,000 to $50,000 for lower level offences such as failure to provide information requested by the Reserve Bank within required timeframes;

Disclosure and director/CEO attestation requirements

17 **agreed** that, at the time that new disclosure requirements are introduced for debt issuers under the Securities Act, specific requirements be applied to RDTs by regulation made under that Act, including (but not limited to) the following matters:

17.1 disclosure at six monthly intervals of a brief key information summary, either as part of or as a supplement to, an RDT's offer document, containing information on an RDT's credit rating, capital ratio and exposures to related parties;

17.2 a requirement that the directors and chief executive officer of an RDT sign attestations in offer documents in relation to whether:

17.2.1 the RDT and its borrowing group are complying with its trust deed and all RDT requirements;

17.2.2 the RDT and its borrowing group have sufficient capital, and adequate governance, risk management systems and internal controls for the nature of the RDT's business;

17.2.3 exposures to, and dealings with, related parties have been entered into, and conducted on, commercial terms and are not contrary to the interests of the RDT's depositors;

17.3 disclosure of a summary of the RDT's trust deed terms and conditions;

17.4 RDTs exempted from a credit rating requirement to disclose prominently that they do not have a rating from an approved rating agency, and prohibitions or restrictions on the disclosure of ratings or rankings from agencies not approved by the Reserve Bank;

Next steps

18 **invited** the Minister of Finance to provide further advice for Cabinet on 10 September 2007 on the implications of the proposals for collective investment schemes;

19 **invited** the Minister of Finance to provide further advice for Cabinet on 10 September 2007 on the penalty regime, explaining in particular, why directors and senior managers but not trustees, could be subject to imprisonment terms;

20 **noted** that the Minister of Finance intends to release the paper attached to EDC (07) 160;

21 **invited** the Minister of Finance to issue drafting instructions to the Parliamentary Counsel Office to give effect to the decisions above.

s9(2)(k)

Kate Mallalieu
for Secretary of the Cabinet

Copies to: (see over)

In Confidence
EDC Min (07) 19/1

Present:
Rt Hon Helen Clark (part of item)
Hon Dr Michael Cullen (Chair)
Hon Jim Anderton
Hon Annette King
Hon Trevor Mallard
Hon Ruth Dyson
Hon Lianne Dalziel
Hon David Cunliffe
Hon David Parker
Hon Nanaia Mahuta
Hon Clayton Cosgrove

Officials present from:
Department of the Prime Minister and Cabinet
Treasury
Ministry of Economic Development

Copies to:
Cabinet Economic Development Committee
Chief Executive, DPMC
Paul Alexander, DPMC
PAG Subject Advisor, DPMC
Secretary to the Treasury
Chief Executive, Ministry of Economic Development
Minister of Justice
Secretary for Justice
Chief Executive, Ministry of Economic Development (Commerce)
Chief Executive, Ministry of Economic Development (RIAU)
Chief Parliamentary Counsel
Legislation Coordinator

In Confidence

Cabinet Legislation Committee

LEG Min (07) 23/1

Copy No: 13

Minute of Decision

Reserve Bank of New Zealand Amendment Bill: Approval for Introduction

On 8 November 2007, the Cabinet Legislation Committee:

1 **noted** that the Reserve Bank of New Zealand Amendment Bill (the Bill) holds a category 4 priority on the 2007 Legislation Programme (to be referred to a select committee in 2007);

2 **noted** that the Bill will amend the Reserve Bank of New Zealand Act 1989 by making changes to the Reserve Bank's institutional arrangements and by adding a new Part 5D to the Act to deal with the regulation of deposit takers, and:

2.1 provides for more accountability by the Reserve Bank by formalising and enhancing some of its reporting requirements;

2.2 provides a greater statutory focus for the Reserve Bank Board on monitoring the Reserve Bank's performance of its financial sector functions;

2.3 provides a ministerial power to direct the Reserve Bank to have regard to government policy that relates to the Reserve Bank's financial sector functions relating to the regulation of registered banks and non-bank deposit takers, as well as its payment system oversight and designation of payment system functions;

2.4 provides for a new prudential regulatory framework for non-bank deposit takers;

2.5 provides for the Reserve Bank to have powers to exempt entities or classes of entities from the non-bank deposit taking requirements;

2.6 provides for the Reserve Bank to have new powers to investigate and enforce regulatory requirements under the non-bank deposit taking regime in the Reserve Bank of New Zealand Act 1989;

2.7 provides that non-bank deposit takers must have a current rating of their creditworthiness;

2.8 provides for regulations to be promulgated to prescribe requirements for non-bank deposit takers in relation to credit ratings, a minimum amount of capital, capital adequacy, limits on exposures to related parties, board composition and size, and liquidity;

2.9 imposes new obligations on deposit-takers and trustees of non-bank deposit takers;

2.10 provides that trustees and non-bank deposit takers must ensure that trust deeds contain certain requirements and gives a trustee the power to amend trust deeds without the consent or agreement of the non-bank deposit taker in some circumstances;

2.11 creates new offences that will apply to non-bank deposit takers and trustees of non-bank deposit takers;

3 **agreed** that the Bill make some minor amendments to sections 16 and 24 of the Reserve Bank of New Zealand Act 1989 which deal respectively with dealing in foreign exchange by the Reserve Bank and the foreign reserves that the Reserve Bank is required to hold;

4 **approved** for introduction the Reserve Bank of New Zealand Amendment Bill [PCO 8166/10], subject to the final approval of government caucuses and sufficient support in the House of Representatives;

5 **agreed** that the Bill be introduced as soon as possible;

6 **agreed** that the government propose that the Bill be:

6.1 referred to the Finance and Expenditure Committee for consideration;

6.2 enacted by July 2008.

s9(2)(k) [redacted]

Andrew Doube
Secretary

Reference: LEG (07) 166

Present:
Hon Dr Michael Cullen (Chair)
Hon Jim Anderton
Hon Pete Hodgson
Hon Parekura Horomia
Hon Lianne Dalziel
Hon Nanaia Mahuta
Hon Harry Duynhoven
Hon Darren Hughes

Copies to:
Cabinet Legislation Committee
Chief Executive, DPMC
Katherine Anderson, DPMC
Secretary to the Treasury
Secretary for Justice
Minister for Economic Development
Chief Executive, MED
Minister of State Services
State Services Commissioner
Chief Parliamentary Counsel
Clerk of the House of Representatives