Ministry of Economic Development
Manatū Ōhanga

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

Discussion Document

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2. INTRODUCTION

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

2. The discussion document 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.

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 document 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 document 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 document 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 document, 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 document, 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 definitions 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 document 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 the existence of 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 document? 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 document 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 document (*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 document 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 document. 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 document.

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 document, 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.

Question for Submission

5. Do you agree with the problems identified with the existing regulatory framework for NBDTs, as assessed in this discussion document? 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 document 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 document 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, 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 document). 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 document, 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 document).

- ***Product disclosure.*** All NBDTs will continue to be subject to product disclosure requirements under the Securities Act. As noted in the *Securities Offerings* discussion document, 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 document). 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 document, 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 document.

90. The *Supervision of Issuers* discussion document 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 document.

- 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 document.

- 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 document 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 have their own identities 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 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 document 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 document 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 document? 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 document? 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.